ABA Submission to Annual Review of Regulatory Burdens on Business – Business and Consumer Services

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1. Introduction

The Australian Bankers' Association (ABA) represents the banking industry on matters of banking, credit and financial services regulation as well as company laws. We welcome the Productivity Commission's review of regulatory burden on business and understand that this first submission will be followed by further discussion and submissions as part of the review.

The ABA believes that this review is timely, especially given the global financial crisis and the particular attention of policymakers, regulators and the community on the provision of banking products and services. Banks in Australia have performed well during the difficult global market conditions. Australia's banking and financial services regulatory framework has partly been the reason for the stability of Australia's financial system.

This brings the ABA to make several observations:

(1) The banking and financial services regulatory framework is not broken. A thorough rethink of the fundamentals underpinning the regulation of banking and financial services in Australia is not warranted. However, certain aspects of the framework could be improved to deliver greater productivity within the sector, more cost-effective products and services, and more efficient functioning of markets.

(2) The global financial crisis will result in new regulatory architectures and international regulatory standards. It will be important within this political environment and regulatory re-emphasis for policymakers and regulators in Australia to give due consideration to the implications of regulation (and possible regulatory changes and cumulative effect of those changes) on banking and finance. While it will be essential for Australia to follow international standards and adopt practices that improve the governance of financial institutions and improve market transparency and efficiency, we should be mindful of implementing these regulatory changes in a manner that is appropriate for local market conditions and the competitiveness of Australia's financial markets and banking and finance sector.

The ABA notes that the banking and finance sector in Australia is in a continuous cycle of responding to, and implementing, new regulation as well as dealing with the effects of existing regulation. Whether or not this additional regulation creates a net benefit to the customer, the economy and the wider community is a much debated point, because in the end, all regulation has a real cost, which is borne by all.

1.1 ABA submission approach

The approach the ABA has taken at this stage of the Commission's review is to present a high level analysis of regulatory impediments to enhancing productivity of Australian banks, the removal or amelioration of which would be to the benefit of the economy as a whole.

This submission does not provide an exhaustive analysis of all regulatory issues facing the sector, and the specific examples described are at a high level of materiality and impact.

This submission has a framework comprising four categories in which significant regulatory impediments can be found:

- Financial structure
- Management processes and governance
- Product innovation and delivery
- International market and environment

In each case, a description of the category is given, together with key examples of regulation that is seen to be unnecessarily burdensome, complex, redundant, inconsistent or duplicative.

2. Regulatory impediments

2.1 Financial structure

Impediments to the development of efficient and productive financial structures and to the utilisation of capital and financial assets.

2.1.1 Capital and liquidity

The Basel Committee on Banking Supervision (BCBS) released major proposals on capital and liquidity on 17 December 2009. The proposals will likely become effective at the end of 2012. The BCBS is accepting comment on the proposals until April 16, 2010 with a view to releasing "fully calibrated" requirements by the end of 2010.

The key issues are:

- Net stable funding ratio (NSFR):
  - This ratio requires a minimum amount of funding that is expected to be stable over a one-year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures.

$$\textit{Net stable funding ratio} = \frac{\textit{Available amount of stable funding}}{\textit{Required amount of stable funding}} > 100\%$$

  - Available stable funding is capital, preferred stock with maturity of equal to or greater than one year, liabilities with effective maturities of one year or greater, and that portion of 'stable' non-maturity deposits and/or term deposits with maturities of less than one year that would be expected to stay with the ADI for an extended period in an idiosyncratic stress event.

  - Required stable funding is the sum of the value of the assets and off-balance-sheet activity of the ADI, multiplied by a set of specific required stable funding factors that reflect that portion of the exposure that the supervisor deems should be supported with stable funding.

- Liquid assets – definition and level:
  - The Basel Committee is assessing the impact of a narrow definition of liquid assets comprised of cash, central bank reserves, and high quality sovereign paper.
  - The willingness of the BCBS to consider a broader definition of liquid assets will be welcome by industry. Notwithstanding this, the definition does not adequately reflect Australian financial markets, in which ADI paper markets are liquid and Australian dollar corporate and covered bond markets are much less liquid (or nonexistent).
- Leverage ratio:
  - The ratio was designed to be a supplementary measure (Pillar 2) with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. The BCBS has welcomed comments on the design, how to ensure an appropriate calibration, and how best to adjust for remaining differences in accounting frameworks.
- Capacity limits in the Australian and international markets (deposits, wholesale and securitisation):
  - Full implementation of the Basel proposals would require banks to hold more capital and more liquid assets. The required liquidity must be in cash equivalents or Commonwealth Government securities (CGS). There is a concern about the capacity of the markets to provide the required liquidity buffer.

While the final form of the Basel proposals will not be known for some time, increased levels of prudential regulation have the potential to significantly impact the funding and balance sheet composition of the ADI sector and, through that, the productivity and efficiency of the economy as a whole.

In relation to liquidity for example, an increase in the required liquidity buffer of the magnitude set out in the September 2009 APRA discussion paper, could lead to:

- ADIs attempting to maintain existing domestic private sector lending by funding the increase in prescribed assets by bidding for additional liabilities, probably offshore (this may, of course, raise the required quantum of liquid assets even further);
- Securitising existing loans from ADIs' balance sheets or by accessing other forms of secured funding; or
- Reduced lending.

2.1.2 Tax issues (Review of Australia's Future Tax System)

The primary role of a country's tax-transfer system is to raise revenue for expenditure on social goods and services, as well as to make welfare payments to those judged to be in need. In doing these tasks, the tax-transfer system should be designed to minimise adverse impacts on economic growth, and as far as possible, enhance the prospects of such growth.

For the "Henry Review", the ABA identified the need for tax reform in four areas to ensure continuing improvements in industry and national productivity:

(1) Enhancing the international competitiveness of Australia's tax regime.

(2) Ensuring secure access to reliable sources of funding and capital for Australian business and households.

(3) Enhancing Australia's position as a strong and influential financial centre.

(4) Enhancing the certainty and simplicity of the overall tax system, and rationalising its components, in order to mitigate its deadweight cost to Australia.

The ABA has focused on the seven key agenda items in its Henry submissions.

(1) Eliminate interest withholding tax (IWT) on foreign-raised funding, including offshore deposits, by Australian financial institution groups.

(2) Create viable options for allocating foreign income to foreign shareholders to address the double taxation of previously taxed foreign earnings of Australian companies caused by the bias of the dividend imputation system against Australian companies with foreign investments.

(3) Increase the after-tax benefit of investment in domestic deposit products.

(4) Reduce the nominal tax rate on corporate entities and produce similar effective tax rates across industry sectors.

(5) Streamline the State tax regime by abolishing certain nuisance taxes, harmonising legislation and reforming Commonwealth/State fiscal relations – including the unification of revenue administration and collection.

(6) Simplify the tax law by removing unnecessary specific anti-avoidance provisions which create complexity and produce uncertainty, and ensure more consistent and balanced administration of the tax law.

(7) Implement structural changes to the GST including the GST-free treatment of all financial supplies, or, at the very least, the GST-free treatment of B2B financial supplies.

2.2 Management processes and governance

Impediments to the efficient and productive management of financial institutions.

2.2.1 Corporate governance and reporting

Banks are subject to a range of differing legal and regulatory obligations which impose governance structures and reporting requirements. Lack of alignment between different regulatory obligations and across different reporting obligations creates unnecessary compliance costs and administrative complexity, for example, in relation to the different reporting requirements and timing for the company's annual report and other reports (i.e. under the NGER Act).

Furthermore, varying requirements in terms of accounting and finance administration, prudential and risk management, and corporate conduct can have implications for governance practices and structures. There needs to be a thorough 'helicopter' review of the various statutes and regulations across Commonwealth, State and Territory legislation and greater harmonisation, consistency and alignment between corporate governance and reporting obligations.

2.2.2 Licensing

The introduction of the new consumer credit laws is resulting in some replication of the Australian Financial Services Licence (AFSL) regime in the Australian Credit Licence (ACL) regime.

Some of the obligations under the ACL are similar (if not the same) as those obligations for AFSL (except ACL covers credit). The governance regimes are also similar, as is the licensing process. We acknowledge the "streamlined application" process for ADIs granted by ASIC, and that current AFS Licence holders are already meeting most of the obligations that are required under the new ACL, but there needs to be a smooth transition for current AFSL holders.

2.3 Product innovation and delivery

Impediments to the efficient development and delivery of financial products to customers.

2.3.1 Financial services regulation

The introduction of the *Financial Services Reform Act 2002* (FSR) saw the implementation of a number of new legal and regulatory obligations on banks and other financial service providers in terms of conduct and disclosure. While a significant number of amendments have been made to the legal framework and regulatory regime, there remain a number of outstanding matters, resolution of which is needed to reduce unnecessary legal complexities and compliance costs. For example, amendments to the law, regulations and/or regulatory guidance are required to:

- clarify the definition of personal advice;
- improve and rationalise disclosure obligations across FSGs, SOAs and PDSs;

- refine the 'retail/wholesale' distinction and sophisticated investors tests;
- introduce a mechanism to rationalise outdated products; and
- clarify the law to ensure financial service providers can utilise electronic disclosure to provide customers and retail clients financial information, and align corporate governance practices across regulatory requirements (i.e. 'fit and proper' prudential obligations and 'organisational competence' conduct obligations).

Furthermore, the nature of constant change in the financial services regulatory framework has itself created unnecessary legal complexity and regulatory burden. Presently, it is very difficult to get an accurate and fulsome picture of the legal obligations imposed on banks due to the myriad of different laws, regulations, class order instruments, regulatory guides, frequently asked questions, information sheets, etc. A significant part of the cost of running a banking business is due to the legal and compliance work required.

2.3.2 Product disclosure

The product disclosure regime covers a number of different classes of financial product and includes a number of different types of documents that must be prepared and provided to retail customers (or potential customers) and retail clients in certain circumstances, including product disclosure statement (PDS), financial services guide (FSG) and statement of advice (SOA). Additional forms of disclosure have in one way or another replaced some of these documents in some service and advisory situations, and in relation to some financial products. However, the preparation of documentation continues to impose unnecessary compliance costs due to the various legal obligations, including content and presentation requirements, delivery expectations, etc.

By way of example, PDSs for superannuation and managed investment schemes must contain information that a reasonable person and their adviser would expect so that they can make an informed investment decision. Industry has been criticised for publishing PDSs that are unwieldy for consumers and members, in particular page lengths exceeding 100 pages in some instances. PDSs are prepared by banks and other financial services providers to meet the necessary legal requirements.

The ABA notes the current work of the Financial Services Working Group (FSWG) to revise some of the legal requirements applied to PDSs as well as to impose prescriptive obligations, in particular a page length limit of 6 pages. The new PDS disclosure requirements will impose initial and ongoing compliance costs on banks and other financial service providers – that is, initial costs associated with development of new documentation and ongoing costs of managing the new disclosure obligations in terms of the PDS itself and other information incorporated by reference.

It is unlikely that the new PDS disclosure requirements will reduce compliance costs, although some cost efficiencies may be gained from leveraging opportunities to incorporate information which resides in other information repositories as well as the delivery of documentation via electronic disclosure. It is more likely that the new PDS disclosure requirements will increase compliance costs, as banks and other financial service providers will need to manage their various product documents and other information repositories pursuant to their various legal obligations.

While the ABA supports efforts by the Federal Government to review and refine the existing disclosure requirements, a number of aspects of the new disclosure obligations must be given further consideration so that unnecessary compliance costs are minimised for banks and unnecessary complexity is minimised for consumers and members. Disclosure requirements should encourage short and concise documents without compromising the quality and usefulness of product specific information or the ability for product providers to provide useful and meaningful information in useful and meaningful ways.

2.3.3 Credit regulation

The Commonwealth is assuming responsibility for the national regulation of consumer credit and of brokers/intermediaries and for the introduction of a national licensing regime. The *National Consumer Credit Protection Act 2009* (NCCP) provides the framework and responsible lending obligations with National Credit Code (NCC) a schedule to the Act replacing the uniform Consumer Credit Code.

Phase 1 (consumer credit) commencement timing and implementation is a key issue for banks, due to delays in finalisation of the first of three tranches of regulations (expected March 2010) and of ASIC guidance ahead of commencement of the NCC on 1 July 2010 and commencement of ADIs' responsible lending obligations on 1 January 2011. There is a myriad of technical and operational aspects of the new regime to be clarified and issues resolved. While industry supports national regulation, sufficient time is needed to implement, and the legislation must be very clear in scope and application. Overly onerous obligations could restrict the supply of credit and stifle consumer demand.

Phase 2 entails possible regulation of small business and investment lending (other than investment lending that is already regulated) and further regulation of credit cards, in particular credit limit increase offers.

The ABA believes that Phase 1 should be completed and operative before moving to Phase 2. There must also be appropriate Government research to identify market failures and the relevant sectors of the market concerned. Furthermore, regulating small business lending on the (Phase 1) consumer model will be much more complex than consumer lending, and is likely to have an impact on the overall cost and availability of credit.

2.3.4 Customer identification

Implementation of the *Anti-Money Laundering and Counter Terrorism Financing Act 2006* (AML/CTF Act) has had a major impact on customer identification processes and procedures in the financial services and gaming industries, and has introduced new obligations such as:

- Requirements to supply originator information in domestic and international funds transfer instructions (subject to certain exceptions).

- Requirements to continuously monitor customer transactions during their provision of the designated service in order to identify, mitigate and manage the risk that the provision of the designated service may involve or facilitate money laundering or terrorism financing.

The cost of implementation of the AML/CTF Act and Rules in Australia has been estimated to be at least $500M.

While the AML/CTF Act adopts a risk-based approach for many obligations, there is no overarching risk-based approach. That means that where an obligation is not expressly stated to be risk-based, it must be performed, regardless of a risk assessment. Examples of such obligations include:

- the requirement for a bank's AML/CTF program to include a procedure to collect the name and address of each beneficial owner (as defined) of particular companies; and
- the requirement for an AML/CTF program to include a procedure to collect minimum (know-your-customer) KYC information.

To protect their own interests, and those of their shareholders, banks must identify their customers, and be satisfied that the person with whom they are dealing is who they say they are, but prescriptive obligations (simply put, "do it every time") add significant cost and complexity to customer identification programs, and are not consistent with the risk-based approach adopted by banks in managing risk more generally.

If there were an overarching requirement that the regime be risk-based, it would be left to banks to perform a risk assessment and determine the extent to which such actions would need to be undertaken, depending on the level of risk identified.

An overarching risk-based approach is consistent with the international regulator's approach. For example, Financial Action Taskforce (FATF) Recommendation 5, which deals with customer due diligence and record-keeping, requires that customers and beneficial owners are identified, but provides that financial institutions "may determine the extent of such measures on a risk sensitive basis depending on the type of customer, business relationship or transaction". An overarching risk-based approach is also consistent with international practice.

The ABA has recommended to Government insertion of a provision into the AML/CTF Act to require its obligations, and those imposed by the Rules, to be subject to an over-arching risk-based approach.

2.4 International market and environment

Impediments to productivity in how banks are obliged to interact with the political and regulatory environment, and the remainder of the industry, including extra-territorial interventions.

Beyond capital and liquidity standards, the impact of internationally generated regulation through the work of international regulatory bodies, including and especially the G20, IOSCO, Basel Committee, the FSB and the IASB, may have a major impact on banks in Australia, and the costs borne by their customers. At this stage we are still waiting to see what national discretion will be exercised by the Federal Government and regulators.

The central objection to this type of international reach is that Australian institutions (and their shareholders and customers) are effectively paying a price for the poor practices of overseas financial institutions.

In addition to the prospect of quasi international regulation, banks in Australia also face the prospect of further extra territorial reach of foreign Court decisions and legislation.

Some key examples of this type of extra-territorial regulation (not canvassed above) include the following.

2.4.1 FSA's Corporate Governance proposals

The "Walker Review" published its final report in November 2009. The recommendations contained in the report set out a number of areas relating to corporate governance for listed banks and insurers, including establishment of board risk committees and appointment of senior executives.

The FSA has released a consultation paper on effective corporate governance in January 2010. The FSA's proposed more intrusive approach to supervisory oversight and authorisation processes will result in a new, more detailed framework of controlled functions, enabling the FSA to vet and track individuals.

The proposed framework will have extraterritorial effect on Australian banks that have operations and business interests in the United Kingdom – that is, the emphasis on governance and senior management at banks will not be limited to those senior executives located in the united Kingdom, but also those senior executives located outside the United Kingdom, but with managerial and decision making responsibilities for the bank. This will increase the regulatory burden and compliance costs with duplication (and possible inconsistency) of corporate governance standards and supervisory oversight processes.

2.4.2 US Foreign Account Tax Compliance Act of 2009

This legislation (still in Congress) would add a new Chapter 4 to the US Internal Revenue Code, which would essentially require foreign financial institutions (including Australian banks operating outside of the United States) to identify from among all of their customers any US persons and any "United States owned foreign entities" and then to report to the US Internal Revenue Service (the "IRS") on all payments to, or activity in the accounts of, such persons.

This will be extremely onerous and costly for a small benefit to the US. As Australia has a double tax treaty and information sharing agreement with the US, the risk of US citizens hiding money in our country appears to be low.

A Reporting Agreement would require:

- Determining whether the account was a "United States account";
- Verifying the identity of US Accounts (e.g. know your customer (KYC) and anti-money laundering standards, including for indirect account holders);

- Annual reporting to the IRS of information with respect to US Accounts;
- Compliance with IRS requests for any additional information; and
- Obtaining waivers of local privacy laws from the owners of US Accounts or, possibly, closure of accounts.

The changes will be additional to current withholding tax regime relating to US source income paid to non-US persons and the qualified intermediary program ("QI"), applying to approved non-US financial institutions.

2.4.3 Morrison v NAB

The US Supreme Court has agreed to hear an appeal in Morrison v National Australia Bank. The outcome of this case will have important ramifications for banks in Australia. The extent of our concern is registered by the fact that the ABA has joined two of its international counterparts in the US and Europe in an amicus brief in relation to the appeal.

Thus far, in *Morrison,* it has been held that US Courts generally lack jurisdiction to hear securities claims brought by non-US investors who purchased non-US Securities of a non-US company, where the responsibility for the dissemination of information to investors rested abroad.

If this principle is completely overthrown by the US Supreme Court a situation may arise where an Australian (or any other) investor could take action against an Australia bank, which has no dealings in the US, which has issued non-US securities in Australia.

This would be an extraordinary turn of events and not in the interests of Australian institutions that issue securities, and ultimately their shareholders and customers.

3. National regulation

The ABA believes that Commonwealth legislation should replace, not augment, State and Territory legislation where they cover the same issues. This would provide truly national regulation and in some cases replace many pieces of legislation with one, providing certainty for business, reducing administrative overheads and delivering consistency for the market and consumers.

Recent examples where this has <u>not</u> occurred include:

- regulation of unfair contract terms under the Trade Practices Amendment (Australian Consumer Law) Bill 2009 and current Victoria legislation;
- the NCCP legislation, which will operate subject to current State and Territory regulation on matters such as interest rate caps, which can vary between different jurisdictions.

The development of Commonwealth legislation also needs to recognise and take account of the roles played by national and State regulators. For example, in relation to privacy legislation, Do Not Call and anti-hawking provisions, there are duplicated functions between ACMA, OPC, ASIC.

There is also a need for enhanced Federal Government education of consumers on national regulatory change, especially in those instances where the reforms cross many different industries (such as Privacy reforms, Do Not Call, Spam and anti-money laundering). Where such reforms are often not fully understood by consumers there will additional costs and consumer dissatisfaction.

4. Consultation processes

The ABA believes that avoidance of unnecessarily burdensome, complex, redundant, inconsistent or duplicative regulation is best achieved by rigorous, transparent and timely consultation with affected entities.

Consultation processes by governments and agencies with the banking industry vary considerably in process and quality. We consider that there should be greater consistency in the:

- approach to consultation (including early consultation prior to formulation of policy or regulatory settings);
- setting of realistic response timeframes to consultation materials; and
- provision adequate explanation about why policy decisions have been made after a consultation process has been completed.

There have been instances where consultation processes have been confined to industry peak bodies overlaid with strict confidentiality requirements for participants. A recent example is the confidential consultation on Phase 1 of the national regulation of consumer credit (NCCP). For the Phase 1 project Treasury convened a single consultative group comprising peak bodies from the financial services sector, the ABA, and consumer groups, dispute resolution schemes and lawyers (Law Council of Australia).

Each member of the group had to enter into a standard form confidentiality agreement, breach of which could give rise to Crimes Act implications. The ABA was only permitted to consult with its member bank personnel if those personnel in turn signed confidentiality agreements. This slowed the consultation process with banks as relevant personnel came into and out of regulatory policy issues as their expertise dictated. We were requested by Treasury to keep the number of confidentiality agreements to a minimum.

There have also been instances where consultation has not taken place before policies have been announced by the Government, yet these policies will intrinsically involve banks and other financial institutions. For example, the First Home Saver Account (FHSA) initiative was announced without detailed consultation with the banking sector. The banking sector then engaged with the Government via a number of processes and via a number of departments involved in the further development of the policy setting, product design and rules, taxation arrangements, disclosure obligations and administration.

Consultation processes engaging with banks were unnecessarily complicated and the FHSA disclosure document was developed with limited industry input. Some adverse bank-customer relationship experiences have resulted from the legislative restrictions imposed on these accounts as well as the prescriptive nature of the FHSA disclosure document, and related issues.

Unsatisfactory policy outcomes from such approaches require re-visiting previously covered ground. This duplication or re-engagement adversely impacts on the deployment of industry resources and delivers consequential negative impacts on industry productivity.

Invariably, as governments and agencies reach an understanding and recognition of companies' and customers' needs and requirements, it is too often late in the process, creating difficulties for them in adjusting to community expectations about commencement, while industry has struggled against unrealistic deadlines, straining resources, inhibiting product design and service delivery, and undermining project management processes.

5. Implementation processes

The ABA believes that industry is only able to proceed with an efficient, productive development and implementation of government and agencies regulatory reform if all regulations and guidance materials are finalised and published and governments and agencies understand implementation from an industry perspective.

To achieve this means that governments and agencies need to understand how, for example, banks are organised and conduct their business. We consider that it is necessary to adopt a project management approach to implementation for all reform initiatives, including planning and timing sequences for efficient and cost-effective implementation.

The implementation plan has to cover such things as resourcing requirements, IT systems development, aligning systems implementation to IT service releases and other normal business requirements, such as policies, risk management procedures, documentary changes, development of internal instruction manuals, staff training and management of customer expectations and relationships.

With this understanding governments and agencies would be able to ensure that all regulations and guidance materials are finalised and published as a single or tightly timed package so that realistic dates can be set for commencement of the reform regime. Unfortunately, there are few examples where this has occurred.

5.1 Example: Tax

In relation to tax regulation there are many examples where lack of consistency in the application of the law and material departures from the original policy intent has lead to ongoing implementation problems.

The ABA gave recent and significant examples in its June 2009 submission to the Inspector-General of Taxation's (IGT's) "Review into the implications of any delayed or changed ATO advice on significant issues". These included:

- Complexity associated with reliance on specific anti-avoidance rules.
- Continuing and increasing uncertainty in the administration of the law, leading to increased tax risk.

- Perceived bias or subjectivity in technical positions adopted by the ATO, in some cases perceived to be connected with maximising tax revenue.

The IGT's report can be found at: www.igt.gov.au