HD **Interim Report of the Murray Inquiry issued – what you need to know**

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Competition and contestability

On balance, the Committee considers that the Australian banking sector is competitive, despite its high level of concentration. On the latter point, the Report observes that concentration has increased since the GFC, "with the major banks' share of total ADI assets increasing from 65.4 per cent in September 2007 to 78.5 per cent in March 2014". According to the Committee, factors such as the historically low level of net interest margins and record high levels of customer satisfaction demonstrate the competitiveness of our banking sector, notwithstanding recent consolidation in what was an already concentrated market.

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At a very high level, the Committee's attitude suggests that the Final Report is unlikely to recommend any far-reaching or urgent reforms designed to improve market-based competition. For instance, the Committee views the maintenance of the "four pillars" policy in the Australian banking sector as appropriate, and does not intend to recommend that it be changed. That being said, the Report notes that the government has a role to play in promoting competition through preventing excessive market power and/or abuse of market power; and by increasing market contestability, although recognising that there is a trade-off between competition and stability. This proposition does not represent a departure from current Australian competition policy.

Two areas in which the Report does explore the potential for competition-enhancing policy changes are regulatory capital requirements and **residential** mortgage-backed securities (or RMBS) (see our comments on "Securitisation" below). On the former, the Report notes that the application of capital requirements is not competitively neutral. The four major banks and Macquarie Bank have had their "Internal Ratings-Based" (or IRB) models approved by APRA, allowing them to utilise lower risk weights for mortgage lending than smaller ADIs, which must comply with the standardised risk weights. The Report identifies a number of potential policy options to deal with this situation, including assisting more ADIs to obtain IRB accreditation, and increasing the minimum IRB risk weights.

More broadly, the Report evinces a nuanced approach to the likely competitive impact of technology on Australia's financial system. It suggests that whilst technology may improve the level of competition in the medium term (by making it easier to compare and switch between products, introducing new business models, etc), there is a long-term risk that the new economies of scales afforded by emerging technologies (particularly in relation to data aggregation) could potentially **lead** to reduced competitiveness. It will be interesting to see how the Final Report manages to balance this double-edged sword.

Stability of the financial system

In his speech to the National Press Club today Mr Murray said that a big issue for the Inquiry has been whether post-financial crisis prudential regulation has gone too far in Australia. Suggestions had been made, especially on regulatory capital, that Australia's regulators have moved far ahead of the pack internationally and that we run the risk of stifling growth. The Report questions some of these claims. In particular, Basel Committee data on actual bank capital ratios suggest that Australia's banks are in the middle of the pack, not out in front.

The Report notes the real cost to the economy of a banking crisis in both the direct costs incurred as well as the indirect effects being the impact on GDP and unemployment as well as costs associated with regulatory measures that tend to be introduced after such crises. These regulatory measures have concentrated the influence of the "four pillars" in the Australian banking sector. The Reports notes the difficult balance that policy makers face in trying to ensure a stable but competitive and efficient banking system.

The Report notes the tension that arises when some financial institutions are considered too-big-to-fail (ie the assumption by investors that some institutions are so systemically important that governments would not allow them to fail) and recommends that the government take measures to reduce the need for government intervention and, controversially, to allow any failure to be dealt with as with all companies - with the losses being borne by creditors and shareholders. Mr Murray said in his speech to the National Press Club today that the Committee was focused on reducing the "moral hazard" problem (ie the risk that perceptions of government support will **lead** to behaviour that increases the likelihood of such support being required).

This perception of an implicit government guarantee created funding/pricing asymmetries which the Report suggests is undesirable, leading some institutions to "become larger than is economically efficient, exacerbating the size of the potential costs of a crisis". Those costs are ultimately borne by taxpayers.

In seeking to mitigate this too-big-to-fail risk the Report appears to be looking for ways in which losses could be imposed on creditors with minimal use of taxpayer funds and how to cover gaps in Australia's regime for dealing with failed or distressed financial banks and insurers There is no direct suggestion that bail-in funds would be used but the G20 commitment to international harmonisation of financial sector regulation points fairly squarely at that approach being considered seriously for Australia. In his speech today to the National Press Club Mr Murray validated that approach by observing that "International standards are no longer an optional extra".

The regulatory gaps identified by the previous Government (including, importantly, lack of regulatory power to deal with a branch of a failed foreign bank) appear to be endorsed by the implication that the regulators' powers should be enhanced to plug those gaps.

The Report recognises the complexity of dealing with the insolvency of financial institutions in a way that minimises the use of taxpayer funds, addresses the perception that some institutions have an implicit government guarantee and minimises the risk of contagion. These complexities include questions around the nature of the liabilities that may best be able to absorb losses in resolution; ensuring that relevant creditors are capable of bearing loss without systemic contagion; appropriate mechanisms and triggers for imposing losses on creditors; interaction with the existing regulatory capital framework; and the effect on funding costs in normal times.

The Report views favourably an "internationally consistent approach to promote a level playing field globally" with a view to possibly implementing:

the ability to impose losses on particular classes of financial institution creditors, including 'bail-in' options such as converting creditors' debt into **equity**; and

ensuring funding is available to systemic institutions to sustain critical services, which funding might include bridging finance or bail-ins to facilitate an orderly **wind**-down.

Planning for the next crisis

In considering systemic risk and how to plan and protect Australia from the next crisis, the Report injected some realism into the analysis by stating that "the next financial crisis never looks quite like the last." However, when considering what else could be done to plan for the next crisis, the Report indicates that there are practical difficulties in using macroprudential tools. There is caution expressed about powers that would allow regulators to go beyond the "prudential perimeter", stating that "for two decades, Australia has effectively navigated systemic risk without the kinds of tools being introduced in some countries."

This is a little surprising and at odds with the remarks made elsewhere in the Report about the weight of evidence suggesting that a more conservative approach to regulation has not placed Australian banks at a significant disadvantage (possibly, code for "that approach helped avoid a recession in Australia"). It is also does not seem to acknowledge the need for the restoration of trust in financial institutions, a point made very strongly recently by Ashley Alder, the CEO of the **Hong Kong** SFC. His view being that prudential regulation can only go so far in protecting against risk; behavioural change to avoid LIBOR-type scandals in the future being the companion piece that regulators must use.

Good bank / bad bank ring fencing

In a global context, economies that experienced first-hand the catastrophic failure of financial institutions providing retail services as a result of the GFC have faced significant political pressure to ensure such collapses could not re-occur. The most extreme method adopted in other jurisdictions to address this concern has been to ring-fence retail banking operations from investment or other riskier banking operations. This has been most prominently observed in the Banking Reform Act 2013 adopted in the UK following the Vickers Inquiry.

While, there is no doubt that this is an effective method of addressing this issue, we query if such a disruptive and costly exercise would be appropriate to the Australian market given the relatively minor proportion of investment banking or similar operations undertaken by our major retail financial institutions and the relative strength and security of those institutions. On the other hand, we believe that even if this kind of regulatory reform if not fully pursued in Australia, the consequences of the foreign regulatory changes should be carefully considered from the perspective of ensuring clean international integration and harmonisation of the regulatory framework for financial institutions.

Another key policy consideration identified by the report is the funding advantages obtained by our largest institutions due to counterparties viewing them as essentially government backed as a result of their too-big-to-fail position within the financial system. A key consequence of any separation of divisions within such banks would be that the riskier part of the bank would expect to lose that implied government backing.

Bank capital and funding

The Report recognises that it is difficult to ascertain whether additional capital and liquidity requirement will materially affect banks' pricing or access to local or offshore funding. Elsewhere in the Report, it is noted that capital and liquidity arrangements do impose constraints on banks and that this could limit banks' ability to finance projects and slow the rate of fixed capital formation.

The view appears to be that holding more capital and having tighter liquidity requirements enhance financial stability and confidence and therefore may reduce wholesale funding and deposits costs and therefore the cost of that type of funding.

But this comment does not fully recognise that Australia's present, let alone future, funding needs, cannot be satisfied from domestic wholesale investors and retail deposits.

The Committee observes that the funding mix for banks has changed as "deposits now represent a larger share of bank funding than they did before the [financial] crisis". It is also noted that superannuation funds are a rapidly growing sector of the deposit base. Deposits held by superannuation funds tend to be held for a shorter period, resulting in ADIs having to hold a larger pool of this type of deposit than if they were retail deposits. APRA's liquidity cover ratio requirement means that deposits by superannuation funds are somewhat more costly retail deposits.

This observation by the Committee suggests that if bank funding through superannuation fund deposits continues to grow, this will not necessarily help banks to fund Australia's growing infrastructure and other economic needs. This is a real conundrum for APRA as regulator of both superfunds and banks. Perhaps some solution lies in APRA treating superannuation fund deposits as having greater eligibility for liquidity cover ratio purposes, than retail deposits.

Shadow banking

The Report briefly addresses risks from shadow banking but not suggest options for the regulation of shadow banking, despite identifying funding by unregulated entities it as a potential offshore systemic risk. Given the acknowledgement of Australia's interconnectedness with the global financial system, it is surprising that authors seem to accept the Council of Financial Regulators' conclusion that shadow banking is a low risk to Australia's financial stability.

Securitisation

Helpfully, the Report notes that the securitisation is a useful part of the competitiveness of Australia's home loan market and acknowledges the need through the financial crisis, for some government support. However, there does not seem to be any strong indication that further government intervention in the RMBS market is required. Further input is sought on the possibility of allowing RMBS to be treated more generously as high quality asset for bank liquidity purposes. The recovery in the securitisation market and the increased competition amongst home loan lenders seems to have led the authors of the Report to conclude that price correction rather than market failure has caused changes in the RMBS market. Strikingly, there is very little mention of how securitisation techniques could be used in relation to other assets and why that could inject competitiveness and greater funding diversification in those sectors.

Corporate bond market

The Report indicates that the size of the Australian corporate bond market is broadly consistent with that of other advanced economies, other than the US. However, it then points out the various factors that have led to a smaller than desired, corporate bond market (eg lower investor appetite for fixed income securities, offshore debt markets more attractive to issuers due to longer tenor and depth of market, greater disclosure burden on issuers).

While the Committee is seeking further information on some issues, the passing reference to the apparent adequacy of the proposed "simple corporate **bonds**" legislation suggests that the final Report is unlikely to suggest any radical changes to either the disclosure regime (and its concessions) nor to the liability position of rating agencies that issue rating on corporate **bonds**.

RMB market

As **China** eases capital and currency market restrictions, RMB denominated trade and capital inflows into Australia are expected to grow substantially. The Report welcomed this prospect as it presented increased opportunities for Australian corporates to access capital from Asia and for Australian and Asian financial services firms to expand into each other's markets and to grow financial services exports and imports. The Report noted a recently set up forum for Australian and **Hong Kong** banks and corporates to discuss the benefits and challenges of RMB trade and investment. While the Report acknowledged that the development of the RMB market in Australia will largely be private sector led and depend on **commercial** and market factors, the Committee believes governments have a key role in initiating structural reforms such as currency and foreign exchange liberalisation and cross-border dialogue. The Report described recent Australian Government steps in this area, such as a bilateral local currency swap agreement between the People's Bank of **China** and the RBA in 2012, direct trading between the Australian dollar and the RMB in 2013 and plans for a future RMB clearing and settlement facility in Sydney.

The Committee has asked for further information on the potential impediments to Australia's integration with financial markets in Asia, how removal of these would benefit the Australian economy and what future government engagement is needed to facilitate this integration. Consistent with comments in this Interim Report, the Final Report is likely to recommend further education and engagement and government-led liberalisation measures to assist Australian companies to take advantage of projected greater RMB trade and capital inflows.

Corporate funding more generally

SMEs: the Report states that financing conditions for small and medium enterprises (or SMEs) could be improved and recognises that "information asymmetries are the most significant structural factor contributing to the higher cost and lower availability of credit for SMEs and can be a barrier to competition in barrier lending".

In particular, it notes that SMEs typically have less documentation and shorter financial histories. In addition, as the SME sector is diverse, lenders may not necessarily have expertise in, and knowledge of, particular industries. Because of these information asymmetries, there are higher risks associated with lending to SMEs, which are passed on to the SMEs by way of higher interest rates on loans.

The Report also refers to lenders requiring more security against business loans, such as **residential property**. There is a concern that the requirement for collateral in connection with SME loans may result in loans being made to businesses with the best collateral, as opposed to those business with the best business prospects. This requirement also disproportionately disadvantages younger Australians and new ventures who are less likely to have collateral such as **residential property**.

Another factor affecting access by SMEs to funding is the higher fixed costs of SMEs raising funds in capital markets. The Report notes that for SMEs and mid-caps (being ASX-listed companies with a market capitalisation below $300 **million**), the costs of issuing **equity** can be prohibitive and are disproportionately greater than the costs of **equity** issues by larger corporates. In particular, the costs associated with the requirement to prepare a prospectus and presumably higher promotional costs which are incurred due to those companies not being as well known may discourage SMEs and smaller companies from raising funds in capital markets.

The Report notes that submissions have suggested that the exceptions to the requirement to prepare a prospectus could be broadened or amended (including by increasing the thresholds for the exemptions for low-value capital raisings such as the "20 in 12" exemption). In our view, this would be a positive measure for SMEs.

The Report asks for views on the costs and benefits associated with the proposed development of an SME finance database which would reduce information asymmetries between lenders and borrowers. It is proposed that this database would provide business-level data to lenders and potential new market entrants, including information from tax returns, business activity statements and lenders.

While it is positive that the Committee has recognised and is seeking to address information asymmetries in lending to SMEs, the proposed finance database would only be successful if businesses and lenders were willing to provide such information. Privacy concerns would also need to be addressed and the database would only be useful in assisting lenders to understand business prospects in certain industries if information on the database was provided by a large number of businesses across a number of industries. The time and cost associated with developing and populating such a database such that it provides useful information may also be a disadvantage of this proposed initiative.

The Report also asks for views on changes to the size and scale of offerings that can be made without a prospectus and further information on whether there is a need to introduce differentiated markets to allow greater access to **equity** markets by smaller companies. Such changes would facilitate access to **equity** funding by SMEs but protections for investors (particularly unsophisticated investors) would need to be carefully considered.

Private **Equity** and Venture Capital: The Report refers to trends in financing provided by venture capital and private **equity** funds, specifically being that these funds typically finance businesses which are more innovative and high-growth. The Report recognises that new ventures have limited access to credit, as a result of the typical years of development which are required before cash flows are generated and the higher risks associated with those ventures. In addition, fee structures of venture capital and private **equity** funds may be discouraging to investors and limit the success of domestic venture capital and private **equity** funds.

The Report refers briefly to the tax treatment of Venture Capital Limited Partnerships (or VCLPs) and the submission from the Australian Private **Equity** & Venture Capital Associated Limited which states that some features of the VCLP tax framework put Australia's funds management sector at a competitive disadvantage.

The Report seeks further information on the best options for improving the tax treatment of VCLPs, in a bid to increase the success of domestic venture capital and private **equity** funds and facilitate access by new ventures to funding from such funds. While this is a positive step, the Report does not refer to specific proposals to improve the tax treatment. It is disappointing that this issue has not been considered in more detail given that these issues were raised as early as 2011, when a **Board** of Taxation Review made recommendations to simplify and reduce uncertainty with respect to the tax treatment of VCLPs.

Agribusiness: The Report briefly refers to financial issues which affect the rural sector, particularly with respect to the volatility of income and difficulty experienced by farmers in meeting debt repayment obligations in periods of low revenue.

However, the Report notes that the first round of submissions did not identify significant structural issues related to rural finance and did not make any suggestions or call for comments with respect to the financial issues which affect agribusinesses.

It is to be hoped that the Final Report will go beyond recognising the industry-specific issues that agribusinesses have in meeting debt repayment obligations in certain periods, to encourage alternative means of funding for agribusinesses such as **equity** funding through co-investment structures.

Technology and cyber-security

The Report highlights cyber security and technology related fraud as an emerging trend for the financial services industry that presents many challenges. It notes that the rapid pace of technology change has already had a significant impact on both consumers' interaction with the financial system and how the system functions. Specifically, the Committee looks to US and UK examples for fighting cyber-crime as options to be considered here.

The Committee also calls for proposals about the costs, benefits and trade-offs of reviewing and updating 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 collaboration. The Report notes concerns that the CSS is out of date and that it 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, the Committee notes that collaborating with government can help institutions fine tune their efforts. One specific model under consideration is the Financial Services Information Sharing and Analysis Center (FS-ISAC) in the US, which is a collaboration between financial institutions and government.

Coupled with the current shift in focus by the Australian Government towards greater prevention of fraud and corruption in the public sector (through the introduction of the Public Interest Disclosure Act 2013 (Cth) among other initiatives) as well as recent suggestions of a push for US-style reforms here in the near future focussing on fraud in the private sector, consideration of overseas models specifically targeting cyber-crime would be a welcomed approach.

Financial services

The inherent shortcomings of the mandatory financial services disclosure regime is a recurring theme in the Report and ASIC's call for higher penalties, banning orders and more regulatory intrusion into product development and distribution appears to be gaining traction given the availability of these "regulatory tool" to overseas regulators.

Many of the observations relating to the shortcomings in the superannuation and wealth management sectors were made as part of the Cooper Review in 2010, which led to the significant StrongerSuper and Future of Financial Advice reforms. Given the recent implementation of those reforms, the focus appears to be on fine-tuning the new regulatory settings. The one exception is income products, which were put in Cooper's "too hard basket", as both compulsion and tax concessions were seen as unpalatable by the community and government for different reasons. Cracking this chestnut is the Inquiry's biggest wealth management challenge given retirees' preference for lump sums on retirement.

In relation to technology in this space, the Report echoes the global trend to encourage product issuers to use big data and technology to build and distribute more "suitable" financial products, improve financial literacy and develop interactive tools to enable financial advisers and consumers to test the suitability of financial products. In this regard, all stakeholders are seeing technology as providing an opportunity to develop more effective consumer centric engagement strategies to address some of the inherent shortcomings of the current financial services regulatory regime.

Consumer protection

The Report recognises the need for a "balanced and effective consumer protection framework" in the financial sector due to product complexity; low levels of consumer financial literacy and engagement; and the significant effects of poor decision-making with respect to financial products and investment.

Since the Wallis Inquiry of 1997, it has generally been accepted that disclosure is one of the key planks of an effective consumer framework. However, this Inquiry queries whether this has been effective in observing that current disclosure practices have been driven by an "industry culture of legal compliance, rather than a focus on how best to inform consumers". The result has been "lengthy and complex documents" that do not fulfil the aim of providing consumers with the necessary information to make informed decisions regarding the suitability of financial products to meet their individual needs. The Report suggests that this is due to too much legal and financial jargon being used, poor financial literacy standards of most consumers, language barriers and consumers being time poor.

The Report also suggests that the focus on disclosure as the primary tool of consumer protection has proven to be insufficient and may not be the most appropriate tool to deal with particular market problems (citing by way of example, conflicts of interest and the misalignment of the interests of issuers and distributors of financial products with those investors). The Report favourably cites other current (and more recent) regulatory solutions to address consumer protection, including mandated detailed design requirements (such as those introduced for MySuper products) and the Insurance Contracts Act 1984 and the ban on an unfair contract terms.

To the extent that disclosure is maintained as a principal consumer protection mechanism, the Report recommends possible improvements by way of:

Layered disclosure: by which consumers are provided with relevant information at the relevant time.

Better information presentation: directed at shorter disclosure documents, plain English and use of graphics.

Improving consumers' ability to understand risk: by use of product dashboards and standardised disclosure formats.

Online comparators and choice engines: through use of third party providers and online tools which (perhaps controversially) depend upon greater access to consumer data and product information.

One further innovation in this area suggested by the Report (drawing on recent experience in the United Kingdom) involves enhancing ASIC's powers to permit the regulator to intervene in the market to address specific issues with financial products and to periodically review financial services industry sectors to ensure product's and governance standards are fair to consumers.

Payment Systems

The Committee was of the view that regulation of credit card and debit card payment systems was required in order for competition to lead to more efficient outcomes. However, systems that perform similar functions were treated differently because of differences in structure and this may not be competitively neutral. The Committee is clearly referring to the fact that four party schemes such as MasterCard and Visa are currently regulated whereas three party schemes such as American Express and Diners Club are not currently regulated. The Committee recognised the need for consistent regulation.

The Report also considered that interchange fee caps have improved the functioning of the four-party payment schemes. However, in an apparent reopening of the previous inquiries into the regulation of payment systems in Australia, notably by the RBA and also the ACCC, the Inquiry invited views on the following policy options:

no change to current arrangements;

lower interchange fees, ban interchange fees, expand interchange fee caps or remove interchange fee caps;

cap merchant service fees or cap differences in interchange service fees between small and large merchants;

require acquirers to enable merchants to choose which scheme to route transactions through and provide merchants and customers with real time pricing information regarding interchange fees and merchant service fees;

allow schemes to reintroduce "no surcharge" rules, broaden the ban on "no surcharge" rules or enforce reasonable cost recovery in surcharging.

The Report noted that the complex structure of retail payment systems and the level of public interaction with them, has resulted in the sector's regulation being fragmented and unnecessarily complex. Further information was sought to simplify the regulatory framework for retail payment systems and their participants.

Infrastructure financing

The report affirms the important role of funds as backers of infrastructure projects and endorses the view of the Productivity Commission in its recent Public Infrastructure report suggesting that there is no shortage of private sector capital available for investment in Australian infrastructure.

Our recent experience advising market participants in highly competitive bids for availability based PPP concessions, privatisations and even secondary equity transfers and debt refinancings in existing infrastructure assets also supports that view. A consensus has been developing as to key project risks and appropriate pricing of such risks and so many transactions become "cost of capital shootouts" that are decided by very small margins. The funding costs and deep pool of internal resources at larger global players, in particular North American pension funds and Asian/Middle East sovereign wealth funds means that they are well placed to be successful in these bids. On the other hand, Australian superannuation funds, particularly mid-sized funds, have indicated that they have significant difficulties in deploying capital allocations into this sector due to the illiquid secondary market and lack of internal investment expertise. Mr Murray confirmed this in his National Press Club speech today, observing that the Australian superannuation system "by international comparisons appears heavily weighted to riskier assets, mostly equities."

So, whilst the availability of efficient debt and equity funding to develop the extensive pipeline of Australian infrastructure requirements would appear to be secure, to our mind the key policy question to be considered in the context of this Inquiry is to what extent the government should be seeking to influence the composition of the investor base capable of successfully executing investments in the infrastructure space. To promote the ability for smaller and mid-sized domestic investors (in particular the superannuation funds managing such a significant proportion of our national wealth) to participate in this sector, consideration could be given to providing appropriate backing for a liquid bond market to develop for issuers of these kinds of investments. That support could include a government-backed infrastructure funding corporation that could provide credit-wrapping of infrastructure bonds or standby liquidity facilities to eligible projects. A quicker fix would be for EFIC's powers to be widened to allow it to support onshore infrastructure projects.

Governments could also give consideration to relaxation of change of control restrictions in project agreements to more easily facility secondary equity transfers, particularly for passive financial investors into post-construction phase projects with long term operations and maintenance services contractually confirmed. The State consent to change in control process can be time consuming and costly and would appear to be of limited benefit to any stakeholder in these circumstances.

International Integration

All of Chapter 10 of the Report is dedicated to the key emerging trend of international integration. The Report notes that Australia has benefited substantially from financial integration with the rest of the world and also notes that the weight of the world's economic activity is shifting to the Asian region which presents significant opportunities and challenges for the Australian financial system. Importantly, the Report supports further financial integration but on the proviso that it does not compromise appropriate standards for financial stability and conduct in Australia. The Report's approach is focused on reducing impediments to further financial integration, supporting enhanced mutual recognition and equivalence processes and supporting Australian regulators continued participation in international standard setting bodies. The Report also states that pro-active government action will be required including improving Australia's coordination effort.

This is terrific news for the broader banking and financial services sector in Australia because it is a clear signal that it is likely the final Report will suggest a number of changes which are designed to achieve the outcome of further financial integration. This outcome will produce benefits for Australia including:

increase in investment flows within the region;

Asia is likely to become a more important additional source of capital for Australian banks, corporates and fund managers;

Asian financial markets will become a more important investment destination for Australians;

increased RMB trade settlement and investment;

even further integration of the Australian funds management industry in the region (building on the Asian Funds Passport Initiative, which the Report describes as a significant first step to better integration with the region).

On this basis the Report (and the final Report) can be expected to build on the recommendations of previous enquiries and reviews including the 2009 Johnson Report.

While not explicitly addressed in the interim report, we believe that an analysis of the Foreign Acquisitions and Takeovers Act 1975 and the ownership restrictions in the Banking Act 1959 and Financial Sector Shareholdings Act 1998 will also be a worthwhile part of the overall regulatory review, particularly in the context of the global re-organisation of banks resulting from similar post-GFC regulatory reform.

Corporate governance

The Report has identifies two apparent issues concerning corporate governance of Australian financial institutions:

there is apparently a lack of delineation between the role of the **Board** and that of senior management, both within financial institutions and by regulators (particularly APRA); and

there is a "diversity of duties" of governing bodies in different parts of the financial industry.

Regarding the first, the Report calls for views on whether there is a need for change. If there is a need for change, the Report appears to be considering recommending:

a review on prudential requirements on Boards to ensure that they are "not drawn into operational matters"; and/or

that regulators, and in particular APRA, continue to clarify its expectations of Boards.

Not surprisingly, the Inquiry appears to accept that the role of Boards is not operational and appears to be seeking to protect Boards from the encroachment of operational responsibilities on their governance and strategic role.

This approach is a positive for Boards and the financial system more broadly. It suggests that there is no need to change the roles of the **Board** and senior management but simply a case for defining them more clearly. To take an example, the Centro litigation concerned the level of care directors are required to take in signing off annual accounts. Middleton J found that the preparation of books and accounts can be delegated by the **Board**.

However, directors must still independently make decisions about the accounts and ultimately cannot abdicate responsibility. If the role of directors can be more clearly defined (including in relation to signing off annual accounts), it must follow that the risk to directors of failing to meet those duties will reduce - with the consequence that litigation such as that against the directors of Centro and similarly James Hardie will be less frequent. More importantly for the Inquiry's purposes, the Boards of financial institutions will be more robust.

If the Inquiry ultimately recommends a review on prudential requirements on Boards to ensure that they are "not drawn into operational matters", the US Sarbanes-Oxley Act may provide a useful guide as it places some requirements on management in addition to directors. However, in the course of any review, the words of Federal Reserve Governor Tarullo, quoted in the Report should also be remembered:

"But it has perhaps become a little too reflexive on the part of regulators to jump from the observation that a regulation is important to the conclusion that the **board** must certify compliance through its own processes. We should probably be somewhat more selective in creating the regulatory checklist for **board** compliance and regular consideration."

It will be interesting to see whether the Inquiry's overall recommendations are influenced by current American writing and practice in relation to the defining of the roles of the **Board** and the management, including the roles of the Chairperson and the Audit, Risk and Compliance committees.

The Report notes that there is a "diversity of duties" of governing bodies in different parts of the financial industry without making much comment. It simply seeks further information on whether that is appropriate.

It lists a number of sources of the duties owed by Boards. In addition to the sources listed in the Report, directors (whether of a financial institution or otherwise) also owe fiduciary duties to the **company** and, indirectly, to shareholders.

The Report also considers the question of remuneration. No policy changes to the regulation of remuneration are suggested and the approach taken by Australian regulators to date is said to 'appear appropriate'.

Insolvency generally

The Report touches on Australia's insolvency regimes. It notes that Australia's insolvency laws are criticised as being biased towards liquidation because of our strong laws against insolvent trading and that the existing arrangements are too complex and costly for SMEs.

The Report is not in favour of Australia adopting the US Chapter 11 regime on the basis that it is costly, leaves the **company** in the control of those responsible for its difficulties and creates uncertainty for creditors by limiting their rights - these arguments against are well known and have been a feature of this debate for many years. The Report is doubtful of whether the existing regime causes businesses to fail and seeks empirical to support that view.

On a positive note, the Report endorses the implementation of the Australian Government's 2012 proposals to improve practitioner competence, align corporate and personal insolvency and promote market competition.

Taxation

The Report noted that the Inquiry's role was not to make recommendations on tax issues but that it would be providing its observations to the Government's forthcoming Tax White Paper. Still, there are some interesting observations:

Tax treatment of housing: the Committee noted the favourable treatment of housing under the tax and transfer system. Returns on owner-occupied housing, such as imputed rent and capital gains, are exempt from tax and as a consequence housing is very attractive for saving. There may however be an inefficient level of consumption of housing services. The favourable tax treatment of investor housing, such as the tax deductibility of interest expenses and the concessional tax treatment of capital gains, encourages leveraged and speculative investment in this sector. This is seen by the Committee as a significant source of risk for the financial system and the economy.

Dividend imputation: the future of dividend imputation, which has been a feature of Australia's tax system since 1987, has been called into question. Imputation was seen as a subsidy to domestic **equity**, making equities more attractive as a savings vehicle. This has contributed to domestic investors, particularly superannuation funds, holding domestic **equity** relative to foreign **equity** and other asset classes, resulting in less diversified portfolios. It is also seen as contributing to the lack of a deep, liquid domestic corporate bond market and a low demand for annuities.

Venture capital limited partnerships: VCLP structures offer concessional tax treatment for certain types of investors in relation to particular types of investments. However the VCLP tax rules were seen as being complex and a possible barrier to fund raising. These barriers may be able to be reduced by adoption of a recent **Board** of Taxation review to simplify the VCLP tax regime. The Committee is seeking further submissions on the best options for improving the tax treatment of VCLPs.

Financial integration tax issues: the Committee reviewed some tax settings in Australia that submissions suggested distorted international financial flows. Interest withholding tax was identified as distorting the funding decisions of financial institutions and placing Australia at a competitive disadvantage internationally. This may be referred by the Committee to be considered by Australia's Tax White Paper. The deductibility of interest paid by an Australian branch of a foreign bank to its parent being capped to the LIBOR rate, and which may not reflect the true cost of raising funds, was also identified and may be considered by the **Board** of Taxation in a forthcoming report.

Goods and services tax (GST):GST is not levied on most financial services. This could result in households over-consuming financial services compared to what they would otherwise do if GST was applied to these services. In contrast, because businesses cannot claim input tax credits for financial services, and therefore pay a higher price for them, they may consume less financial services than they otherwise would. It was recognised that levying a GST on financial services was difficult.

Crowd funding

It is noteworthy that the Report has not made any particular observation on crowd funding. It appears to be content to leave the Government to consider the 200-odd page CAMAC report on the future shape and form of regulation of the crowd funding industry. That report recommends a specific type of corporate entity for this type of fundraising and a tailored regulatory structure.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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