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An Unexpected Sea Change

Update on Regulatory Reform to Australia's Financial System

Over the past two decades, Australia has become one of the world's wealthiest nations and developed a surprisingly large financial services sector. A once-in-a-generation review of this small but impactful nation's financial system will likely alter financial life for all Australians while creating challenges and opportunities for all operators in the market.

The Murray Inquiry

The sheer size of the Australian financial services segment is difficult to overstate, which is why this week's **Interim Report from the Financial System Inquiry** has generated so much interest from all sides of the market. Chaired by former Commonwealth Bank chief executive David Murray, the inquiry was tasked with "examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth." After reviewing thousands of pages from over 280 submissions representing the whole of the nation's financial market participants, from banks to brokers and regulators to industry associations, the Panel released its much anticipated interim report this week.

The report makes no firm recommendations and is non-binding, but its pithy "observations" carry substantial weight and have captured the attention of the nation's financial professionals who see clear change on the horizon.

The 460 page report leaves few corners of the Australian financial system unturned, broadly finding the system to be "competitive, albeit concentrated," and well suited to the needs of the country and the population. At the same time, the report bravely challenges some of the most fundamental aspects of the financial system and assesses the risks they carry for the country.

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Superannuation

Far from being the anodyne, comfortably neutral review widely expected by the market, the report takes clear aim at the country's massive US$1.5 trillion superannuation system, the world's fourth largest retirement savings scheme. The panel observes that *"There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system."* Efforts at reforming the super sector in recent years have yielded little to no benefit for consumers, while structural circumstances and general consumer disengagement have allowed costs to remain high by international standards despite clear competition in the market.

In its most radical suggestion to drive down fees in superannuation, the report considers introducing a new "default" superannuation scheme for *all* Australians who do not elect their own fund. This follows the experience of Chile which in 2008 introduced a single, national default fund following a public auction; fees have since fallen 65%.

Taxes

Criticism of the superannuation system has been historically quiet given the broad success of the system, but criticism of Australia's peculiar tax regime may be even more anathema. Australians enjoy not only deductions for paper losses on rental income from investment properties, but also a "dividend imputation" system which provides tax credits to investors who receive dividends from their equity investments (the theory being that dividend payouts have already been taxed at the corporate level and should not be taxed again at the personal income level). The Inquiry politely notes that such credits "create a bias for individuals and institutional investors, including superannuation funds, to invest in domestic equities," with clear consequences for asset allocation.

Retirement

For the inquiry's Panel members, superannuation and the coming wave of retirees are likely the most significant risk to the financial system and the economy. Use of income products such as annuities or account-based pensions is worryingly low: "the size of Australia's annuity market is only around 0.3% of GDP, compares with 28.8% in Japan, 15.4% in the US and more than 40% of GDP in some European countries." This leaves longevity risk primarily resting on the Government and

its age pension offering to senior Australians with insufficient retirement saving.

Too big to fail

Of course, no financial system inquiry would be complete without a discussion of "too big to fail." Australia's largest financial institutions have largely benefited from a market perception, entrenched by government actions around the world during the global financial crisis, that they will receive government support in the event of a failure or crisis. Here the panel has used a combination of international precedent and carefully-considered domestic circumstances to suggest that Australia's largest banks may be required to hold additional capital given their relative market size.

Other issues raised in the report are more in line with the market expectations. These include:

- enhancing supply, demand and liquidity in Australia's relatively small fixed income market;
- expanding and clarifying the role of Australia's regulators;
- appropriately regulating new technology-based entrants and potential shadow banking entities in the system;
- maintaining trust and security in digital commerce;
- ensuring that Australian financial institutions are optimally placed for integration with Asia;
- making more digestible and easier to comprehend disclosure for financial products; and
- ensuring the integrity of financial advice.

The full report is available at fsi.gov.au.

Implications

The report carries large weight in the market and is being taken seriously by participants.

Many international financial services organisations have entered the Australian market in the past two decades, lured by sustained economic growth and eyebrow-raising margins on their services which would be near impossible to find in comparable developed markets.

The inquiry has not formalised its recommendations yet; that report is expected in November following another round of industry consultation, and even then the recommendations are non-binding. But the report carries large weight in the market and is being taken seriously by participants.

Over the next two weeks, the Panel members will be travelling overseas to Hong Kong, London and New York for consultation with international stakeholders on the process. In the meantime, we see five likely outcomes from the debate at this stage:

- **Fund managers and service providers will likely face margin pressure.** Superannuation funds, including the not-for profits, have relied heavily on armies of asset managers, consultants and scores of service providers to support their operations. Fees across the supply chain are likely to come under fierce pressure as the whole of the super industry begins cutting costs.
- **Allocation to fixed-income products will likely increase,** and Australian fund managers typically have less specialised expertise in this asset class than equities or alternatives. Debt issuers, fixed-income trading desks and product providers could be major beneficiaries of efforts to deepen this underdeveloped market.
- **Changes to Australia's tax system are on the public agenda now.** Previously sacrosanct topics such as "negative gearing" and franking credits have faced their first true challenge in the public debate. While popular, these distortive policies are becoming increasingly difficult to defend and may begin to slowly phase out.
- **Australia is looking to create a framework for a secure digital identity which could become a global model.** A concerted, unified effort to create a portable and secure identity across the internet and digital channels is under consideration. Other markets are pursuing similar initiatives, but if Australia can develop an economy-wide solution it could serve as the blueprint for other countries looking to establish similar mechanisms for security in the digital ecosystem.
- **Banking regulations and capital requirements will likely become more restrictive, or at least stay at their current level.** Australia's prudential framework means that local banks are relatively well-capitalised by international standards; they will likely need to be even more capitalised. Meanwhile the authority and independence of Australia's regulatory bodies will be enhanced through better funding and clearer mandates.

The Murray Inquiry has set the stage for a future financial system which is risk averse, highly-capitalised and carefully focused on consumer protections. International financial services organisations should keenly read the interim report to calibrate their strategy in this market.

For the Aussies, this is their chance to show the world what good banking regulation can look like.

Context: Australia's Retirement Scheme in its 20s

For a country of less than 23 million people, Australia punches above its weight in financial metrics. It is the world's 12th largest economy by nominal GDP with the world's 10th highest GDP per capita. The Australian Securities Exchange is the 11th largest stock exchange by market capitalisation with a diversity of listed corporations freely accessing domestic and local capital.

A developed and predictable legal and regulatory framework, relative proximity to Asia's expanding economies and an abundance of critical natural resources has powered the Australian economy continually since the early 1990s.

Superannuation is now the world's fourth largest retirement savings scheme by total assets, managing over US$1.5 trillion.

Despite a recent slowdown in global demand for Australia's primary exports, iron ore and coal, GDP has grown every year since 1991, even expanding through the global financial crisis (colloquially called the "GFC") between 2008 and 2010. Average annual GDP growth over the past 23 years has been approximately 3%, with no period of contraction.

A parallel expansion of wealth has occurred in the country's compulsory retirement scheme, **superannuation**. Born of bilateral agreements between unions and employers, the federal government in 1992 enshrined a compulsory "superannuation guarantee" that required all employers to contribute an additional portion of employees' salaries to a tax-sheltered retirement saving vehicle. Starting with a 3% contribution, current regulations require employers to contribute 9.5% of salaries to superannuation.

Since its inception, this retirement savings system has expanded rapidly, now managing over US$1.5 trillion in total assets. Australia's superannuation scheme is now the world's fourth largest retirement savings scheme by total assets, having grown at a compound annual growth rate of 14% over the past 10 years.

No other nation can claim such rapid expansion in pension assets, and the economic weight of the superannuation scheme now represents more than 100% of the entire economy.

While closely monitored by the prudential regulator, the superannuation segment is relatively privatised. Assets are held in defined contribution, not defined benefit, schemes. Funds are managed by a mix of not-for-profit managers ("industry" funds) and private financial services firms ("retail" funds), while an increasing portion of the population is electing to directly manage their superannuation savings ("self-managed superannuation funds", or SMSFs). Given that the system itself is still, in aggregate, in accumulation phase with limited payout liabilities, investment allocation is heavily skewed towards growth assets such as equities and real estate.

All of this expansion has manifested itself in a dramatic rise in personal wealth, which when coupled with a strengthening of the local currency has provided Australians with unprecedented international purchasing power. Increasingly, Australians are turning to wealth management professionals to grow their newfound fortunes, and this fortune is dramatically concentrated in the nation's remarkably large financial services sector. Of a total ASX capitalisation of approximately AU$1.5 trillion, over AU$400 billion is represented by the country's four largest banking institutions.

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