HD **The Final Report of the Financial Services (Murray) Inquiry: it aint broke, it just needs a good tune-up**

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Introduction

On Sunday 7 December 2014 the Federal Treasurer, Mr Joe Hockey, released the Final Report of the Financial System Inquiry (or 'Murray Inquiry' after its Chair, David Murray) having received it at the end of November in accordance with the Terms of Reference. The Inquiry was established by the Treasurer in December 2013 to review Australia's financial system in the aftermath of the global financial crisis.

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In the press release which accompanied the Final Report the Treasurer stated that it 'lays out a blueprint for the financial system over the next decade.' He went on to say that the Government intends to consult with industry and consumers before making any decisions on the recommendations. This consultation will take place until 31 March 2015.

It is fair to say that the Report contains no real surprises and, perhaps a little disappointingly, no new 'Big Ideas' of the scale of the so-called 'twin peaks model' suggested by the Wallis Report in 1997 and adopted soon afterwards. The overall theme seems to be 'it ain't broke so all it needs is a good tune-up'. This was not unexpected after statements in the Interim Report of July 2014 that 'the Australian financial system has performed reasonably well in meeting the financial needs of Australians and facilitating productivity and economic growth' and 'many areas of the financial system are operating effectively and do not require substantial change'.

Readers will recall that the Interim Report contained the Inquiry's preliminary observations following the first round of submissions and consultations, but it made no firm or formal recommendations (see our bulletin on it here). Interested parties were invited to make further submissions to be considered for the Final Report. By the closing date of 26 August 2014 some 6,500 further submissions were received (on top of the almost 300 original submissions).

The Final Report contains 44 recommendations and these are set out below. We then include observations from Norton Rose Fulbright specialists on some of the highlights.

Primary themes

The Inquiry asserts that Australia's financial system has performed well since the Wallis Inquiry and has many strong characteristics. But it also has a number of weaknesses: taxation and regulatory settings distort the flow of funding to the real economy; it remains susceptible to financial shocks; superannuation is not delivering retirement incomes efficiently; unfair consumer outcomes remain prevalent; and policy settings do not focus on the benefits of competition and innovation. As a result, the system is prone to calls for more regulation.

The Final Report focuses on seven primary themes:

Funding the Australian economy: reduce distortions that impede the efficient market allocation of financial resources like taxation, information imbalances and unnecessary regulation.

Competition: strengthen competition by removing impediments to its development.

Resilience: strengthen the economy by making the financial system more resilient.

Superannuation and retirement incomes: lift the value of the superannuation system and retirement incomes.

Innovation: drive economic growth and productivity through settings that promote innovation.

Consumer outcomes: enhance confidence and trust by creating an environment in which financial firms treat customers fairly.

Regulatory system: enhance regulator independence and accountability, and minimise the need for future regulation.

The recommendations

The Final Report states that its recommendations seek to improve efficiency, resilience and fair treatment in the Australian financial system, to allow it to achieve its potential in supporting economic growth and enhancing standards of living for current and future generations. The recommendations are as follows:

Chapter 1: Resilience

Set capital standardssuch that Australian authorised deposit-taking institution capitalratios are unquestionably strong. 2 Narrow mortgage risk weight differences:
Raise the average internal ratings-based (IRB) mortgage risk weightto narrow the difference between average mortgage risk weights forauthorised deposit-taking institutions using IRB risk-weight modelsand those using standardised risk weights. 3 Loss absorbing and recapitalisation capacity:
Implement a framework for minimum lossabsorbing and recapitalisation capacity in line with emerginginternational practice, sufficient to facilitate the orderlyresolution of Australian authorised deposit-taking institutions andminimise taxpayer support. 4 Transparent reporting:
Develop areporting template for Australian authorised deposit-takinginstitution capital ratios that is transparent against the minimumBasel capital framework. 5 Crisis management toolkit:
Complete theexisting processes for strengthening crisis management powers thathave been on hold pending the outcome of the Inquiry. 6 Financial Claims Scheme:
Maintain theex post funding structure of the Financial Claims Schemefor authorised deposit-taking institutions. 7 Leverage ratio:
Introduce a leverageratio that acts as a backstop to authorised deposit-takinginstitutions' risk-weighted capital positions. 8 Direct borrowing by superannuation funds:
Remove the exception to the general prohibition on direct borrowingfor limited recourse borrowing arrangements by superannuationfunds.

Chapter 2: Superannuation and retirement incomes

Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly onhow policy proposals are consistent with achieving these objectivesover the long term. 10 Improving efficiency during accumulation:
Introduce a formal competitive process to allocate new default fundmembers to MySuper products, unless a review by 2020 concludes thatthe Stronger Super reforms have been effective in significantlyimproving competition and efficiency in the superannuationsystem. 11 The retirement phase of superannuation:
Require superannuation trustees to pre-select a comprehensiveincome product for members' retirement. The product wouldcommence on the member's instruction, or the member may chooseto take their benefits in another way. Impediments to productdevelopment should be removed. 12 Choice of fund:
Provide all employeeswith the ability to choose the fund into which their SuperannuationGuarantee contributions are paid. 13 Governance of superannuation funds:
Mandate a majority of independent directors on the board ofcorporate trustees of public offer superannuation funds, includingan independent chair; align the director penalty regime withmanaged investment schemes; and strengthen the conflict of interestrequirements.

Chapter 3: Innovation

Establish a permanent public-private sector collaborativecommittee, the 'Innovation Collaboration', to facilitatefinancial system innovation and enable timely and coordinatedpolicy and regulatory responses.15 Digital identity:

Develop a nationalstrategy for a federated-style model of trusted digitalidentities. 16 Clearer graduated payments regulation:

Enhance graduation of retail payments regulation by clarifyingthresholds for regulation by the Australian Securities andInvestments Commission and the Australian Prudential RegulationAuthority. Strengthen consumer protection by mandating theePayments Code. Introduce a separate prudential regime with twotiers for **purchased** payment facilities.17 Interchange fees and customer surcharging:

Improve interchange fee regulation byclarifying thresholds for when they apply, broadening the range offees and payments they apply to, and lowering interchangefees. Improve surcharging regulation by expanding itsapplication and ensuring customers using lower-cost payment methodscannot be over-surcharged by allowing more prescriptive limits onsurcharging.18 Crowdfunding:

Graduate fundraisingregulation to facilitate crowdfunding for both debt and equity and,over time, other forms of financing.19 Data access and use:

Review the costs andbenefits of increasing access to and improving the use of data,taking into account community concerns about appropriate privacyprotections.20 Comprehensive credit reporting:

Supportindustry efforts to expand credit data sharing under the newvoluntary comprehensive credit reporting regime. If, over time,participation is inadequate, Government should consider legislatingmandatory participation.

Chapter 4: Consumer outcomes

Introduce a targeted andprinciples-based product design and distribution obligation. 22 Introduce product intervention power:

Introduce a proactive product intervention power that would enhancethe regulatory toolkit available where there is risk of significantconsumer detriment.23 Facilitate innovative disclosure:

Removeregulatory impediments to innovative product disclosure andcommunication with consumers, and improve the way risk and fees arecommunicated to consumers.24 Align the interests of financial firms and consumers:

Better align the interests of financialfirms with those of consumers by raising industry standards,enhancing the power to ban individuals from management and ensuringremuneration structures in life insurance and stockbroking do notaffect the quality of financial advice.25 Raise the competency of advisers:

Raisethe competency of financial advice providers and introduce anenhanced register of advisers. 26 Improve guidance and disclosure in general insurance:

Improve guidance (including tools andcalculators) and disclosure for general insurance, especially inrelation to home insurance.

Chapter 5: Regulatory system

Create a newFinancial Regulator Assessment **Board** to advise Government annuallyon how financial regulators have implemented their mandates. Provide clearer guidance to regulators in Statements of Expectationand increase the use of performance indicators for regulatorperformance.28 Execution of mandate:

Provide regulatorswith more stable funding by adopting a three-year funding modelbased on periodic funding reviews, increase their capacity to paycompetitive remuneration, boost flexibility in respect of staffingand funding, and require them to undertake periodic capabilityreviews.29 Strengthening ASIC's funding and powers:

Introduce an industry funding model for ASICand provide ASIC with stronger regulatory tools. 30 Strengthening the focus on competition in the financial system:

Review the state of competition in thesector every three years, improve reporting of how regulatorsbalance competition against their core objectives, identifybarriers to cross-border provision of financial services andinclude consideration of competition in ASIC's mandate. 31 Compliance costs and policy processes:

Increase the time available for industry to implement complexregulatory change. Conduct post-implementation reviews ofmajor regulatory changes more frequently.

Appendix 1: Significant matters

Explore ways tofacilitate development of the impact investment market andencourage innovation in funding social service delivery.
Provide guidance to superannuation trustees on the appropriatenessof impact investment. Support law reform to classify aprivate ancillary fund as a 'sophisticated' or'professional' investor, where the founder of the fundmeets those definitions. 33 Retail corporate bond market:

Reducedisclosure requirements for large listed corporates issuing'simple' bonds and encourage industry to develop standardterms for 'simple' bonds. 34 Unfair contract term provisions:

SupportGovernment's process to extend unfair contract term protectionsto small businesses. Encourage industry to develop standardson the use of non-monetary default covenants. 35 Finance companies:

Clearly differentiatethe investment products that finance companies and similar entitiesoffer retail consumers from authorised deposit-taking institutiondeposits. 36 Corporate administration and bankruptcy:

Consult on possible amendments to the external administrationregime to provide additional flexibility for businesses infinancial difficulty. 37 Superannuation member engagement:

Publishretirement income projections on member statements from definedcontribution superannuation schemes using ASIC regulatoryguidance. Facilitate access to consolidated superannuationinformation from the Australian Taxation Office to use withASIC's and superannuation funds' retirement incomeprojection calculators. 38 Cyber security:

Update the 2009 CyberSecurity Strategy to reflect changes in the threat environment,improve cohesion in policy implementation, and progresspublic-private sector and cross-industry collaboration. Establish a formal framework for cyber security information sharingand response to cyber threats. 39 Technology neutrality:

Identify, inconsultation with the financial sector, and amend priority areas ofregulation to be technology neutral. Embed consideration ofthe principle of technology neutrality into development processesfor future regulation. Ensure regulation allows individualsto select alternative methods to access services to maintain fairtreatment for all consumer segments. 40 Provision of financial advice and mortgage broking:

Rename 'general advice' and requireadvisers and mortgage brokers to disclose ownership structures. 41 Unclaimed monies:

Define bank accountsand life insurance policies as unclaimed monies only if they areinactive for seven years. 42 Managed investment scheme regulation: Consumer detriment, including illiquid schemes and freezing of funds. Regulatory architecture impeding cross-border **transactions** and mutual recognition arrangements.

Support Government's review of the Corporations and MarketsAdvisory Committee's recommendations on managed investmentschemes, giving priority to matters relating to: 43 Legacy products:

Introduce a mechanism tofacilitate the rationalisation of legacy products in the lifeinsurance and managed investments sectors. 44 Corporations Act 2001 ownership restrictions:

Remove market ownership restrictionsfrom the Corporations Act 2001 once the current reforms tocross-border regulation of financial market infrastructure arecomplete.

Norton Rose Fulbright expert observations

Here are our thoughts on specific highlights (in no particular order):

Bank capital

The recommendations include an increase in the amount of capital held by ADIs so that those institutions rank in the top 25% globally on regulatory capital levels, potentially requiring ADIs to hold a further 1% in regulatory capital. This is likely to lead to further equity capital raisings by ADIs to achieve what the Final Report calls "a safety buffer to absorb losses". ADIs have already successfully raised further capital this year, so finding investors is unlikely to be too great a challenge. However, there may well be a cost passed on to business and consumers. If ADIs do pass on the cost of holding this further capital, an estimated additional 10 bps will be added to funding costs.

At a time when we have most likely reached an inflection point between bank lending rates and costs of equivalent funding in the debt capital markets, these additional bank costs will encourage borrowers to seek funds from the debt capital markets. The Final Report is encouraging greater issuance of corporate bonds (see below), so we assume that the Inquiry is not concerned at the potential shift in risk from the banking to the debt capital markets sector.

The recommendation to implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice is driven by the "too big to fail" concern. This is about "bail-in" capital. The Inquiry has enunciated a lingering worry that investors in ADIs will rely on an implicit guarantee by the government of Australian ADIs and that the taxpayer may suffer as a result. Loss absorbing or recapitalisation measures will have already found their expression in "non-viability" conversion triggers on certain types of subordinated debt or other similar debt instruments. If investors have bought on this basis without requiring a commensurately higher return, then ADIs may not find this requirement too troublesome.

The recommendation to raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weight should be welcomed by regional banks and other ADIs that have been using a standardised risk weighting system. This is because it should reduce the competitive disadvantage they have been under by having to hold more capital to mortgage exposures than IRB-based banks. Conversely, the IRB-based banks will consider this an unnecessary increase in capital for institutions whose mortgage books performed very well, particularly compared to offshore banks, during the GFC. If implemented, the increased costs are likely to be passed on to the long-suffering consumer.

Finance companies and shadow banking

Notably, the Final Report did not recommend the regulation of shadow banking but has left that sector to be reviewed annually by the Council of Financial Regulators. There is to be ongoing reliance on the Financial Claims Scheme and the depositor protection regime, with a hint that perhaps the $250,000 level of protection currently provided for each account with each institution, should be revisited. The absence of a recommendation on shadow banking will be welcomed by the non-bank financial sector, as it seeks to increase competition and choice for consumers. However, that may not be the end of it. The Final Report acknowledges that alignment with international developments will be important in relation to shadow banking. The US has already begun to regulate some bank-type entities that do not take deposits (eg. GE Capital and AIG) and recent comments from the ECB and BIS indicate that the EU may well follow the same path for European shadow banking entities.

International competitiveness and the funds management sector

The Report brings good news for the funds management sector and its desire to compete internationally. This is described as a priority area of reform and Government action as it is a key component of getting the blueprint right for the Australian financial system into the future. The Inquiry's rationale for supporting this area of reform is based upon its philosophy that the primary means of improving the efficiency of our financial system is through competition, noting that developments and opportunities in Asia make change imperative.

The Inquiry's recommendations in this area are intended to rebalance ASIC's regulatory focus towards competition and remove barriers to cross border provision of financial services and the free flow of capital into and out of Australia. In addition the Inquiry also recommended:

that the Government should treat as a priority area of action the recommendations of CAMAC in their 2012 and 2014 reports including in relation to removing impediments in Australia's regulatory architecture which make it harder for our funds sector to do cross border business; and

that the Government consider the introduction of alternative collective investment vehicles such as corporate tax flow-through vehicles to facilitate the growth of our management of foreign funds.

Superannuation

Borrowing prohibition

The proposal to remove the exception to the borrowing prohibition may have the unintended consequence of closing down the market for instalment warrants and other structured products that involve in-built forms of leverage, as well as closing down the **residential property** asset class for SMSFs.

Improving efficiency

The Inquiry clearly has reservations about the effectiveness of the Stronger Super reforms to bring down fees. While recognising that those reforms should be allowed to run their course, the Report recommends that a Parliamentary Committee inquiry should commence as early as next year to test the design features for a new competitive tender process for the super industry. The successful bidders will be a smaller number of super funds (with no hint as to the number) that will receive the super guarantee contributions of new entrants. The catch is that those funds must also offer the same fees and other features to their existing members. This recommendation could result in massive industry consolidation as funds seek to gain the necessary scale in order to compete on fees and brings Australia more in line with compulsory pension regimes overseas.

Retirement phase of super

Tilting the retirement product bias away from account-based pensions towards a default income stream chosen by trustees will be welcome by the super industry. However, as many of the submissions pushed for some element of compulsion, it is arguable that the Report does not go far enough. Rather, it encourages the development of retirement income products with pooled longevity risk protection and the removal of tax and other barriers to the development of such products. While these recommendations are welcome, it is unclear whether they will change consumer behaviour as consumers will continue to be able to choose to take their super benefits as lump sums, and then fall back on the age pension.

Majority of independent directors

The Inquiry is strongly supportive of a governance model of a majority of independent directors for public offer super funds as well as introducing civil and criminal penalties for director misconduct and recommends that equal representation (the current model) be restricted to defined benefit funds where employers bear the investment risk.

Taxation of super

The Report dodges the bullet on tax reform and leaves it to the Tax White Paper to recommend changes to the taxation of super. In its sights will be the concessional contribution caps and the taxation of earnings in the retirement phase (which are currently tax free) as well as the taxation of high super balances.

Consumer outcomes

Facilitating innovation

The Inquiry has effectively deferred making a policy recommendation on the use of consumer data pending a further Productivity Commission review by the end of 2015, and perhaps with good reason. The use of consumer data is a double-edged sword. Consumer data can be used to create and promote personalised products tailored to a consumer's specific needs. This data can also be used to predict customer needs, making marketing and customer service for existing customers more efficient - which ought to result in cost savings that can be passed on to the consumer. On the other hand, some consumers have legitimate privacy concerns about the use of their private data for the **commercial** gain of financial institutions. For consumers that financial institutions deem less desirable, tailored products can also have a damaging effect, making it harder for them to access credit, or requiring them to access credit through products designed to prey on their tendency to make payments late or overdraw.

The Report recommends the establishment of a permanent public-private sector collaborative committee, the 'Innovation Collaboration', to facilitate financial system innovation. This is similar to the 'Innovation Hub' initiative by the UK's Financial Conduct Authority established earlier this year, indicating that a close monitoring of UK developments will provide valuable insights into the future of regulation in Australia.

Following the lead of the UK regulator, the Report recommends the facilitation of innovative forms of disclosure, noting consumer behavioural biases and **commercial** disincentives currently limit the effectiveness of our current disclosure regime. While the Report is scant on detail, it is echoing the consistent need for reform to facilitate innovation in financial services.

Technology neutrality

Consistent with recent ASIC announcements, the Report clearly endorses the principle of "technology neutrality" in the regulation of financial services. It is encouraging that the reform dial is moving in the right direction but it is not just about allowing electronic delivery. Regulation needs to adjust the bias away from paper, page and document type formats to facilitate the use of interactive multi-media personalised engagement with customers and allow the disclosure to be adaptive for use with all types of mobile devices.

Such reform should result in significant cost savings for financial services providers as well as improve the customer experience and reduce the risk of misselling products and services.

However, much depends on the regulators and how facilitative they are prepared to be. The Report recognises that the regulators need to adopt a flexible approach to respond to future developments in the market and technology. However, the regulators may need more resources and potentially new and different skill sets, in order to quickly identify both the opportunities and risks that new technology poses for financial services providers and consumers.

Conduct regulation

The Report's explicit and implicit endorsement of the UK approach also extends to its recommendation to introduce the UK FCA style product intervention powers into the Australian regulator's toolkit. By making issuers and distributors of financial products more accountable for design and distribution, the Report believes that such conduct regulation will lead to positive consumer outcomes and strengthen consumer confidence and trust in the system. These powers include bans on specific products, product terms, distribution channels, mandated warnings and product labelling. If implemented, these wide ranging powers will significantly strengthen the intrusive reach of ASIC into product development and distribution.

Intervention powers of this sort could mean a new era of conduct regulation in Australia, where the focus of regulation will shift from enforcement action to preventative action by ASIC. Currently, this is the realm of APRA, which has the power to impose prudential standards (in addition to its enforcement powers). Prudential regulation has the objective of preventing the failure of institutions that can have a significant systemic impact on the whole economy.

Rather than conferring "standards making" powers on ASIC, the Report recommends ASIC be given the power to impose licence conditions that require the applicant to strengthen their internal systems to address misconduct risk. Currently, ASIC can only do so through enforceable undertakings, which come too late for investors who have already suffered loss. By recommending the introduction of these preventative powers through licence conditions, it is clear that the Inquiry is aligning ASIC's powers with the new UK FCA. It will be interesting to see how ASIC will seek to transform itself, if these recommendations are ultimately adopted by the Government.

Introduce a targeted and principles-based product design and distribution obligation

The Inquiry proposes that this obligation would require product issuers to consider the consumer whose financial needs will be met by the product, and how the product should be distributed to those consumers. The obligation would also require ongoing review of products (including post the point of **sale**) to ensure that they continue to meet the needs of target consumers. The Inquiry has recommended that breach of this obligation should result in a civil penalty.

This approach to product design regulation won out over two alternatives: an individual appropriateness test (similar to those used in Japan, **Hong Kong** and Singapore) which was deemed to be too expensive for product issuers; and industry self-regulation, which was rejected as ineffective, given the failure of industry self-regulation to improve the conduct of financial advisers.

Even without an individual appropriateness test, an ongoing obligation to review financial products will increase compliance costs for product issuers (assuming the obligation cannot be discharged by a mere gestural review), and we expect to see a push back from the banking and financial advice industry on this aspect of the recommendation.

Introduce a proactive product intervention power

This recommendation reflects ASIC's submissions to the Inquiry, seeking a greater regulatory toolkit. If adopted, ASIC would have the power to temporarily ban products, restrict their distribution and change the way the products are marketed and communicated to consumers.

The Inquiry has recognised that such a power would have "significant **commercial** impact", and has indicated that the power would be subject to judicial review, as well as requiring ASIC to consult with APRA and the proposed Financial Regulator Assessment **Board** on its use. The Inquiry has also suggested a review of the power after 5 years.

By making this recommendation, it seems that the Inquiry has also recommended improved funding for ASIC, another request made by ASIC in its submissions to the Inquiry. Certainly, the change would have little real impact without increased funding for the regulator.

Remove regulatory impediments to innovative product disclosure

This will be a change welcomed by financial institutions - in its submissions, the Australian Bankers' Association called for simplifications to disclosure rules, which it asserted do not take into account the persistent availability of information online and other advantages of electronic delivery of information. Absent from this recommendation is the concept of 'layered disclosure', the provision of information to consumers as and when it becomes appropriate, which was previously considered by the Inquiry's interim report, and advocated for by consumer protection groups in their submissions.

There is no guarantee that ASIC-granted individual exemptions, and broader legislative exemptions without more, will promote the development and use of novel and user-friendly disclosure materials. The Inquiry is hoping that competition in financial services, and the disruptive influence of 'new entrants', will bring innovation. But in an industry dominated by a small number of large, well-established institutions, it remains to be seen where these new entrants will come from. One potential source of new competition could be large players in other markets expanding into financial services, such as the major supermarket chains' foray into insurance products.

Better align the interests of financial firms with those of consumers

While the Inquiry has recommended improving the culture of financial firms, it is hard to see exactly how the Inquiry proposes to accomplish this aim. However, the Inquiry addresses the real cause of misbehaviour by financial advisers - which it identifies as incentive-based remuneration - in respect of only 2 discrete areas, life insurance and stockbroking. As a response to phoenix activity, the Inquiry has also recommended that ASIC be given enhanced powers to ban individuals from managing financial firms.

Raise the competency of financial advice providers

The Interim Report considered a number of proposals about improving the education of financial advisers, and it is no surprise to see a number of them here. The Inquiry has proposed a minimum level of tertiary education for financial advisers, consistent with similar efforts in other jurisdictions to improve the competency of advisers. However, the final report is silent on specialist training requirements for trustees of SMSFs, which was considered by the interim report and which ASIC asked for in its submissions, noting that SMSF promotion models are a top enforcement priority for the regulator.

Better minimum education standards are welcome, though the Inquiry's decision not to recommend a national exam is perhaps a missed opportunity to clearly establish a uniform competency baseline. The final report has also not completely addressed the inevitable increase to the cost of financial advice that will accompany the shrinking of the financial adviser profession when less qualified advisers leave the industry. The Inquiry has recognised the risk of an 'advice gap', and has given a nod to "cost effective market developments" such as scaled advice, limited scope advice, and advice delivered online, but has not made a policy recommendation on how to implement these - nor, more importantly, a policy recommendation on how to make sure that these forms of delivery still provide customers with sound and effective advice.

Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance

Underinsurance and inappropriate insurance was a big area of concern for consumer groups making submissions to the Inquiry, and this recommendation seeks to address those concerns. The Inquiry reports that these problems can be resolved primarily through better disclosure, such as requiring insurers to help consumers to determine an appropriate level of insurance by providing information about replacement costs. The Inquiry has noted that some insurers provide this information to a limited degree through online calculators, and has proposed improving disclosure through better electronic and on-line tools.

Curiously, the Inquiry has rejected solutions such as standardised or default insurance products and total replacement policies in favour of better disclosure tools, despite its comments about the need for regulation of product design for other financial products.

Retail corporate bond market

The expansion of debt capital markets funding by corporates has been on the agenda of both this present and previous governments, as they seek to encourage diversification of funding sources and create investment products for retail and institutional investors. The Report's recommendation should be welcomed and supported by the industry which has long advocated for some template-style issuance.

Disappointingly, there is no specific recommendation for standardised terms and reduced disclosure requirement for some types of asset-backed issuance, or "simple securitisation". The resurgence of the RMBS market and greater simplification and consistency of those **transactions** present an ideal opportunity for the extension of this approach to that type of securitisation. An opportunity missed.

Payment systems

Two of the recommendations by the Inquiry were directed at payment systems:

Clearer graduated payments regulation

The Inquiry noted that Australia has a complex, fragmented and less than clear framework for regulating payments which is administered in various respects by ASIC, APRA and the Payment Systems **Board** (PSB). It proposed that the regulators should publish a clear guide to the framework for industry, in particular for new entrants, that outlines thresholds and regulatory requirements. Changes were suggested to consumer protection regulation for retail payment service providers with a view to simplification and improvement. The Inquiry also foreshadowed the problems with the current regulatory regime in not accommodating future innovation in payments, such as digital currencies. A review of current legislation was recommended as it was not clear that the PSB can regulate payment systems involving alternative mediums of exchange that are not national currencies. It is encouraging that the Inquiry did recognise issues with current system of regulation of the payments system. While some regulation is clearly warranted, it would have been pleasing to see some recognition of the possible benefits of stepping back from what some perceive as over-regulation in this area and whether, in some instances, there may be benefits in self-regulation.

Interchange fees and customer surcharging

A continuing issue arising from the introduction of regulations in 2003 allowing merchants to impose surcharges in relation to payment card **transactions**, so as to recover the cost of accepting payment cards, has been the problem of some merchants "over-surcharging" ie. recovering more than their reasonable costs. The proposal by the Inquiry that the PSB consider ways to simplify compliance and improve the accuracy of surcharging is a good one. However, irrespective of the regulatory means that may be adopted as a result, the Inquiry did not have a solution for enforcing any such regulation. It is suspected that we may not see an end to over-surcharging by some merchants any time soon. A major, and continuing, issue for the four-party credit card schemes in Australia was the introduction, in 2003, of restrictions on the amount of interchange fees that could be charged in credit card **transactions**. The recommendation by the Inquiry that the PSB consider, as a means of improving the transparency and efficiency of interchange fee regulation, reducing interchange fees in the short term, with a view to possible further lowering in the longer term, is likely to revive this issue.

Technology and cybersecurity

As with the Interim Report, the Final Report highlights cyber security and technology related fraud risks as an emerging trend for the financial services industry that presents many challenges. At the forefront of the risks that arise is the rapid pace of technological change that is occurring within the financial system and how the system operates. As a result, the emergence of new technology is placing demands on regulators to be more flexible, and raising issues relating to identity, privacy and cyber security. The Final Report highlights that Australia's regulators need the funding and skills to meet these challenges into the future.

Specifically in relation to cyber security, the Committee recommends an update to the 2009 whole-of-Government Cyber Security Strategy (CSS) to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public-private sector and cross-industry collaboration. It is recommended that such an update be in conjunction with the establishment of a formal framework for cyber security information sharing and response to cyber threats.

As noted in the Interim Report, due to the advances in technology and the sophistication of cyber-crime, even in the space of 5 years the CSS is now largely out of date and lags behind similar strategies adopted in the US, UK, Canada, New Zealand, France, Germany, Japan and Singapore. While financial institutions obviously retain ultimate responsibility for maintaining the security of their own systems, an updated CSS will provide a framework that will allow institutions to collaborate with Government and co-ordinate their efforts. Interestingly, the Inquiry did not go so far as to formally recommend a model that was under consideration at the time of the Interim Report - being the Financial Services Information Sharing and Analysis Center (FS-ISAC) in the US, which is a collaboration between financial institutions and government. Even so, it is likely that updates to the CSS will include a greater push for public and private sector collaboration. A current push for US-style legislative reforms here focussing on fraud risks in the private sector will also need to cover risks arising from cyber-crime, and this, coupled with updates to the CSS and the development of a formal mechanism for public-private sector collaboration, will further improve the resilience of the financial system.

Taxation

Consistently with the taxation comments foreshadowed in the Interim Report, and having regard to the major review of Australia's taxation system currently being undertaken, and the Tax White Paper due for release in 2015, the Inquiry did not purport to make any express recommendations so far as tax was concerned. However, it did identify a number of taxes that distort the allocation of funding and risk in the economy and indicated that the Tax White Paper should consider reform in these areas. Among the tax distortions identified by the Inquiry were the following:

Negative gearing and capital gains tax

Housing was identified as a potential source of systemic risk for the financial system and the economy. The combined effect of concessional rates of capital gains tax for assets held for longer than a year and the deductibility of interest on borrowings to acquire investment properties was seen as a tax subsidy. Since these tax breaks have long been a feature of the Australian tax system - apart from the short lived attempt to deal with negative gearing in 1985- there would be clear political implications in any attempt to remove this particular tax subsidy.

Dividend imputation

The Inquiry saw the case for retaining dividend imputation as being less clear than in the past. With Australia's economy becoming more open and connected to global capital markets, imputation is viewed as a subsidy for domestic investors, including superannuation funds, to invest in domestic equities. The benefits of imputation have been an important factor in investments decisions by many Australians - particularly retirees relying on superannuation. There would be a political dynamic associated with any attempted removal.

Interest withholding tax

Withholding taxes were said by the Inquiry to generally increase the required rate of return for foreign investors which, in turn, reduces the relative attractiveness of Australia as an investment destination. Where the tax cost is passed on to domestic borrowers this raises the cost of capital in Australia. Lower, more uniform, withholding taxes would reduce distortions. This observation has considerable merit. There do exist exemptions from interest withholding tax in a few tax treaties to which Australia in a party and, otherwise, some large scale borrowings can be structured to take advantage of domestic exemptions - such as the s128F ITAA 1936 exemption for public offers of debt securities. It would be more equitable if a lower interest withholding tax regime were more widely available rather than being confined to those foreign lenders who benefit under a tax treaty or where the borrowing can be structured to utilise an exemption.

Corporate Administration and Bankruptcy

The Report accepts that "Australia's external administration provisions are generally working well and do not require wholesale revision".

ASIC is to retain its supervision of corporate insolvency with recommendations that it be better resourced and "should devote more attention to industry supervision including more proactively identifying and weeding-out misconduct". This approach is consistent with the intentions of the recently released Insolvency Law Reform Bill and stated public intention of ASIC.

One recommendation that should have impact in the insolvency industry is Recommendation 39 that "priority areas of regulations" be made "technology neutral" and that future government policy and regulation adopt the principle of "technology neutrality". The aim of the recommendation is to avoid regulation that "assumes or requires the use of certain forms of technology", for example, a paper based environment. The Report considers that efficiencies should be available from "digital processes that are not being used" in external administration and bankruptcy regulation.

The Report refers to proposals for a US Chapter 11 style framework and protection for directors by a "'safe harbour' to permit restructuring firms in financial difficulty without invoking external administration processes". The Report recognised that more work needs to be done on these proposals without reaching any tentative conclusions on the direction of further enhancement and made a recommendation that further consultation should be undertaken for possible amendments to provide additional flexibility (recommendation 36). This recommendation follows the general thrust of the report of not making major recommendations as the Australian financial system has generally performed well.

Start-ups and crowdfunding

The Report describes certain tax distortions in relation to start-ups and notes the need for better targeted tax settings to facilitate innovation, acknowledgement of the barrier to fundraising caused by existing tax uncertainty around venture capital limited partnerships and recognition of the benefits of more flexible access to R&D tax offsets.

The Report cites stakeholders as suggesting that Australia is already lagging other jurisdictions in the facilitation of crowdfunding, meaning time is of the essence. Equity investment is a critical aspect of the viability of seed-stage and early-stage ventures as banks traditionally do not lend to pre-revenue companies. The costs of preparing a prospectus for most seed-stage and early-stage enterprises would normally be prohibitive. We see meaningful benefit in creating a new special category of small scale offering for crowdfunding which:

recognises the 20 cap on investors is not appropriate and that there is a strong argument that no cap on the number of investors should apply

reassesses the cap of $2m and considers a graduated cap depending on the risk factors associated with the issuer, and

balances these additional risks with a pragmatic basic disclosure regime (where no regime might otherwise apply) as well as reporting with minimal red-tape to ensure an appropriately informed market.

Conclusion

The Final Report is of great significance for the financial sector as its recommendations have the potential to significantly affect how business is done in and by Australia, as well as the cost of doing business. It should also further enhance confidence in the Australian economy and financial system. Of course, we are left with the question of how many of the recommendations are adopted and implemented, and that is as much a question of politics as one of economics.

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