

# Centre for International Finance and Regulation

## Submission to the Financial System Inquiry

May 2014

AUSTRALIAN UNIVERSITY PARTNERS



GOVERNMENT PARTNERS



RESEARCH CENTRE PARTNERS



INDUSTRY PARTNERS



**Peter Mason AM**

Chairman

The Centre for International Finance and Regulation (CIFR) was delighted to host the Financial System Inquiry (FSI) Workshop at Sydney's Westin Hotel on 7 May 2014. The Workshop was developed in collaboration with the FSI Secretariat and brought together senior representatives of the FSI Panel and Secretariat, government, regulators, academia and industry to hear presentations from 45 industry and academic experts, and discuss key issues impacting the Australian financial industry.

This report brings together a variety of outputs from the Workshop, including summaries of all of the presentations, copies of the speakers' presentations, photos and video footage.

CIFR is a Centre of Excellence established to address fundamental issues affecting the Australian financial industry through research and education. Its mission is to promote financial sector vibrancy, resiliency and integrity, supporting Australia as a regional financial centre through leading research and education on systemic risk, financial market developments, and market and regulatory performance.

CIFR's activities are funded by the Commonwealth and NSW Governments, consortium member universities and research centres, and industry partners. Our consortium member universities are UNSW Australia; The University of Sydney; Macquarie University; University of Technology, Sydney; The University of Melbourne; The Australian National University; Capital Markets Cooperative Research Centre (CMCRC); and Securities Industry Research Centre of Asia Pacific Limited (SIRCA). Our industry partners are KPMG, the Commonwealth Bank, Macquarie Group and King & Wood Mallesons.

Since 2012 CIFR has funded 47 research projects, involving over 100 researchers and combined cash and in-kind funding from CIFR and its consortium members of over \$18 million. More than half of these projects involve highly regarded academics from overseas universities.

As CIFR's Chairman, it is my great privilege to commend this report to you.



*Peter Mason AM, CIFR Regulator Briefing – The Westin (March 2012)*

# CIFR WORKSHOP

Financial System Inquiry The Westin Hotel Sydney – 7 May 2014

## PROGRAM

---

<b>Welcome and Introduction:</b> Professor David Gallagher	Page 4
<b>Plenary Session – Keynote address:</b> David Murray AO	Page 5
<b>Plenary Session – Panel address:</b>	
• Emeritus Professor Robert Officer AM	Page 7
• Alan Cameron AO	Page 9
• Tom Karp	Page 10
• Mike Callaghan AM	Page 11
<b>BREAKOUT SESSION ONE</b>	
• <b>Markets</b> – Professor Mike Aitken; Professor Terry Walter	Page 13
• <b>Banking</b> – Professor Ross Buckley	Page 16
• <b>Superannuation &amp; Wealth</b> – Dr Scott Donald; Professor Susan Thorp	Page 19
• <b>Insurance</b> – Associate Professor John Evans	Page 22
• <b>Financial Advice</b> – Professor Kevin Jameson; Professor Dimity Kingsford Smith	Page 24
<b>Keynote address:</b> Professor Patrick Honohan (via video), introduced by Steve Harker	Page 28
<b>BREAKOUT SESSION TWO</b>	
• <b>Markets</b> – Professor Mike Aitken; Professor Terry Walter	Page 31
• <b>Banking</b> – Professor Deborah Ralston	Page 34
• <b>Superannuation &amp; Wealth</b> – Dr Scott Donald; Professor Susan Thorp	Page 36
• <b>Foreign Capital &amp; Investment</b> – Professor Justin O’Brien; Dr Megan Bowman; Dr George Gilligan	Page 41
• <b>Portfolio Management &amp; Disclosure</b> – Professor David Gallagher; Dr Zhe Chen	Page 44
<b>Plenary Session – Panel discussion moderated by Professor Justin O’Brien:</b>	Page 49
• Professor Kevin Davis	Page 50
• Peter Kell	Page 50
• Pauline Vamos	Page 50
• Steven Münchenberg	Page 51
<b>Speaker Profiles</b>	Page 54
<b>CIFR/KPMG Financial System Inquiry Dinner</b>	Page 66
<b>Appendix</b>	Page 74

## Welcome and Introduction



### Professor David Gallagher

Chief Executive Officer,  
Centre for International Finance and Regulation (CIFR)

[View video](#)



[View presentation](#)

- The Centre for International Finance and Regulation (CIFR) is delighted to host this workshop, which brings together senior representatives of government, the Financial System Inquiry (FSI) Panel and Secretariat, our financial regulators, academia and industry. The aim of the workshop is to highlight issues and ideas that are worthy of consideration by the FSI.
- CIFR is a \$41m Centre of Excellence, supported by a consortium including the Commonwealth and NSW Governments and a number of major Australian universities and research centres. CIFR represents a strategic link between academia, financial regulators, policy makers and industry, promoting financial market developments, best practice policy and regulatory responses, through leading research and education.
- CIFR is assisting the FSI by undertaking a number of research projects, including: an assessment of the costs and benefits of financial regulation; consideration of portfolio disclosure issues for sovereign wealth funds and state-owned enterprises; and consideration of the logistical issues, costs and benefits associated with enhancing our financial data architecture.
- CIFR has undertaken some text analysis to gain a better understanding of the submissions received by the FSI. A total of 298 FSI submissions have been received, from 233 unique contributors. Professional industry associations (25%) represent the major single source of submissions. The number of submissions and their sources are broadly similar to the experience of the Wallis Inquiry (1997).
- The topics most commonly addressed by the submissions include: the banking system, superannuation, financial advice, markets, system integrity, funding, insurance, legislation, payments and regulation. A major area of concern was the regulation of superannuation.
- Based on the submissions, there appears to be broad support for the current financial system.



*Professor David Gallagher*

## Plenary Session – Keynote address



### David Murray AO

Chairman, Financial System Inquiry

- The submissions received by the FSI address a wide range of issues, including competition, regulation, consumer issues, technology and the ageing of the Australian population.
- The big business sector appears to be reasonably comfortable with the current system, however it would like a more active bond market.
- The larger players in the financial services sector believe that they operate in an over-regulated but competitive market. The smaller players argue that they are disadvantaged and that there needs to be a levelling of the playing field.
- The regulators are of the opinion that the system works well, although they seek increased powers.
- Given the ageing of the population, there are calls for the superannuation system to better serve the needs of members in retirement.
- There is broad agreement that the financial system has worked well over the period since the Wallis inquiry. There have, nevertheless, been several major institutional failures during this period, including HIH Insurance and Trio Capital.
- A major issue confronting the system post the Global Financial Crisis (GFC) is moral hazard, which has created the need to reconsider regulation.
- The regulatory response to the GFC has been an attempt to avoid any repeat of the crisis, which may be too ambitious.
- Technology is having a significant impact on the financial industry. The broad array of self-service opportunities for customers utilising the internet is changing the way customers interact with their banks and providing opportunities for efficiency gains within the banking sector.



David Murray AO

- Technology is also being utilised to enhance risk management systems across the industry. For example, the industry has come a long way in product development (derivatives, etc.) since Black and Scholes developed an option pricing model.
- Data usage by banks was initially limited to information gathering and scenario testing. This has been extended to encompass the analysis of behaviour profiles and the establishment of new businesses operating in the shadow of the established financial sector. The establishment of new business models has implications for the development of new payment systems.
- Advances in thinking have prompted questions regarding the continued validity of long-held concepts and theories such as the Capital Asset Pricing Model (CAPM) and the Efficient Market Hypothesis (EMH).
- The concept of information asymmetry has previously been relied upon to justify regulatory intervention in the markets. With financial literacy becoming increasingly more widespread, the level of intervention has become an area of debate. Nevertheless, the consumer's general level of understanding needs to be enhanced in relation to issues such as the impact of fees; portfolio rebalancing and diversification; mean reversion of markets; and return expectations. Studies have shown that increasing financial literacy has the potential to increase GDP growth.
- Rigorous academic studies, such as those conducted by CIFR, play an important role in promoting greater understanding and challenging the frontiers of current thinking.
- Great emphasis is placed on the organisational role of technology systems. However, human systems are equally important.
- The impact of culture in contributing to the performance of two otherwise similar organisations achieving significantly different operational outcomes is an area that warrants closer examination.
- The interim report of the FSI will hopefully be published in July 2014. This will be followed by another round of submissions.



*Mr David Murray AO,  
Chairman, Financial System  
Inquiry with Professor David  
Gallagher, CEO, CIFR*

## Plenary Session – Panel address



### Professor Robert Officer AM

Emeritus Professor, The University of Melbourne & Chairman,  
Acorn Capital Limited

[View speech notes](#)

[View presentation](#)

- **Banks:** Central banks play a key role in limiting runs on banks, preserving the payments system and promoting financial stability.
- The GFC highlighted the systemic importance of central banks, which provided liquidity by buying commercial banks' assets. Central bankers were required to make judgement calls on extending their purchase programs beyond the government sector, and pricing their purchases of corporate bonds at levels that would allow them to subsequently exit their investments.
- If central banks are forced (as a commercial judgement) to purchase assets at great discounts, the flow-on impact could cause commercial banks to fail. Excessive prices paid for purchases could lead to moral hazard, and have implications for the stability of the payments system.
- Asset quality was not the only factor at play in the GFC. The failure of Centro Property Group was an example of a business that had solid assets backed by a poor funding structure.
- The presence of a lender of last resort cannot entirely prevent the risk of insolvency. For this, a broader insurance scheme is required. An alternative approach is to increase prudential regulation. However, the question then arises as to how far this ought to go.
- A scheme to provide a government guarantee to all depositors for a fee could be re-introduced. Moreover, this could be done at a time when there is no systemic stress.
- The original intention behind the four pillars policy was to limit the powers of the banks, and also to protect them from foreign takeover. The Wallis Inquiry advocated removing this policy, referring to it as an unnecessary constraint. The FSI is likely to recommend retaining this policy.
- The banking system is presently competitive, and technological advances have increased the level of competition.
- If two of the major banks were to merge, economies of scale would result however the total assets of the merged entity would not be overly large by global standards. The assets of the two largest banks (NAB and CBA) currently rank around 40th in the world individually. Their combined assets would rank 17th globally.
- Australian banks could achieve more overseas if they were allowed to merge.
- **Superannuation:** A current major point of debate within the superannuation industry is why Australians apparently pay higher fees than pension fund investors in comparable OECD countries.

- Fees charged within superannuation are dependent on the size and nature of fund mandates. It is hard to compare fees across countries. One reason for this is that most Australian super funds are defined contribution funds, while most overseas funds are defined benefit funds, which have more onerous risk management requirements and, consequently, more conservative asset allocations. It is preferable to examine potential barriers to entry.
- Most investors end up in balanced funds, either by choice or because those funds are typically the default option. Accordingly, it is the more active marginal investor who really determines the price, and not the relatively passive majority.
- The report recently published by the Grattan Institute uses a maximum of ten years' data (which coincides with a period of decreasing interest rates) and has led some to conclude that bonds are the best investment option. Such conclusions would no doubt have been different if a longer-term time frame had been employed. This report describes balanced fund investors as 'disengaged' because the default option tends to be the balanced option, however many investors in the balanced option have chosen to invest in this option for sound reasons.
- **Housing:** The housing sector presently accounts for over half of all bank loans, and almost half of all bank assets. The argument that investors are crowding owner occupiers out of the market overlooks the stimulus to supply typically brought on by increased demand by investors benefits renters. Housing research is typically characterised by partial analysis often driven by emotion.
- Some argue that the tax concessions associated with negative gearing should be removed, however this would result in the double taxation of debt and reduce efficiency.
- It is important to recognise that any form of innovation requires risk taking.



*Professor Robert Officer AM*



## Alan Cameron AO

Consultant, Ashurst  
Former Chairman, Australian Securities and Investments Commission (ASIC)

*The comments made in this address represent the speaker's personal views.*

- This address will cover three points:
  - The basic structure of financial regulation in Australia is pretty right and doesn't require dramatic change.
  - The government should stop giving ASIC more things to do.
  - ASIC's culture and ethos must be that of an enforcer.
- The Wallis Inquiry opposed the merger of the regulatory agencies that ultimately became ASIC and APRA. The four reasons they provided in support of this position are still valid today. The two bodies work well independently and need their own cultures and roles.
- Too many additional areas of work have been given to ASIC, none of which in isolation are major, but in combination are distractions from its core roles. Recent examples include shifting market supervisory responsibility from the ASX to ASIC and making ASIC responsible for the oversight of auditors. ASIC's role should be supervisory, not that of a front line regulator.
- While ASIC should embrace an enforcement culture, it is unrealistic to expect a high success rate in litigation, especially in relation to litigation for insider trading, as that will encourage ASIC to be risk averse.
- Insider trading nevertheless represents a scourge, and ought to be prosecuted wherever possible, pursuing both criminal and civil penalties. The way in which the regulatory system tackles insider trading has a major impact on the broader credibility of the financial markets.



Alan Cameron AO



### Tom Karp

Independent Consultant,  
Former Executive General Manager, Australian Prudential Regulation Authority (APRA)

*The comments made in this address represent the speaker's personal views.*



[View presentation](#)

- It is good that we are having an inquiry into the financial system when there is nothing seriously wrong with the system and a calm assessment can be made.
- Australia survived the GFC relatively unscathed, in part due to the effective functioning of our 'twin peaks' regulatory system. Importantly, the Council of Financial Regulators played a vital role in ensuring that our regulators worked together during the crisis. This was not the case in the US.
- As moral hazard is a political reality, operational mechanisms to deal with it need to be put in place before a crisis arises.
- The GFC demonstrated that market disciplines and disclosure may not protect investors in a financial crisis, and are not a panacea for excessive risk taking.
- Regulation aims to balance safety and competition. The GFC highlighted that the cost of market instability outweighs the cost of regulation.
- Technical standards and behavioural standards both play important roles in financial regulation. Technical standards tend to address financial or balance sheet issues, and focus on the current situation; while behavioural standards address governance and practice issues, and tend to be more forward looking.
- Day-to-day liaison with companies helps regulators gain a better understanding of the companies they monitor, which makes the monitoring process more effective. This requires significant regulatory resources and powers. A number of overseas economies paid the price for not doing this well prior to and during the GFC.
- Australia continues to punch above its weight in the area of financial regulation, helping shape regulation globally.



Tom Karp

- Where appropriate, we should adopt international standards when they exist, as this helps build our international profile.
- Most of the Australian companies that have failed overseas didn't adapt properly to the overseas markets and cultures. Australian regulation was not the problem.
- The role played by the insurance sector as a shock absorber within the economy is generally not well understood. In general, sources of systemic risk can more often be traced back to the banking sector, rather than the insurance sector.
- Under-insurance is still a significant issue in Australia.
- Mechanisms need to be put in place to deal with legacy products.
- The superannuation system acted as a shock absorber during the GFC, as it is lightly leveraged and has a longer-term investment horizon that provides depth and stability to our financial system.
- The focus of defined contribution funds tends to be on the accumulation phase. Given the ageing of our population, greater focus is now required on managing the retirement phase, including the design of products that provide ongoing income streams.
- The plethora of tax and other regulations relating to superannuation appears overly complicated and conflicting.
- The concept of superannuation being used to fund infrastructure investments must be reconciled with the need to put members' interests first. The packaging of these investments must be done in a way that preserves member investment liquidity and valuation integrity.
- The use of leverage by Self-Managed Superannuation Funds (SMSFs) is an area of concern, as it adds to the level of unintended risk. We need to ask how these tax concessions benefit the community.



### **Mike Callaghan AM**

Director G20 Studies Centre, Lowy Institute for International Policy;  
former Executive Director, International Australian Treasury;  
former G20 Finance Deputy for Australia; former member of the Financial Stability Board

*View speech notes*

- This address will cover three big picture issues:
  - The FSI needs to establish its own framework, or regulatory philosophy, which will be the foundation of its approach and recommendations.
  - The importance of fully assessing the role and contribution of the regulatory arrangements for the performance of the Australian financial system during the GFC and subsequently.
  - The steps Australia can take to help ensure that the wave of new international financial standards is appropriate for the Australian financial system.
- The Wallis Inquiry spent a lot of time on establishing its regulatory philosophy. Concern over moral hazard figured prominently as well as ensuring that there was an appropriate risk spectrum for the provision of finance. The outcome was to identify institutions performing certain functions and subject them to prudential supervision, with the rest of the financial system subject to market integrity and disclosure rules.

- In drawing the regulatory barrier for institutions subject to prudential supervision, the Wallis report focused on the ‘intensity of the promise’. This is not understood today.
- Underlying the reliance on disclosure was the belief that ‘sophisticated’ investors can look after themselves. Anecdotal evidence suggests that even ‘sophisticated’ investors have not fared well. Many have questioned the ability of the market to provide discipline and self-correct. Risk was not appropriately priced before the GFC.
- Successive ASIC chairmen have called for a re-think of a disclosure based-approach. But if you move away from disclosure, what do you replace it with?
- There are apparent ‘gaps’ in the provision of finance, such as for small business, start-ups and even project finance. The Inquiry will have to give a lot of thought to how a balance can be achieved between stability and ensuring the financial system meets the needs of all parts of the economy.
- There is a tendency to ascribe the relative resilience of the Australian financial system to our regulatory framework. But the lesson from the crisis is that all elements of economic policy are linked. The stability of the financial system does not simply depend on the quality of financial supervision and regulation. The stability of the Australian financial system in the GFC depended on the strength of the economy, and taking policy action to avoid a recession. The Four Pillars Policy was a source of stability in protecting Australian banks from taking risky actions to avoid takeover.
- There has been a global wave of international regulatory change since the crisis. Many have questioned whether it is relevant to the Australian financial system. The response is normally to say that we have no option other than to adopt the new standards, but our officials are working in the international forums to ensure that the new standards are right for Australia.
- We may have no option but to adopt the new standards, but what is the rationale for adopting an even more stringent regulatory approach than the new minimal standards?
- As chair of the G20 in 2014, Australia should use the opportunity to establish better processes in the G20 and FSB to ensure that the positions of all countries are appropriately taken into account in establishing new standards.
- The Inquiry should also consider how to have better oversight of the appropriateness of the Australian financial system. This oversight should not depend on an external inquiry every 17 years or so.



*Mike Callaghan AM*

## BREAKOUT SESSION ONE

**MARKETS** – moderated by Co-chairs **Professor Mike Aitken**, CEO, Capital Markets CRC (CMCRC), & **Professor Terry Walter**, University of Sydney



*Professor Mike Aitken*



*Professor Terry Walter*

### **Professor Mike Aitken**

CEO, CMCRC – **Optimal market design & evidence-based policy making**

- An evidence-based approach should underpin any changes to the design of markets and regulatory systems.
- In this session Professor Aitken demonstrated how Australian capital markets are capable of investigating the impact of any and all market design changes in Australia or in markets around the world.
- Such a process mitigates the need for regular financial system inquiries, at least in the capital markets area, but is noticeably absent in the insurance, banking and investment marketplaces in Australia.
- CMCRC is a \$100 million joint investment of the Federal Government, universities and industry, the object of which is optimal market design. This investment, which has given rise to the evidence-based capability, has become cash flow positive for all parties within a 10 year timeframe from spinning off some of the capabilities into commercially viable entities like the Reuters Tick Data History Service, which provides systems to distribute real-time and historical data to the world's financial markets, and SMARTS Pty Ltd, which provides real-time surveillance services for most of the world's marketplaces.
- These systems were two of the necessary steps, along with the building of the Market Quality Dashboard, to give rise to evidenced-based policy making in capital markets in Australia and, eventually, around the world.
- Working off the security regulator's mandate, to ensure that markets are fair and efficient, a practical definition is given to optimal market design such that evidence can be adduced around market design changes.
- The CMCRC has developed a number of systems to give effect to evidenced based policy making and demonstrated the Market Quality Dashboard in the seminar.
- The presentation takes recent changes to dark pool regulations in Australia and shows how the system can quickly and easily evaluate the impact of the change, which was shown to be positive for the market place.
- The key message coming from the presentation was that if the other areas of the financial system are to be similarly evidenced-based, then similar investments need to be made in them along the lines of the CMCRC, which involves a unique three way partnership between government, industry and universities.



*Professor Mike Aitken*

### **Paul Hilgers**

CEO, Optiver

- The latest edition of the Global Financial Centres Index Survey shows Sydney has become more domestically-focused, as opposed to internationally-focused, over the last seven years. Many major market players have relocated overseas.
- Australia has fallen behind in its efforts to compete regionally. Institutions have responded by shifting their operations to Singapore or Hong Kong.
- Local markets, notably equity options, have been experiencing declines in volumes.
- Governments must strive to attract businesses and skilled people to Sydney, as Australia's financial centre. Singapore's government has been effective at attracting businesses from overseas.
- We need to not only compete, but to embrace competition. We risk becoming the Spain of Asia if we become too protective.
- The proposed merger between the ASX and the Singapore Exchange was a missed opportunity to create a pan-regional exchange.
- Education is critical to the creation of a well-functioning global market. Local students' knowledge of economics and financial markets needs to improve.
- Product innovation is another key area of importance for market growth. Greater diversification of local product offerings is required.
- The stability of Australia's regulatory regime, a stable society, and a generally well-educated population nevertheless represent key points in our favour.

**John Fildes**

CEO, Chi-X Australia

- Competition is equally important as fairness and efficiency in the markets.
- Fostering competition and innovation needs to be a key component of any inquiry into Australia's financial system.
- The next 20 years will see a substantial rise in the middle class population of Asia, which will have a profound impact on regional financial markets.
- Anecdotally, there is widespread evidence of the decline of Sydney as a regional financial centre. Hong Kong appears to be assuming the role of the region's financial centre.
- Australian companies are now considering raising capital on overseas markets. The Australian dollar is traded more overseas than it is locally.
- Regulatory outcomes need to enhance Australia as a place to do business.
- Chi-X took approximately 6 months to gain regulatory approval in Europe. The same process took 3 years in Australia, and involved considerable cost.
- There is no time limit on regulatory decisions in Australia, in contrast to the major overseas markets where time limits generally apply.
- Chi-X takes the view that any stifling of competition may lead to benefits for incumbent entities, but represents a poor longer-term outcome for Australia as it restricts the development of the broader financial services sector.
- Regulation presently appears to be lighter for those operating in the shadow system, compared to the mainstream system.
- Having more securities exchanges is essential to gaining recognition as a regional financial centre.
- A research study has shown that market quality is highest in those areas where competition is greatest.
- Increased competition from Chi-X has contributed to a lowering of ASX fees and an improved product offering.
- Lack of certainty of outcome from a regulatory perspective is a competitive disadvantage for Australia.
- Cost recovery continues to have a dampening effect on competition and innovation. The FSI needs to have proper oversight of the governance of cost recovery to ensure that the industry is not damaged.

## BREAKOUT SESSION ONE

**BANKING** – moderated by **Professor Ross Buckley**, UNSW Australia



*Professor Ross Buckley*

### **Professor Deborah Ralston**

Executive Director, Australian Centre for Financial Studies (ACFS) and Monash University

#### – **The financial claims scheme**

[View presentation](#)

- This issue goes to the heart of the trade-off between stability and efficiency.
- The rationale for deposit insurance lies in preventing a run on banks.
- Deposit insurance provides reassurance for retail investors.
- The absence of major bank failures in Australia has led to the assumption that there is an implied guarantee of their stability.
- The question arises as to whether a retail run on a bank would signal the start of a crisis of confidence in the bank, when it is wholesale funding sources that typically provide the majority of bank financing and tend to be keenly aware of developments relating to bank solvency.
- The financial claims scheme was introduced in October 2008 in response to the GFC, and was initially capped at \$1 million. The cap was subsequently reduced to \$250,000 in 2012.
- The claims scheme allows APRA to recover any costs of providing support to an individual bank through a levy on the entire banking system.



*Professor Deborah Ralston*

- Such intervention can lead to negative distortions. At a time of intense competition within the financial sector, banks may be seen as having an advantage in the competition for retail funds due to the operation of the guarantee. This can flow through to banks enjoying a lower cost of funding for lending.
- The issue of moral hazard was highlighted by the US savings and loan experience of the 1980s, where a flat guarantee fee led to the adoption of risky behaviour to boost returns on assets.
- It is difficult to quantify the impact of the financial claims scheme. Non-bank entities, such as cash management trusts, have had to offer higher rates of return in order to remain competitive. Similarly, the yield on corporate bonds had to rise to compete with the return on risk-free bank deposits.
- Superannuation funds' cash investments with banks are not covered by the guarantee, however SMSF's cash investments are covered.
- A possible remedy for distortions created by the guarantee could be to increase the fee so it becomes more risk related. Alternatively, the guarantee could be spread to other forms of at-call deposits.
- Another option might be to issue an increased volume of retail government bonds to accommodate the demand for safe haven deposits.

#### Associate Professor Gordon Menzies

University of Technology, Sydney – Costs and benefits of financial regulation



[View presentation](#)

- Important questions to be addressed when conducting a cost benefit analysis in the financial sector include: Who bears the costs? Who receives the benefits? What type of model should be used for analysis?
- As the financial industry has a social role, we should try to measure the costs and benefits of financial regulation to society.
- The main benefit to society we look to measure is the reduced chance of a financial crisis.



Associate Professor Gordon Menzies

- We consider the societal cost of regulation in terms of the potential impact of a less innovative financial sector.
- Prior to the GFC, regulatory policy was probably tilted towards the laissez faire end of the spectrum. Post the GFC, this tilt shifted back towards more stringent regulation.
- Our research has revealed results consistent with the economic notion that the circular flow effects of spending can be real even if the spending itself is wasted. The direct costs of a financial sector that allows, or even encourages, wasteful expenditure are probably small in the short term, however, if the boom implies a higher chance of a subsequent recession, the indirect cost over the longer term could be substantial.
- Our approach to measurement of the benefit of regulation for the economy is the marginal change in the probability of a crisis and the associated cost.

### Associate Professor Valentyn Panchenko

UNSW Australia – **Too central to fail: financial networks, risks and policy responses**



[View presentation](#)

- Interconnectedness is a crucial feature of financial and economic systems.
- We have attempted to establish a general network structure to model systemic risk responses within the banking sector.
- Data from APRA has facilitated the modelling of significant exposures for particular institutions.
- Our network model construction shows that regulators attach major importance to the exposure risk of the four main banks, and correspondingly less importance to the smaller institutions.
- The model shows that second-order potential exposures to an entity presumed to encounter financial stress are far larger than first-order potential exposures. Second-order exposures tend to raise the level of systemic importance of institutions above what would be evident if attention was solely focused on first-order exposures.
- Recent research has examined issues such as optimal levels of disclosure for inter-connected banks.



*Associate Professor Valentyn Panchenko*



*Dr Scott Donald*

## BREAKOUT SESSION ONE

**SUPER & WEALTH** – moderated by Co-chairs **Dr Scott Donald**, UNSW Australia, & **Professor Susan Thorp**, University of Technology, Sydney



*Dr Scott Donald*



*Professor Susan Thorp*

### **Dr George Kudrna**

UNSW Australia – **2010 policy reforms to superannuation**

*View presentation*

- Two major reforms to superannuation were announced in 2010: an increase in employer contributions over time, from 9% to 12%; and the introduction of low-income superannuation contributions. These reforms have since been respectively deferred and abandoned.
- We used life cycle optimisation models to analyse the impact of these changes to superannuation. Our model covers household, government and production sectors, but includes only mandatory superannuation contributions and assumes that superannuation benefits are always paid out as lump sums.
- The model suggests that superannuation reforms have contributed to a significant increase in assets within the household sector.
- All age cohorts appeared to gain from the reforms, although gains for lower income earners were adversely impacted by the removal of the proposed low-income superannuation contributions.

**Dr Xiadong Fan**UNSW Australia – **Investment choice** *View presentation*

- Many people leave their superannuation funds in default options to avoid having to make an investment choice. This raises the question as to whether and how default options affect the choices people make.
- Our research indicates that the level of switching costs appears to be a significant factor in people's exercise of choice.

**Dr Fedor Iskhakov**UNSW Australia – **Lifetime annuities** *View presentation*

- Our research addresses two questions:
  - Why don't Australians buy lifetime annuities?
  - Should we be compelled to buy lifetime annuities?
- We find theoretical reasons why Australians should not buy lifetime annuities, given the availability of a means-tested age pension, even if illiquidity of wealth considerations, bequest considerations and behavioural issues are disregarded.
- We concluded that Australians should not be compelled to buy lifetime annuities because it would be a sub-optimal outcome for less wealthy investors.

**Professor Susan Thorp**University of Technology, Sydney – **Default and diversification heuristics in annuity choice** *View presentation*

- People simplify hard decisions by using short cuts ('heuristics').
- Consequently, the positioning of default allocations has a significant bearing on their level of appeal. Research shows that allocations with equal weightings on alternative choices have broad appeal.
- Using a choice experiment, we found that more than 30% of retirement income stream choices are based on default (22%) or 50:50 diversification (10%) heuristics.
- We found that people with a better level of understanding of retirement income products are less likely to take short cuts.
- We found that the use of plain English in product descriptions (including avoiding the use of the word 'annuity') helps increase the reader's level of understanding and the probability that they will not use heuristics in making product decisions.

**Dr Geoff Warren**
**CIFR – Long term investing by institutional investors**

[View presentation](#)

- This research project is being undertaken by CIFR in collaboration with the Future Fund.
- While there is no clear-cut definition of what constitutes a ‘long-term’ investor, we propose two indicators:
  - Discretion over trading (they are able to choose when they buy or sell); and
  - Approach to investing, especially the information used – they focus on drivers of long-term value and returns, rather than near-term price changes (trading behaviour).
- Length of holding period is not a reliable indicator of whether an investor is a long-term investor.
- We have identified twelve influences on an investor’s investment horizon, classified under four broad headings:
  - Influences related to investor circumstances (nature of funding; discretion over trading);
  - Influences related to the design of the investing environment (organisational; evaluation and remuneration; financial market structure);
  - Influences related to investor choice (investment approach; information used; behavioural; decision maker attributes); and
  - Other influences (cultural; limits to arbitrage; increased use of alternative assets).
- Having a mix of short-term and long-term investors in the market is a healthy and natural situation. Some argue that there are too many short-term investors in the market, however this may provide opportunities for long-term investors. It is important to recognise that not all short-term behaviour is bad.
- Three public benefits of long-term investing are:
  - It provides a stabilising force in the market;
  - Long-term investors tend to be engaged, responsible asset owners; and
  - It finances long-term, productive activity.



*Dr Geoff Warren*



*Associate Professor John Evans*

## BREAKOUT SESSION ONE

**INSURANCE** – moderated by **Associate Professor John Evans**, CIFR & Sydney Business School, University of Wollongong



*Associate Professor John Evans*

### **Associate Professor Anthony Asher**

UNSW Australia – **Could the life insurance industry be more innovative?**

- US and European entities are major players in Asian insurance markets, while Australia is barely present.
- Until the 1990s, Australian insurers were comparatively active overseas. Their subsequent partial withdrawal occurred when they gave up their mutual status. A significant factor was the lack of success achieved by AMP in its 1990s overseas expansion campaign. AMP/AXA had represented over half the industry's presence.
- Losses incurred recently by a number of risk insurers seem to demonstrate a lack of understanding of the business. Some of these entities were not even collecting their own mortality data, and there is evidence of under-investment.
- There is little evidence of non-price differentiation in the local market. The level of non-price innovation is regarded as below that in overseas markets such as the UK and Singapore.
- This may be partially explained by the banking groups' focus on other areas of their business, and imposing unrealistic profit targets on their insurance divisions. The industry might become more competitive if insurers were not predominantly owned by banks.

**Tim Clark**

Chief Actuary, IAG – **Could harmonisation of regulation benefit risk management?**


- Business models, and hence key risks, differ fundamentally between banks, life insurers and general insurers. From a policyholder / depositor viewpoint, general insurance companies are less susceptible to external change as deposit withdrawal or insurance policy lapsation do not alter guaranteed contractual payments or expense over-runs – hence these externalities can be managed. By comparison, banks are constrained by the fact that they generally borrow short and lend long, thereby engaging in maturity transformation.
- General insurance companies have balance sheets which are mostly estimated. This differs markedly from banking, where the majority of estimation is applied to bad debt provisions (a much smaller percentage of the whole). The importance of the estimation process is higher in a general insurance company, whilst the risk of a liquidity crisis or a heavily correlated asset shock is more important in a bank.
- A core function of insurance companies is the pooling of risks assumed from a large number of policyholders. Risk pooling reduces the volatility of losses, which allows insurers to cover the underlying risks with less capital than the aggregate amount of capital that would be needed if each firm or individual had to set aside precautionary savings against potential losses independently. A key exception to this rule is exposure to natural perils that impact a group of risks, which can be diversified through the use of international reinsurance.
- Banks tend to calculate their total assets and liabilities on a daily basis. Insurers require much more elapsed time to improve their estimate of the liabilities. The implication is that many banking processes operate on a much shorter time horizon than insurance processes, and with lower volatility. This increases the difficulty in having banks and insurers co-exist within a single organisation.
- The liability profile of a general insurer does not change because of a one-off event. This contrasts with a bank, where a single economic event can cause a run on the bank. Life Insurers are protected from some forms of lapsation by surrender value structures.
- The treatment of overseas joint ventures from a prudential regulatory view should be different for different segments of the financial services industry due to the fact that economic conditions, and hence banking risks, are much more correlated than the principle risks for general insurers, which are localised and largely independent.
- Similarly, due to differences in business models and risk profiles, the prudentially required capital structures do not need to be the same.
- The potential impact of operational risks on broader reputational risks does not carry the same severity in general insurance as it does in banking.
- The potential impact of natural perils or catastrophe risk is significantly greater within the insurance sector.

**Peter Carroll**

Independent Consultant


 View presentation

- Claims versus premiums data for 2013 show that private health insurance provides the highest rate of return, while life insurance provides the lowest rate of return.
- Operating expenses relative to premiums are highest in life insurance, and lowest in CTP and private health insurance. Most of the costs arise from areas other than consumers, with regulation being a key source.
- In health insurance, regulators tend to implement blanket policy solutions in response to one-off problems. Their policy of naming and shaming with regard to pricing control is inducing insurers to degrade the benefits, rather than adjust the prices, of products.
- The variety of organisational structures within the industry is good for competition.
- The insurance element within superannuation is having a major cost impact on the broader system.
- A major crisis is typically required to remove structural burdens from the industry and encourage innovation.


 Insurance  
Discussion Questions  
view here

## BREAKOUT SESSION ONE

**FINANCIAL ADVICE** – moderated by Co-chairs **Professor Kevin Jameson**, Macquarie University, & **Professor Dimity Kingsford Smith**, UNSW Australia



Professor Kevin Jameson



Professor Dimity Kingsford Smith

**Dr Kingsley Jones**

 CIFR – **Changing patterns of financial advice**

 View presentation

- Electronic trading has driven down transaction costs for DIY investors.
- There is an emerging grey area between personal and general advice.
- The market is moving towards an unbundled 'financial services stack', comprising a range of transaction, custody, tax and reporting services which can be accessed by operators of managed funds and DIY investors.
- There is now a wide range of information services that can be purchased by institutional and retail investors online at low marginal cost for distribution.
- Brokerage trading costs in Australia are generally applied on a flat rate for parcels of less than \$10,000 and a percentage rate above that. There is a wide spread of trading costs for transactions. Flat rates range from a low of \$6 to as much as \$75 for full-service brokers. Percentage commissions range from a low of around 0.08% to as much as 0.50%.



*Professor Geoff Kingston*



*Dr Kingsley Jones*

- For SMSF investors using online brokers, broker commissions are a small part of the overall cost.
- Fund administration, audit and reporting costs appear relatively high. Audit and reporting costs can be as much as \$5,000 or as little as \$700, depending on the service provider.
- The level of fees charged by service providers does not necessarily reflect their market share. The highest market share online broker was in the highest tier of the most expensive commission rates charged. The highest market share fund administration service was in the lowest tier of cost.
- There is a marked difference in the range of trading costs for fund exposures in Australia compared to the US. It is substantially cheaper to trade in the US.
- Bid ask spreads for ETFs are significantly narrower in the US relative to Australia. This partially reflects the depth of their markets. The fact that investors in our market typically transact overnight in the US is another factor that increases costs for market making of locally listed ETFs that mimic their US listed counterparts. However, where comparable products exist, the embedded Management Expense Ratios are similar.
- Current trends that warrant further investigation include: growth of the advisor manager; the changing nature of advice; services provided by stockbrokers; the rise of self-directed investments; and scalable fund administration.

### **Professor Geoff Kingston**

Macquarie University – **Superannuation advice**



*View presentation*

- People who are in a defined contribution super fund and within 5 to 10 years either side of retirement are deemed to be in the 'retirement risk zone'.
- People who have most of their wealth in their house and super have a comparatively high exposure to risk.

- Sequencing risk relates to the notion of a negative investment impact. These impacts are greatest at the height of the asset accumulation phase.
- To reduce the significance of the retirement risk zone, we advocate a progressive reduction in the allocation to risk assets as the time of greatest risk approaches. We advocate having less than half of your superannuation allocated to growth assets on the date of your retirement. Risk can potentially be re-elevated post retirement.
- In the optimal contract between an investor and an investment manager, we advocate that funds required for essential expenditure should be excluded from the proposed investment mandate. We further contend that the investment manager should charge a flat fee and two asset-based fees. One of the asset-based fees should be a fulcrum fee to discourage closet indexing and the other should be an active management fee.
- Model financial plans typically include a flat fee for tax, no fulcrum fee, an asset-based fee and a fee to the licensee.
- The Harmer Report in 2009 highlighted the significant increase in aged pension applications received during 2008 in the wake of the GFC.
- The Commonwealth budget is becoming increasingly exposed to the stock market.

### **Professor Dimity Kingsford Smith**

#### **UNSW Australia – The socio legal aspects of financial advice**



*View presentation*

- The Wallis Inquiry concluded that Australians are increasingly relying on the financial system, and are increasingly exposed to particular financial services providers.
- The mandated financialisation of the relationship between citizens, governments and the welfare system justifies regulation other than that simply related to market failure.
- The use of the concept of a financial citizen can be used to identify those who do not, or are not able to, fully participate in the system.
- Research highlights the need for increased financial literacy, particularly in relation to fees and charges.
- Recent research has shown that lack of investment success can be the result of not just apathy, but behavioural and cognitive deficiencies.
- Prior inquiries have identified information failure as the deficiency justifying regulatory intervention.
- High levels of market concentration and related entity transaction links have underpinned other failures.
- The variable quality of financial advice is another area of shortcoming. More needs to be done to improve the competency levels of financial advisors.



*Professor Dimity Kingsford Smith*

- A more open approach to the identification of sources of market failure should be adopted.
- ASIC has devoted significant efforts to making disclosure more generally useful, however this has had a fairly limited effect.
- Investor education and literacy take time to improve, limiting the immediate benefits of regulatory disclosure.
- The high incidence of consumers being sold investments with excessive risk leads to consideration of whether the concept of buyer-beware should be tilted more towards seller-beware.
- In financial markets the concept of fairness does not take on the distributive purpose that it does in broader political and legal circles. In financial markets, fairness can be equated to impartiality, equality of opportunity or mutuality of obligations.
- These concepts should be an important foundation of investor protection. The need for fairness, not just the need to mitigate the risk of market failure, underpins the need for investor protection.
- The Dodd-Frank Act in the US requires consumer markets to be both transparent and fair. Treating customers fairly is also at the heart of retail investor protection in the UK.
- Providing adequate disclosure to customers may involve three stages: the first being a brief outline document, which could contain a link to a second, more detailed, disclosure document and a link to a third, full disclosure, document.
- Another option is to more fully address the issue of vertical disclosure.
- Suitability of product is a prominent area of disclosure discussion in the US.

## INTRODUCTION TO KEYNOTE SPEAKER



### Steve Harker

Managing Director, Morgan Stanley Australia

View video



- The Republic of Ireland was one of the countries most impacted by the GFC. The country was battered by a fiscal, economic, social and political crisis. Its major banks collapsed due to poor underwriting standards and lack of internal and external oversight. This led to a three-year period of economic stewardship guided by a troika comprising representatives of the European Commission, European Central Bank and IMF, and a comprehensive re-examination of banking and regulatory practice.
- Three senior executives of Anglo Irish Bank were recently found guilty of conducting an illegal share support operation, however the judge decided against imposing custodial sentences after taking into account the behaviour of the financial regulator and the wider political establishment. The judge found that the executives had committed their crime with the implicit support and connivance of the state itself.
- The task of transforming Irish banking culture and practice has been assigned to Professor Patrick Honohan, who was appointed Governor of the Central Bank at the height of the crisis. A former professor of economics at Trinity College Dublin with extensive experience working within the IMF, Professor Honohan had the task of negotiating the terms of the bailout and implementing the reform agenda imposed by the troika.
- Professor Justin O'Brien from UNSW Australia travelled to Dublin to speak to Governor Honohan about the regulatory lessons learned in Ireland and the future of European financial regulation.



Steve Harker, CEO Morgan Stanley  
CIFR Board Member

## KEYNOTE ADDRESS



### Professor Patrick Honohan

Governor, Central Bank of Ireland

**The fall of the Celtic Tiger and the future of European financial regulation**

Interviewed by Professor Justin O'Brien, Director, Centre for Markets Law and Regulation, UNSW Australia in Dublin Ireland.

[View video](#)



[View transcript](#)

- Ireland entered the GFC in a poor financial state due to over-lending for property development and construction. Accordingly, a collapse was inevitable.
- In fact, the boom had already peaked prior to September 2008, and a period of fiscal adjustment was already underway.
- The absence of warning signals in the lead up to the crisis was attributable to a prevailing sense of over-optimism. This was driven by the rapid recovery from the financial crisis of the 1980s and the expectation that high rates of sustainable growth had become the norm. Another factor was the increased availability of cheap funding following Ireland's entry into the Eurozone.
- Property bubbles in the US and UK were similarly reflective of the view that risk had been removed from the system.
- The so-called 'light touch' approach to regulation that prevailed at the time proved largely ineffective. There was an undue faith in the power of the markets, while risk and its measurement were largely overlooked.
- A subsequent report into the regulatory regime revealed the problems associated with a sole focus on attracting foreign companies, while ignoring the health of Irish banks.



- Recognition by the Irish government that rectification of the fiscal imbalance was beyond its ability paved the way for the 3-year reform package from the IMF. The imposed timetable accelerated reform momentum within the political and regulatory establishment.
- The ultimate supervision of Irish banks now resides in Europe, although Irish authorities remain heavily involved in day-to-day matters.
- A properly funded and sufficiently staffed regulator is vital.
- A work practices review showed that changes in behaviour had become necessary. This led to the codification of operational behaviour for prudential and regulatory bodies.
- There remains a continuing element of community anger over the failings that led to the crisis. Most of this anger comes from mortgage holders who remain under water on their loans. The banks recognise the need to work in a sensitive manner to sort out impaired loans.
- The Irish financial sector has shrunk dramatically in size since the crisis.
- The imposition of targets for loan-to-deposit ratios has led to large-scale de-leveraging, with loans being repaid faster than new loans are established.
- The end result of this process will be a smaller banking system in terms of both total assets and number of banks.
- Ireland implemented a large-scale reform process to correct the crisis situation, and this process remains a work in progress.



*Professor Patrick Honohan interviewed by Professor Justin O'Brien*

## BREAKOUT SESSION TWO

**MARKETS** – moderated by Co-chairs **Professor Mike Aitken**, CEO Capital Markets CRC, & **Professor Terry Walter**, University of Sydney



*Professor Mike Aitken*



*Professor Terry Walter*

### Joseph Barbara

Senior Specialist, Market Participant Supervision, ASIC – **ASIC's study into high frequency trading**

*View presentation*

- Risks associated with high frequency trading primarily relate to: any failure of the market to fully clear supply and demand; any purposeful attempt to cheat others; and any cost inefficiencies inherent in the market.
- Technology expands the range of products that can be traded in the market, and compresses the time horizon for decision-making.
- Algorithms are already a feature of market trading.
- High frequency trading is already a large part of the market.
- Dysfunctional trading programs represent a real risk to the market.
- The language within our regulatory framework is sufficient to deal with trading misconduct.
- The number of individual high frequency trading accounts in the market is small. Consequently, direct conversation is often the most effective method of controlling any potential misconduct.
- There are clear points of differentiation between algorithmic and high frequency trading. Most of the trading in the market is sourced from algorithms.
- ASIC's systems do not label traders. They merely identify trading patterns so that high frequency traders become evident.
- Data analysis does not show high frequency accounts unduly impacting order to trade ratios.
- Analysis of order book stability shows that high frequency traders do not unduly impact market liquidity.
- Analysis of the interaction between high and non-high frequency traders shows that high-frequency traders have some skill at picking the market's direction, but only over extremely short time periods.
- High frequency traders appear to be contributing to market liquidity and reducing volatility.
- The cost of high frequency trading in terms of its contribution to market liquidity is substantially lower than transaction costs such as brokerage.

**Dr David Lynch**

CEO, Australian Financial Markets Association (AFMA)

 [View presentation](#)

- Economic growth is positively correlated to the savings rate and capital productivity, and negatively correlated to financial intermediation costs.
- AFMA's submission to the FSI made the following points:
  - A strong economy depends on well-functioning banking and financial markets;
  - Well-functioning markets depend in part on good regulation – but there remains an opportunity to build on our current position;
  - The policy focus to date has mainly been on how to regulate financial markets, rather than how to develop them; and
  - We need a clear strategy for ongoing financial system development.
- Economic development, opening up of international trade and investment, and financial deregulation that gave real economic meaning to financial prices drove the development of derivatives markets. We are asking the financial system and financial markets to do a different and far more important job than in the 1980s; so they have a larger role to play.
- OTC contracts are bilateral trades in financial instruments. The OTC markets are significant in scale relative to the equity markets and there is a good spread of institutions within each of the markets.
- OTC markets should be thought of as being part of a highly integrated financial system. Changes to one part of the system will often affect other parts.
- Exchange and OTC markets compete and are complementary to each other.
- OTC markets provide an important source of funding for banks. They also provide competition and diversification benefits, and assist in capital allocation.
- Entity level risk management maximises shareholder wealth and lowers capital costs.
- Derivatives complement underlying markets, reducing risk management costs.
- Factors presently shaping the financial system include:
  - Demographic change – primarily through the growth of savings in the superannuation system;
  - 'Asian century' influences – Australia has well developed OTC markets, and we can export this expertise within the region;
  - Infrastructure financing – the bond market can play a key role in this area;
  - Rapid technological developments;
  - Regulation (e.g. G20 derivative reforms);
  - Increased standardisation of products – which promotes broader confidence and participation in the system; and
  - Innovation – competition drives better client services and lower costs.

- Financial policy settings must take account of the cumulative effect of policy, and not just make a measure-by-measure assessment.
- Sound policy is vital to effective policy making, so Treasury must be adequately resourced.
- It is important to have a coherent and disciplined regulatory system if we hope to convince industry that they should contribute towards the cost of this system.
- There needs to be a clear line between policy-making and regulation. Recently, there has been some blurring of this line.
- There should be appropriate delegation of rule-making authority to regulators. Uhrig's recommendation for the appointment of an Inspector General of Regulation has merit.
- It is essential that Australian regulators actively participate in international standard setting bodies and the Financial Stability Board, in order to protect the national interest and help shape standards.
- Effective policy formation and sound regulation are essential inputs into the ongoing development of the OTC markets.
- Australia's international competitiveness should not be measured just in terms of the business we attract from countries such as Singapore, but rather should also consider how successful we are in retaining the businesses we have here.



*Dr David Lynch*

## BREAKOUT SESSION TWO

**BANKING** – moderated by **Professor Deborah Ralston**, ACFS & Monash University



*Professor Deborah Ralston*

### **Dr James Cummings**

Macquarie University – **Effect of the Basel accord capital requirements on the loan-loss provisioning practices of Australian banks**



*View presentation*

- We are currently undertaking a CIFR-funded research program looking at bank loan loss provisioning.
- The study focuses on the regulatory provisioning model, which is forward-looking. The regulatory model distinguishes between credit losses that are expected to be realised in the short term (within the next 12 - 18 months) and losses that are expected but not certain to arise in the longer term. Regulatory provisions feed into calculations of the banks' risk-based capital ratios. There is an immediate and direct relationship between capital and provisioning practices.
- The approach taken by the New York Federal Reserve is to consult with depository institutions about how to apply the incurred-loss model of provisioning under accounting standards. A concern with the incurred loss model is that it discourages banks from provisioning proactively during good economic times.
- Our study sample comprises 22 banks, representing both locally-based institutions and overseas institutions with operations here. The sample data runs from March 2004 to December 2012.
- The research is important, because it will demonstrate: (i) the extent to which provisions reflect the default risk of banks' loan portfolios, and (ii) how banks use the forward-looking provisioning model to build up loan-loss reserves during good times so they can draw down on them in bad times.
- The research findings will be released at the CIFR Symposium on Market and Regulatory Performance on 17 July 2014.

### **Associate Professor Harald Scheule**

University of Technology, Sydney – **Systematic credit portfolio risk and implications on regulations for bank capital and securitisation ratings**



*View presentation*

- Our current research project focuses on the capital regulation of banks, and goes to the micro-level of allocating capital for loan portfolios and asset-backed securities.
- US losses on securitised exposures for banks in the GFC exceeded expectations based on ratings-implied risk weights. This begs the question: are credit ratings or, alternatively, ratings-implied risk weights appropriate?



*Associate Professor  
Harald Scheule*

- To date, there have been no minimum standards set for credit ratings. Such standards are not required by the regulators.
- The FSI submissions reveal a disparity in the amount of capital required for similar risk exposures for banks applying different permissible capital calculation approaches.
- Australian banks often use domestic economic data to drive their risk models, however we have not had a severe economic downturn in more than two decades.

### **Professor Richard Holden**

UNSW Australia – **Financial regulation and internal incentive schemes**



*View presentation*

- Trading of risky instruments, such as CDOs, featured prominently in the lead up to the GFC in the US.
- Also at play was moral hazard across institutions, in that traders were speculating with house money, as opposed to their own, and were consequently inclined to take on excessive levels of risk.
- The incentive contracts given to people at all levels within institutions encouraged excessive risk taking.
- A basic premise of incentive contracts is that people shouldn't be rewarded for mere good luck.
- Investment professionals should have their remuneration tied to market benchmarks and relative performance.
- We have constructed a model to assess how traders in a principal / agent relationship perform individually and relative to others.
- The search for traders who outperform their peers leads to the assumption of progressively greater levels of risk. This makes rational sense for the individual but produces a less than ideal social outcome.

- Banning certain types of incentive contracts represents a less than ideal solution.
- Although financial incentives are important, it is dangerous to ignore the impact of competition between firms on incentive structures.

## BREAKOUT SESSION TWO

**SUPER & WEALTH** – moderated by Co-chairs **Dr Scott Donald**, UNSW Australia, & **Professor Susan Thorp**, University of Technology, Sydney



*Dr Scott Donald*



*Professor Susan Thorp*

### **Dr Jacquelyn Humphrey**

University of Queensland – **Should retirement savings be diversified across funds?**

*View presentation*

- Diversification is one of the fundamental principles of finance. It reduces the total risk of an investment portfolio.
- An easy way for an investor to diversify is to invest in a managed fund.
- However, a recent research study suggests that investing in a single managed fund may not sufficiently diversify investment risk, particularly for retirement savings. This research was conducted in the US, where investment choice is not as broad as in Australia.
- Our study, which is currently in progress, examines whether investors should be concentrating their exposure in one fund or diversifying across multiple funds.
- There are a number of reasons why investors might be better off diversifying across multiple funds, including:
  - Evidence on whether Australian fund managers can, on average, outperform broad market indices after fees is, at best, mixed;
  - Any outperformance does not appear to be persistent, so it may be beneficial to diversify manager skill; and
  - Portfolios containing a number of funds appear to have better Sharpe ratios than portfolios containing just one fund.



*Dr Jacquelyn Humphrey*

- There are also several reasons why investors should consolidate their fund exposures, including :
  - Minimising fees;
  - Reducing paperwork / record keeping;
  - Gaining more control over their investments; and
  - It is costly – in both monetary terms and time – for investors to identify, properly investigate and invest in new funds.
- Our study used data from Morningstar and concentrated on equity funds. The sample size was 624 funds and the sample period was from January 1992 to December 2012.
- Replicating recent studies by Elton et al. (2007) and Moorman (2009), we found that there is indeed a benefit (increased Sharpe ratio) from diversifying across funds. However, this analysis relies on a number of unrealistic assumptions.
- We relaxed these assumptions and looked at actual fund returns and risk for our full sample period and also just the period post investment choice (July 2005 to December 2012). We found that investors would be better off having exposure to two super funds, rather than one, in only 18% of cases. This figure is even lower in the post-choice era.
- Should investors decide to have exposure to more than one fund, the optimal fund to add to their portfolio would appear to be a fund that is completely different in terms of family, style and asset class.
- Our analysis has not taken into account the cost of altering the portfolio.
- For engaged, financially-literate investors, a less than one-in-five chance of their portfolio having a higher Sharpe ratio may be sufficient incentive to justify the required research and cost involved in diversifying across multiple funds.
- However, this may not be the case for the majority of superannuation investors. For most investors, consolidation of super funds would appear to be the most logical investment strategy.

### Professor Andrew Ferguson

University of Technology, Sydney – **Aspects of SMSFs**



*View presentation*

- Our study focuses on the size, asset allocation and cost characteristics of SMSFs. It also looks at the independence of the audit arrangements for these funds. The relevance of this study was highlighted by the Cooper Review (2010), which noted the lack of empirical research on SMSFs and their auditors.
- SMSFs now account for approximately one third of all superannuation assets, which currently amount to \$1.8 trillion.
- Our study focused on funds in the accumulation phase, and the sample period was June 2008 to June 2010.
- Listed shares and cash represented the largest component of the funds' asset allocations.
- Contrary to popular belief, SMSFs have little exposure to residential property and little borrowing. They benefited from having little exposure to overseas shares during the GFC.
- The cost of running a SMSF is generally low, with the median cost being just over 0.5% pa, and this cost declines significantly with increased fund size due to economies of scale.
- We find that larger suppliers, in terms of partner client numbers, charge lower audit fees, presumably due to economies of scale. We observe no independence threats from the supply of non-audit services.
- Limitations with the data set (due to Privacy Act constraints) included:
  - There is no firm-level data;
  - There is no demographic breakdown of SMSF members;
  - There is no indication of the age of the SMSFs; and
  - There is no panel data to facilitate year-on-year comparisons.
- The main conclusions from the study were:
  - SMSFs have a relatively low cost structure, due to scale economies;
  - Large audit suppliers appear to be taking advantage of scale economies and employing a service bundling pricing strategy;
  - Charging lower audit fees can secure revenue from higher margin non-audit services; and
  - The supply of non-audit services poses no threat to auditor independence.

### Dr Rob Nicholls

UNSW Australia – **Systemic risk in the superannuation system**



*View presentation*

- Despite the trend towards consolidation, there are still more than 300 industry and corporate super funds. None of these funds has a market share of more than 7%, so the industry cannot be considered to be too concentrated.

- Given the diversity of the system, one would expect it to be resilient.
- In our study we took the approach that system resilience does not come only from stability, equilibrium, safety or efficiency.
- We note that super funds are different from other financial institutions in that:
  - Funds have no separate legal existence – they are ‘virtual’ institutions;
  - Fund trustees can (and do) fail without bringing down the fund;
  - Funds are not typically linked as counterparties; and
  - Funds outsource most of their activities.
- Despite the lack of concentration at the fund level, there is significant concentration in the supply of custody and administration services to super funds. The three largest custodians account for 75% of the equities held by super funds.
- There is also significant concentration in the provision of asset consulting services to super funds, and the trustee directors share common networks. This increases the risk of interdependence and / or synchrony across the industry.
- Our work has highlighted the systemic importance of the four major banks, AMP and Macquarie, which represent key nodes in the network. Essentially, the super fund industry constitutes a network with nodal differentiation.
- Importantly, many of the key nodes (such as fund managers, custodians, administrators and asset consultants) are outside APRA’s jurisdiction.
- Super fund and market conduct regulators should be cognisant of these potential systemic risks.

### Dr Mike Rafferty

University of Sydney – **Governance and performance of superannuation**



*View presentation*

- Super funds differ in three key dimensions:
  - Governance and business models;
  - Distribution; and
  - Performance.
- When comparing the governance of not-for-profit super funds with for-profit (‘retail’) funds, we found that trustees of not-for-profit funds:
  - Come from more diverse backgrounds;
  - Are much less likely to be employed by the fund or a service provider;
  - Hold fewer additional directorships;
  - Spend more time on individual board matters;
  - Have fewer direct relationships with the fund and its service providers;
  - Have fewer service contracts with related parties; and
  - Typically invest more of their retirement savings in the fund.

- Using 25 years' data provided by Rainmaker, we found that not-for-profit funds are generally lower cost than retail funds and have consistently outperformed retail funds.
- We compared the performance of equal investments in balanced and default funds of not-for-profit and retail funds over 25 years from 1987 to 2012 (compounding annual crediting rates) and found a 36% performance differential in favour of not-for-profit funds. This means that a person who invested in a retail fund for 25 years could have achieved their final account balance 8 years earlier if they had invested in a not-for-profit fund.
- On the basis of this research, we concluded that there appears to be a clear link between the governance of a super fund and its performance. One possible explanation for the out-performance of different funds with different governance processes seems to be representation mechanisms on not-for-profit fund boards.

#### **Dr Scott Donald**

UNSW Australia – **Can superannuation funds engage in impact investing?**

- Can super funds engage in impact investing in a manner that is consistent with their obligations to members? We believe the answer is yes, subject to two conditions: firstly, the financial best interests of members must be maintained; and secondly, appropriate due diligence must be carried out on all potential investments, which must fit the fund's investment strategy.
- From a diversification perspective, the ability to add value should be readily evident as impact investments are, by definition, not engaged in activities served by market mechanisms.
- These types of investments typically have liquidity considerations in terms of access and redemption.
- Specialist knowledge, skills and processes may be required to properly evaluate investments.
- There needs to be appropriate governance within the investment structure, covering areas such as potential conflicts of interest and financing.
- Investors must have access to adequate financial reporting and independent valuations.
- The deal flow of potential investments may be inadequate to accommodate the amount of money that larger funds would be looking to invest, but this is a chicken and egg problem.
- Notwithstanding these challenges, it should be possible for superannuation funds to navigate the regulatory requirements to at least consider investing in assets with social impact.

## BREAKOUT SESSION TWO

**FOREIGN CAPITAL & INVESTMENT** – moderated by Co-chairs **Professor Justin O'Brien**, UNSW Australia, **Dr Megan Bowman**, UNSW Australia, & **Dr George Gilligan**, UNSW Australia



*Professor  
Justin O'Brien*



*Dr Megan Bowman*



*Dr George Gilligan*

### **Professor Justin O'Brien**

UNSW Australia

- China is significantly expanding its overseas investments, bringing the issue of state-owned capitalism into focus.
- According to the World Bank, a major aim behind China's overseas investment program is to ensure stability of supply.
- The increasing number of Chinese companies seeking stock exchange listings in the major western markets raises questions regarding their governance, and the Chinese government's broader strategic intentions.



*Dr Megan Bowman*



*Professor Justin O'Brien*

**Dr Megan Bowman**UNSW Australia – **The rise of state-directed capital**

- The two main avenues of operation for state-directed capital are sovereign wealth funds (SWFs) and state-owned enterprises (SOEs). Both types of institutions have an impact on domestic competition and international competitiveness.
- SOEs are corporate entities that are administratively and functionally controlled by the state. These entities represent the main conduit via which capital flows from the BRIC economies to the world.
- Whether the ultimate motivation behind SOEs investing in Australia is political or commercial is a point of contention.
- Concerns regarding such investments typically focus on security implications for the host state.
- There is a lack of empirical data regarding the motivation of SOEs investing in Australia. The Foreign Investment Review Board (FIRB) does not provide a breakdown of private versus government-sponsored investment.
- We collated data from statistics agencies in Australia and China, which included data from private organisations.
- Our findings revealed that, although data sets are not easily compared, SOEs are the dominant conduit for Chinese investment in Australia. These entities account for 76% of total Chinese investment in Australia, including the 10 largest Chinese investments. To date, most investments have been directed towards the energy and natural resources sectors, with only 2% directed towards agricultural land. Moreover, in company acquisitions, Chinese SOEs tend to rely on local Australian management in the acquired company. These data show that Chinese SOEs are behaving in a commercially strategic way.
- Under the Australian foreign investment regime there are more burdensome thresholds for SOE investors.
- The FIRB plays an advisory role in relation to foreign investment approvals. The final decision rests with the Treasurer, based on the ‘national interest’ test.
- The notion of ‘national interest’ is not defined in the legislation or policy. Instead, it is determined on a case-by-case basis, taking into account factors such as community concerns and implications for competition.
- To ensure that the Foreign Acquisitions and Takeovers Act (FATA) remains fit for purpose and Australia continues to comply with the OECD non-discrimination principles, there needs to be transparency and consistency regarding the process of applying the national interest test; and a foreign investment register to document all foreign ownership in Australia (land, companies, etc.), including ownership type (i.e. private or government-sponsored foreign entities).

**Dr George Gilligan**UNSW Australia – **The potential for SOEs to contribute to the public good**

- In March 2014, the combined holdings of SWFs globally amounted to US\$6,357 billion. Norway's government pension fund owns 1% of all listed global equities.
- These funds have provided a significant source of market liquidity post the GFC.
- SWFs entail the state assuming the role of both investor and regulator, and can stimulate capital growth and nation building in their home country. They can help promote good governance and ethical investment practices.
- Although there is a risk that SWFs may be vulnerable to corruption, research indicates little difference in decision making between SWFs and mutual funds. The Santiago Principles (2008) indicate improved governance levels for SWFs.
- SWFs are becoming increasingly attractive as potential funding vehicles for public infrastructure.
- Recent developments in some overseas SWFs may result in nation-building pressure increasing upon the Future Fund.

*Dr George Gilligan*

## BREAKOUT SESSION TWO

**PORTFOLIO MANAGEMENT & DISCLOSURE** – moderated by Co-chairs **Professor David Gallagher**, CIFR, & **Dr Zhe Chen**, CIFR



*Professor David Gallagher*



*Dr Zhe Chen*

### **Professor David Gallagher**

CIFR

- Australia is fortunate to have a well-functioning, healthy and stable financial system.
- As performance measurement is critical to the process of determining whether the investment objectives of the investor are being met, any performance review framework will require that sufficient data is available to make a clearer assessment about overall performance, and the sources of performance generation.
- Participants in the investment industry provide regular performance data feeds to investors, and performance surveys by professional asset consultants provide a simple and effective means of understanding the performance of fund managers against their peer group at monthly or quarterly intervals (with a small time lag).
- Increased granularity of information enables investors to review their investment manager with respect to their performance against industry benchmarks and competitors.
- Much research in academia has sought to better understand how investment performance should be measured (as a means of understanding whether managerial skill truly exists, and therefore the value of the services being provided), as well as the impact of performance on the investment behaviour of investors.
- Research clearly shows that investors are highly responsive to performance. Indeed, past period 'winning' fund managers experience a disproportionate increase in next period fund flows compared to poorly performing fund managers.
- The process of disciplining poor performers is an integral part in ensuring a healthy, vibrant and well-functioning investment market.
- Much of our research over the past years has been to ponder whether professional investors can achieve improved precision in their decision making through the use of more granular portfolio management data, compared to the current, widely available aggregated returns data used within the industry.
- The comprehensive database of information we have on Australian equities managers has allowed us to pioneer in this space, and to more closely evaluate these managers and assess whether they are true to label. This is the subject of current CIFR research work.

- All data relating to fund managers should be disclosed, as long as there are genuine benefits to the regulator, analysts and investors, and the costs to the fund manager are minimised.
- The question of who should have access to this data is subject to debate, and also the subject of a current review by Commonwealth Treasury.

### **Professor Russ Wermers**

University of Maryland, USA – interviewed by Professor David Gallagher, CIFR

- In 2001 we undertook a study that looked at the costs and benefits of disclosure in the US.
- There are two main issues to consider when formulating an optimal disclosure regime:
  - ‘Free riding’, which can happen when a fund manager discloses their portfolio holdings too early, thereby enabling others to create copycat portfolios without paying any fees. Free riding reduces assets under management, fund manager profitability and market pricing efficiency.
  - ‘Front running’, which involves traders (normally hedge funds) using portfolio holding and / or trading data to anticipate the trades of mutual fund managers and trade in advance of these managers. Front running increases the trading costs of mutual funds.
- Free riding and front running enable the transfer of wealth from disclosing entities to other entities.
- Having too little disclosure makes it difficult to assess whether funds’ investment processes are true-to-label, whether there is style drift and whether fund performance is due to manager skill or luck.
- In the US, fund advisers are required to disclose their end-of-quarter equity portfolio holdings on an aggregate basis (via Form 13F). Mutual funds are required to disclose their end-of-quarter equity portfolio holdings on a fund-by-fund basis. Money market funds are required to disclose portfolio holdings on a monthly basis.
- In the past it was costly for mutual funds to provide information to investors because this information took the form of hard-copy documents delivered by mail. These costs have been significantly reduced in recent times, as fund disclosures can be posted on the Securities and Exchange Commission’s (SEC) website.
- Mutual funds that are not money market funds can delay providing holdings information for up to 60 days after the period end.
- Research indicates that most profit from free riding and front running is made in the first quarter after disclosure. The 60 day delay goes some way towards closing this window of opportunity.
- Some assets are more market sensitive than others, for example bonds are far less sensitive than equities.
- If regulators require information more frequently than monthly, they need to establish a persuasive case. More frequent equity holding information may be required in a crisis, however this should only be necessary in special circumstances.
- Further study is required to determine who needs what information, when, and which asset managers require an extra layer of monitoring.



*David Haynes*

### **David Haynes**

Executive Manager of Policy & Research, Australian Institute of Superannuation Trustees (AIST)

- The question of how, and by whom, information will be used is a major source of contention in Australia.
- With regard to disclosure of portfolio holdings, the question arises as to whether this is to inform members and consumers, or to provide information for academics, regulators and rating houses.
- Consumers want information that is simple and clear, for example major holdings.
- Researchers and academics want highly granular information that is capable of manipulation.
- Meaningful disclosure, in the context of superannuation fund members, must take into account varying levels of financial literacy and engagement.
- Our position is to support high levels of regulation, because most people lack sufficient understanding of, or engagement with, their super fund.
- We believe disclosure should be simple and not misleading.
- We support disclosure of investment returns on a net of investment and administration fees basis.
- Members' best interest underpins the disclosure regime of My Super.
- The aim of disclosure is to help members make informed and sensible decisions.
- Portfolio holdings were a late addition to the Stronger Super disclosure process, and AIST welcomes the twelve-month delay in including them in disclosure requirements.

### Pauline Vamos

CEO, Association of Superannuation Funds of Australia (ASFA)

- From a consumer's perspective, disclosure regarding whether a fund manager is true to label is particularly important as it can influence whether an investor buys or retains a product.
- Extensive disclosure to satisfy particular interest groups or investors can have cost implications for the broader investor body. A response to this has involved focussing on the investment process, rather than specific holdings.
- Super fund trustees need to be clear on where the fund's assets are invested, who is managing these assets, and what fees the fund is paying.
- Portfolio disclosure must address how tax and risk are managed.
- Free riding and front running are considerations that impact portfolio disclosure.
- There is work to be done to get the disclosure regime right for consumers, particularly in terms of fees.

### Dr Jim Minifie

Productivity Growth Program Director, Grattan Institute



[View presentation](#)

- Fees paid by Australian super funds are relatively high when measured against other OECD countries, and appear unusually high given the economies of scale in Australia.
- Data from APRA shows that expenses as a percentage of funds under management have increased for all fund sizes from 2004 to 2013.
- We need to consider how to contain fee pressures in default products while maintaining appropriate asset allocations.



Dr Jim Minifie

- An analysis of fund returns from 2004 to 2013 showed that high-fee funds generated lower returns without reduced risk.
- Based on overseas experience, increased disclosure does not appear to have a major impact on consumer behaviour.
- Based on overseas experience, it appears possible for government-run default funds to operate at low cost.
- Chile provides an example of a cost-efficient default fund that is not government-run, but where the management is determined via a tender system. Although the Chilean system drove down default fees, it did very little for non-default products.
- Australia should consider running a tender for default superannuation funds.
- Making tax time super choice time could increase fee pressure if dashboards provide appropriate information.

#### Dr Zhe Chen

#### CIFR – The balance between improved transparency and compliance costs



[View presentation](#)

- A key issue in relation to increased disclosure is the potential market impact of information leakages, which can result in investors copying other investors' portfolios.
- From a regulatory perspective, one of the benefits of increased disclosure is enhanced visibility of fund managers' portfolios, which facilitates a better assessment of whether they are true to label and operating within regulatory and mandate constraints.
- Increased clarity could lead to greater efficiency in the overall system.
- An area we have focused on in our research is how accurately disclosed portfolios match underlying portfolios.
- We have also looked at how susceptible increased disclosure will make the industry to copy-cat investors.
- In our research study we varied frequency of disclosure and waiting times for disclosure.
- We found that more frequent disclosure results in a more accurate reflection of the underlying portfolio. Furthermore, copycat funds potentially provide more competition to average and low-performing funds.

## Plenary Session

**CONCLUDING INTERVIEW PANEL** – moderated by **Professor Justin O'Brien**, UNSW Australia



*Professor Justin O'Brien*

### Professor Justin O'Brien

UNSW Australia

- When the GFC struck in 2008, Sydney's property market was the third most overvalued in the world. Dublin ranked as the most overvalued market. The Dublin market has subsequently fallen by 65% and many other markets have also fallen significantly. Australian property markets have been remarkably resilient in comparison.
- Ireland followed the UK in adopting a 'light touch' approach to financial regulation and is paying a high price for doing so.



*Professor Justin O'Brien, Professor Kevin Davis, Pauline Vamos, Peter Kell & Steven Münchenberg*


**Professor Kevin Davis**

Panel Member, FSI

- A key issue for consideration by regulatory decision makers is the extent to which markets can be left to develop unfettered, as opposed to being governed by specific parameters.
- There needs to be a clear regulatory philosophy regarding issues such as the importance of market efficiency, and individuals' propensity to act in a rational manner.
- The runs on banks that were experienced during the GFC highlight the need to re-think the approach advocated by the Wallis Inquiry.
- While it is acceptable to have some entities operating in the unregulated sector of the financial industry, some of these entities should be moved into the regulated sector.


**Peter Kell**

Deputy Chairman, ASIC

- The historical philosophy behind regulation was that disclosure was paramount. Regulation was non-prescriptive in relation to fees, risks and conflicts of interest as long as these were disclosed. The prevailing attitude appeared to be that 'anything goes as long as you disclose'.
- Disclosure requirements impose additional costs on product issuers and service providers that are passed on to consumers.
- Conflict of interest is one of several areas where mere disclosure is insufficient.
- Disclosure remains integral to the present regime, but the lesson is that it cannot solve all market problems.
- Recent collapses have revealed a misalignment of risk due to factors such as product design and sales practices.
- To distinguish between sophisticated and non-sophisticated investors purely on the basis of fund size is not altogether valid.


**Pauline Vamos**

CEO, ASFA

- The historical philosophy behind regulation was that disclosure was paramount. Regulation was non-prescriptive in relation to fees, risks and conflicts of interest as long as these were disclosed. The prevailing attitude appeared to be that 'anything goes as long as you disclose'.
- Disclosure requirements impose additional costs on product issuers and service providers that are passed on to consumers.



*Pauline Vamos*



*Professor Kevin Davis*

- Conflict of interest is one of several areas where mere disclosure is insufficient.
- Disclosure remains integral to the present regime, but the lesson is that it cannot solve all market problems.
- Recent collapses have revealed a misalignment of risk due to factors such as product design and sales practices.
- To distinguish between sophisticated and non-sophisticated investors purely on the basis of fund size is not altogether valid.



### **Steven Münchenberg**

CEO, Australian Bankers Association (ABA)

- The impact of the GFC on Ireland and elsewhere highlighted the danger of ineffective implementation of legislation.
- Several factors contributed to Australian banks emerging relatively unscathed from the GFC. These included sound management; effective regulatory supervision; ongoing economic growth in China; and a strong domestic fiscal position. Accordingly, any regulatory system changes should aim to further enhance, not re-build, the system.
- Technological advancement will continue to be a major driver of change within the banking sector.
- It would be undesirable to remove the power to make investment decisions purely because investors make mistakes.

# CIFR WORKSHOP

## Financial System Inquiry

The Westin Hotel Sydney – 7 May 2014

The workshop will provide an important opportunity for participants to provide their views and perspectives to the Financial System Inquiry Committee and Secretariat members. Opening with a plenary session and then a choice of breakout sessions covering 6 major areas of the financial system:

### SESSION ONE

**MARKETS      BANKING      SUPER & WEALTH      INSURANCE      FINANCIAL ADVICE**

### SESSION TWO

**MARKETS      BANKING      SUPER & WEALTH      FOREIGN CAPITAL & INVESTMENT      PORTFOLIO MANAGEMENT & DISCLOSURE**

# AGENDA

8.15am Registration

8.45-8.55am **Welcome and Introduction**  
**Professor David Gallagher**, Chief Executive Officer, Centre for International Finance and Regulation (CIFR)

8.55-9.15am **David Murray AO**, Chairman, Financial System Inquiry

- 9.15-10.35am
- **Professor Robert Officer AM**, Emeritus Professor, University of Melbourne & Chairman, Acorn Capital
  - **Alan Cameron AO**, Consultant, Ashurst, Former Chairman, Australian Securities and Investments Commission
  - **Tom Karp**, Independent Consultant, Former Executive General Manager – Australian Prudential Regulation Authority
  - **Mike Callaghan AM**, Director G20 Studies Centre, Lowy Institute for International Policy, Former Executive Director, International, Australian Treasury, Former Australia's G20 Finance Deputy and former member Financial Stability Board

10.35am Morning Tea

11am-12.30pm **BREAKOUT SESSION ONE (CONCURRENT)**

SESSIONS	MARKETS	BANKING	SUPER & WEALTH	INSURANCE	FINANCIAL ADVICE
	<b>Professor Mike Aitken</b> Capital Markets CRC  <b>Professor Terry Walter</b> University of Sydney	<b>Professor Ross Buckley</b> UNSW Australia	<b>Dr Scott Donald</b> UNSW Australia  <b>Professor Susan Thorp</b> University of Technology Sydney	<b>Professor John Evans</b> Centre for International Finance and Regulation (CIFR) and Sydney Business School, University of Wollongong	<b>Professor Kevin Jameson</b> Macquarie University  <b>Professor Dimity Kingsford Smith</b> UNSW Australia

12.30-1.30pm **LUNCH & KEYNOTE SPEAKER**

12.50-1pm **Welcome Steve Harker**, Chief Executive Officer, Morgan Stanley Australia and CIFR Board Member

1-1.30pm **Keynote Professor Patrick Honohan**, Governor, Central Bank of Ireland  
**The fall of the Celtic Tiger and the Future of European Financial Regulation.** Interviewed by Professor Justin O'Brien – Director, Centre of Law, Markets and Regulation – UNSW Australia, in Dublin, Ireland for this workshop.

1.30-3pm **BREAKOUT SESSION TWO (CONCURRENT)**

SESSIONS	MARKETS	BANKING	SUPER & WEALTH	FOREIGN CAPITAL & INVESTMENT	PORTFOLIO MANAGEMENT & DISCLOSURE
	<b>Professor Mike Aitken</b> Capital Markets CRC  <b>Professor Terry Walter</b> University of Sydney	<b>Professor Deborah Ralston</b> Australian Centre for Financial Studies (ACFS) and Monash University	<b>Dr Scott Donald</b> UNSW Australia  <b>Professor Susan Thorp</b> University of Technology Sydney	<b>Professor Justin O'Brien</b> UNSW Australia  <b>Dr Megan Bowman</b> UNSW Australia  <b>Dr George Gilligan</b> UNSW Australia	<b>Professor David R. Gallagher</b> Centre for International Finance and Regulation (CIFR)  <b>Dr Zhe Chen</b> Centre for International Finance and Regulation (CIFR)

3-4pm **INTERVIEW PANEL – CONCLUDING REMARKS**

- Moderated by **Professor Justin O'Brien**, Director, Centre for Law, Markets and Regulation, Professor of Law, UNSW Australia
- **Professor Kevin Davis**, Panel Member, Financial System Inquiry
- **Peter Kell**, Deputy Chairman, Australian Securities and Investments Commission
- **Pauline Vamos**, Chief Executive Officer, Association of Superannuation Funds of Australia
- **Steven Münchenberg**, Chief Executive Officer, Australian Bankers Association

4pm Refreshment

## AGENDA

8.15am

*Registration*

8.45-8.55am

**Welcome and Introduction**



### **Professor David R. Gallagher**

Chief Executive Officer, Centre for International Finance and Regulation (CIFR) and Professor, Australian School of Business, UNSW Australia

**Profile:** Professor David R. Gallagher was appointed Chief Executive Officer of the Centre for International Finance and Regulation (CIFR) in April 2013. He also holds a Chair at the Australian School of Business at UNSW Australia.

David previously held senior academic appointments at the Macquarie Graduate School of Management, The University of Texas at Austin, the Australian School of Business at UNSW Australia, and the University of Technology, Sydney. He has also served as a visiting scholar with the Investment Company Institute in Washington DC.

David's research interests and expertise are in the fields of investment management and capital markets. His research has led to industry and academic awards, together with competitively awarded research grants. He is well known in industry, and has undertaken research and consulting work for numerous organisations within the financial industry.

He is a Research Director at the Capital Markets CRC Limited, an Editor of 'Accounting and Finance' and serves on the advisory board of MARQ Services Pty Limited. David was awarded a PhD in Finance from The University of Sydney Business School in 2002.

8.55–9.15am



### **David Murray AO**

Chairman, Financial System Inquiry

**Profile:** David Murray joined the Commonwealth Bank in 1966, was appointed Chief Executive Officer in June 1992, and retired from this position in 2005. In November 2005 the Australian Government announced that Mr. Murray would be Chairman of the Future Fund. His statutory term ended in April 2012. Mr. Murray is a member of the Oliver Wyman Senior Advisory Board and a Consultant to Tenix Pty Ltd. He was formerly a Senior Advisor to Credit Suisse, Sydney. He has also previously served as a member of the Finance Sector Advisory Council and was the inaugural Chair of the International Forum of Sovereign Wealth Funds. In 2001, he was awarded the Centenary Medal for service to Australian Society in banking and corporate governance and, in 2007, he was made an Officer in the Order of Australia (AO). Mr. Murray holds a Bachelor of Business and a Master of Business Administration. He holds an honorary PhD from Macquarie University and the University of Technology, Sydney. Mr. Murray is currently the Chair of the Financial System Inquiry.

9.15–9.35am



### Professor Robert Officer AM

Emeritus Professor, University of Melbourne & Chairman Acorn Capital

**Profile:** Professor Emeritus of the University of Melbourne, Professor Officer was at the University of Melbourne's Melbourne Business School as a Professor of Finance from 1986 to 2002. Previously, he was Professor with the Department of Accounting and Finance at Monash University. He is a past President of the Accounting Association of Australia and New Zealand and for eight years was Editor of Accounting and Finance and has held positions at the Universities of Chicago, Queensland, Rochester (USA), Stanford Business School and The Wharton School at the University of Pennsylvania. Professor Officer was Chairman of the Victorian Commission of Audit in 1992/3, and Chairman of the National Commission of Audit in 1996. He was Chairman of the Victorian Work Cover Authority from December 1997 to February 2001 and Chairman of the Victorian Funds Management Corporation, 2002 to 2006. He was on the Board of the Bank of Melbourne before its takeover by Westpac in 1998. Currently, he is Chair of several fund management companies each covering different products of financial markets.

Professor Officer has published research papers in Australian and overseas journals covering a number of areas including corporate finance and taxation, share markets, statistics and the regulation/deregulation of business and particularly an entity's cost of capital.

9.35–9.55am



### Alan Cameron AO

Consultant, Ashurst  
Former Chairman, Australian Securities and Investments Commission

**Profile:** Alan Cameron is a consultant in the corporate group in Sydney. Alan's practice focuses on regulation and governance. His experience includes mergers and acquisitions, prospectuses, corporate governance, trust deeds, administrative law and general corporate work. Alan works principally as a company director, and an advisor on corporate governance and regulatory issues. He is Chairman of several companies in the Westpac Bank group, and of the Reliance Rail consortium. He has been the Commonwealth Ombudsman and served for eight years as chairman of the Australian Securities and Investments Commission and its predecessor. Alan is also a Fellow of the Australian Institute of Company Directors and the Securities Institute of Australia. He was national executive partner of Ashurst from 1989 to 1991, and managing partner from 1982 to 1985.

9.55–10.15am



### Tom Karp

Independent Consultant,  
Former Executive General Manager, Australian Prudential Regulation Authority

**Profile:** Tom is an actuary with 15 years experience working in insurers and almost 20 years experience as a financial regulator, including considerable international regulatory work. Tom's private sector experience was with a large Australian composite insurer and a large Australian specialist health insurer. His roles ranged across a variety of areas, including investments, accounting, underwriting, policy administration, product development, systems and actuarial

His financial regulatory experience has been with the Insurance and Superannuation Commission in Australia and the Australian Prudential Regulation Authority (APRA). At both agencies he held executive level roles responsible for day to day supervision of institutions (including major banks, insurers and superannuation [pension] funds), as well as setting regulatory requirements and providing specialist advice. In his last role at APRA he managed 140 staff. Tom helped establish APRA when he was the Acting Insurance and Superannuation Commissioner. He has also had a role in regulating health insurance funds in Australia. At the international regulatory level Tom was heavily involved from 1999 until 2007 in the International Association of Insurance Supervisors (IAIS), as a member of the Executive Committee, Vice Chairman and Chairman of the Technical Committee.

Tom is a member of the Professional Standards Committee of the Institute of Actuaries of Australia's (IAAust), represents the IAAust at the International Actuarial Association (IAA) and is a member of the IAA's Actuarial Standards Committee which develops International Standards of Actuarial Practice. He is also a director of the Australian Reinsurance Pool Corporation, which is a Government corporation responsible for offering reinsurance for terrorism risk in Australia.

Recent project work Tom has undertaken includes being the external insurance assessor for the IMF for the FSAP of the USA (2010), the UK (2011) and France (2012).

10.15–10.35am



### Mike Callaghan AM

Director G20 Studies Centre, Lowy Institute for International Policy  
 Former Executive Director, International Australian Treasury (2008- 2012)  
 Former Australia's G20 Finance Deputy and member of the Financial Stability Board

**Profile:** Mike Callaghan commenced as Program Director of the G20 Studies Centre in December 2012. Mike has extensive experience on international economic issues, both in the Australian Treasury and the International Monetary Fund. Mike was Executive Director, International, in the Australian Treasury from 2008 until 2012. He was also Australia's G20 Finance Deputy and a member of the Financial Stability Board. Mike also served as the Prime Minister's Special Envoy, International Economy. From 2005 until 2007 Mike was Executive Director, Revenue Group in the Australian Treasury and was responsible for tax policy and legislation. Prior to this position he spent four years in Washington DC as Executive Director representing a constituency of 14 countries, including Australia and Korea. Mike was also a member of an eminent persons group tasked with reporting on improving cooperation and collaboration between the IMF and the World Bank. Between 1999 and 2000, Mike served as Chief of Staff to the Australian Treasurer, the Hon Peter Costello. Mike Callaghan joined the Australian Treasury in 1974 and has held various senior positions, including heading the Economic Division and Financial Institutions Division and being the Secretary to the Prime Minister's Task Group on International Financial Reform in 1998. He also worked at the IMF in the early 1980s. Mike has economic and law degrees from the Australian National University and is a graduate of the Royal College of Defence Studies, London. In 2009 he was awarded the Public Service Medal for services to the Australian Government. In 2013 he was made a Member of the Order of Australia.

10.35am

*Morning Tea*

11am–12.30pm

## BREAKOUT SESSION ONE (CONCURRENT)

### MARKETS



**Professor Mike Aitken**  
 Capital Markets CRC

**Profile:** Listed among the top 1000 authors publishing in the finance literature over the last 50 years, Mike Aitken is also a serial entrepreneur who founded the CMCRC, its predecessor organisation SIRCA ([www.sirca.org.au](http://www.sirca.org.au)) as well as the SMARTS Group, a private Australian company that set the standard in real-time market surveillance, recently sold to NASDAQ-OMX. He has overseen the development of fraud detection technologies not only for securities markets, but also accounting and audit markets, and in health insurance and general insurance. As Chief Scientist, he leads a team of over 30 academic and industry researchers and over 50 PhD students, in a world class PhD program across the disciplines of finance, accounting, engineering, computer science and information systems.

Mike was awarded a PhD from the University of New South Wales and a Master of Business Studies from Massey University. In recognition of his contributions, in 2010 he was named E&Y ICT Entrepreneur of the Year and Prime Minister Exporter of the Year.

11am–12.30pm **BREAKOUT SESSION ONE (CONCURRENT)**

## MARKETS



### **Professor Terry Walter**

University of Sydney

**Profile:** Terry Walter holds a fractional Professor of Finance in the Finance Discipline at the University of Sydney Business School. His first academic appointment was in 1973, and since then he has held longstanding appointments at the University of Western Australia, UNSW and the University of Sydney. He was first appointed as a Professor at the University of Sydney in February 1988, and has since then held several senior administrative appointments including Director of Program, Head of School, Head of Division and Dean. In July 2012, he retired from his full-time position at UTS, to take up a newly created position of Chief Research Officer at Sirca Limited, a position he held until April 2014. He has had several successes with ARC research funding (seven discovery grants, one infrastructure grant, two collaborative grants and one cooperative research centre). Terry Walter has a substantial publication record (including papers published in some of the top finance and accounting journals; *Journal of Financial Economics*, *Journal of Banking and Finance*, *Journal of Quantitative Finance*, *Abacus*, *Journal of Accounting and Public Policy*, *Review of Accounting Studies*) and has supervised more than 20 PhD students to completion.

## BANKING



### **Professor Ross Buckley**

Professor, Scientia Professor

Centre for International Finance and Regulation (CIFR)

King & Wood Mallesons Chair of International Finance Law

**Profile:** Ross joined the Faculty as a Professor in 2007, and was appointed a Scientia Professor and to the CIFR King & Wood Mallesons Chair in International Finance and Regulation in 2013.

He currently holds a Discovery Senior Outstanding Researcher Award – a professorial fellowship from the Australian Research Council. His principal area of research interest is in regulatory measures to increase the resilience and stability of financial systems: Australia's, East Asia's and the international system.

He has led three major three-year research projects funded by the ARC and has received numerous other grants. He also co-edited two book series for Wolters Kluwer of The Hague.

In the past Ross has led a research centre into global trade & finance at another Australian University for six years. He has consulted to banks, finance houses and government departments. In the U.S. He has consulted to the Securities and Exchange Commission, the Comptroller of the Currency and the Department of Justice. Closer to home, he has also consulted to the Australian Tax Office, the Asian Development Bank, the Indonesian Ministry of Finance and the Vietnamese Ministry of Trade. He is also chair the Research Committee of Jubilee Australia, the global anti-poverty NGO. In what now feels like a past life, he once practised banking and finance law in Australia and Hong Kong and on Wall Street for nine years.

## SUPER AND WEALTH



### Dr Scott Donald

Deputy Director, Centre for Law, Markets and Regulation, UNSW Australia

**Profile:** Scott Donald joined the University of New South Wales Law Faculty in February 2010.

Prior to joining the Faculty, Scott worked in a variety of senior roles for Russell Investment Group (1994-2005, 2006-2009), including Director of Research, Director of Product Development (EMEA) and, most recently, Director of Fiduciary Research. Before that he was an investment analyst with Ipac Securities (1986-1994). In that time Scott has advised a wide range of public and private sector organisations in Australia and overseas on issues associated with the regulation, governance and investment of superannuation and investment funds. He was a consultant to the Super System Review (the ‘Cooper Review’) that reported in June 2010 and a member of the Stronger Super Governance Consultative Working Group in 2011.

Scott sits on the Policy Advisory Committee of Finsia, the Financial Services Institute of Australasia and is a past member of Finsia’s Sustainability and Managed Funds Advisory Groups.

Scott was a recipient of a Brian Gray Scholarship from RBA/APRA in 2009 and was joint winner of the inaugural Research Prize at the 7th Annual Australian Sustainability Awards in 2008. He has published widely in the academic, professional and industry press on issues related to regulation, law, governance and investment strategy.



### Professor Susan Thorp

Professor of Finance and Superannuation, Finance Discipline Group  
 Core Member, Centre for the Study of Choice  
 Core Member, Quantitative Finance Research Centre  
 University of Technology Sydney

**Profile:** Professor Susan Thorp holds the Chair of Finance and Superannuation at the University of Technology, Sydney. The Chair is funded by the Sydney Financial Forum (through Colonial First State Global Asset Management), the NSW Government, the Association of Superannuation Funds of Australia (ASFA), the Industry Superannuation Network (ISN), and the Paul Woolley Centre for the Study of Capital Market Dysfunctionality within the UTS Business School.

Susan’s research focuses on retirement savings and long-horizon wealth management, with particular interest in consumer decision making. Susan is a Chief Investigator on three current Australian Research Council projects studying member choices in superannuation. Her publications in leading international journals have included studies of financial market integration, retirement savings portfolio management, annuitisation, retirement income streams, and the features of the Age Pension. She is a member of the Centre for the Study of Choice and the Quantitative Finance Research Centre at UTS, and an associate of the Centre for Applied Macroeconomic Analysis, ANU, and the National Centre for Econometric Research, QUT. Professor Thorp gained her BEd (Hons) from the University of Sydney, and her PhD from the University of New South Wales. She previously worked in the Economic Group at the Reserve Bank of Australia.

11am–12.30pm **BREAKOUT SESSION ONE (CONCURRENT)**

## INSURANCE



### Professor John Evans

Executive Education Director, Centre for International Finance and Regulation (CIFR)

**Profile:** John Evans is an Associate Professor at the Sydney Business School, and Chairman of several Risk & Compliance Committees for financial institutions. He was previously a Guardian of the New Zealand Superannuation Fund and consulted to several industry superannuation funds.

John lectures in Australia and Hong Kong on risk management and researches extreme risk and operational risk management. John is a member of the Council of the Actuaries Institute, Convenor of the Research Council Committee of the Actuaries Institute, and Convenor of the Research Subcommittee of the Risk Management Practice Committee.

## FINANCIAL ADVICE



### Professor Kevin Jameson

Director, Applied Finance Centre, Macquarie University

**Profile:** Professor Jameson has extensive experience teaching within the Masters in Applied Finance program, in addition to over 30 years global experience in the finance industry. He is currently a member of the Advisory Council of the Centre for International Finance and Regulation, and a member of the Editorial Board of JASSA: The Finsia Journal of Applied Finance. He has been the Australian Head of Capital Markets, Country Head for Japan and Regional Head of Treasury & Capital Markets for Asia (based in Tokyo) and Global Managing Director of Capital Markets (based in London) for a large UK banking and investment group. He has also been a Director of the Sydney Futures Exchange (and Chairman of its New Products Committee), a Director of and advisor to several private investment businesses, and Chairman of a technology company specialising in products and services for the wholesale asset management industry, operating in Sydney, Europe and the US.



### Professor Dimity Kingsford Smith

Professor of Law, UNSW Australia

**Profile:** Professor Kingsford Smith teaches in the areas of corporations law and regulation of securities and financial products in the undergraduate degree. She teaches master of laws courses on corporate governance and on the regulation of online investing. She supervises a number of postgraduate research students on a wide range of corporate and financial regulatory questions. At the moment these range from a thesis investigating compliance with ASX disclosure rules and selective disclosure, through the effectiveness of independent directors to whether trust law is still an effective contributor to regulation of occupational superannuation schemes. She is also very interested in corporations and securities regulation in developing economies, and has supervised a PhD in this area. She also supervises Master of Laws and Honours theses.

Professor Kingsford Smith's own research and publication is in the areas of corporate and financial regulation and regulatory theory and policy. She is currently the first chief investigator in an Australian Research Council Discovery Grant 2005-08 examining the regulation of online investing. Entitled 'One Day, We'll All Invest This Way! Regulating Online Investment' the project includes leading Australian, US, Canadian and UK researchers. With the growth of retail investment more generally, Professor Kingsford Smith has extended her research to legal and empirical consideration of the effectiveness of disclosure as a regulatory technique in consumer investment. She has published work which considers to what degree disclosure may need supplementation by other regulatory approaches. In 2009 she published research on the effect of the global financial crisis on retail investors.

Professor Dimity Kingsford Smith joined the University of New South Wales Law Faculty in January 2005. She was professor of law and Director of the Centre for Law in the Digital Economy at Monash University between 2000-2004. She previously held appointments at the University of Sydney and in the UK at University College London and Warwick University. In 1999 she was a visitor at the London School of Economics law department.

**11am–12.30pm BREAKOUT SESSION ONE (CONCURRENT)**

Professor Kingsford Smith is the Chair of the Conduct Review Commission, a professional disciplinary panel in the financial services industry. She has advised the Australian Securities and Investments Commission, and consulted to the Canadian Investment Dealers Association. Professor Kingsford Smith has served on the Executive Committee of the Australian Corporate Law Teachers Association, and is a member of the Australian Society of Legal Philosophy and the Julius Stone Institute. She holds membership of the US and Canadian Law & Society Associations. In 2006 she was the author of a research report entitled 'Importing the E-World' for the Task Force to Modernize Securities Legislation in Canada. Prior to contributing to the work of this Task Force, Dimity Kingsford Smith authored policy submissions to the Australian Wallis Committee on the regulation of financial markets, and was a member of the legal committees of the Australian Institute of Company Directors and Law Society of New South Wales.

**12.30–1.30pm**
**LUNCH & KEYNOTE SPEAKER**
**12.50–1pm**
**Welcome**

**Steve Harker**

Chief Executive Officer, Morgan Stanley Australia  
and CIFR Board Member

**Profile:** Steve Harker is a Managing Director of Morgan Stanley and Chief Executive Officer of Morgan Stanley Australia. Prior to joining Morgan Stanley in 1998, Steve spent fifteen years with Barclays de Zoete Wedd. In 1996, he was transferred to London where he was promoted to Chief Executive Officer of Global Equities and a member of the BZW Global Management Committee.

Steve graduated from the University of Sydney with a Bachelor of Economics (first class honours) and a Bachelor of Laws. Steve serves as a Guardian of Australia's Future Fund, Non-Executive Director of Investa Property, Director of the Australian Financial Markets Association (AFMA) and Treasurer of Ascham School.

**1–1.30pm**
**Keynote**

**Professor Patrick Honohan, Governor, Central Bank of Ireland.**

*The fall of the Celtic Tiger and the Future of European Financial Regulation.* Interviewed by Professor Justin O'Brien – Director, Centre of Law, Markets and Regulation – UNSW Australia.


**Professor Patrick Honohan**

Governor  
Central Bank of Ireland

**Profile:** The tenth Governor of the Central Bank of Ireland, Patrick Honohan, was appointed on 26 September 2009. Before his appointment as Governor, he was Professor of International Financial Economics and Development at Trinity College Dublin from 2007. Prior to this, he spent almost a decade at the World Bank where he was Senior Advisor on financial sector policy. He was previously Research Professor with the Economic and Social Research Institute, Dublin (1990-98), Economic Advisor to Taoiseach Garret Fitzgerald (1981-82 and 1984-86) and he spent several years as an economist at the Central Bank of Ireland (1976-81 and 1984-86), and at the International Monetary Fund (1971-73). A graduate of University College Dublin, he received his PhD in Economics from the London School of Economics in 1978. He has taught Economics at the LSE and at the University of California – San Diego, the Australian National University and University College Dublin, as well as at Trinity College. In recent years, his research has mainly focused on monetary and financial sector policy. The appointment of the Governor of the Central Bank of Ireland is made by the President for a seven year term.

1.30–3pm

## BREAKOUT SESSION TWO (CONCURRENT)

### MARKETS



**Professor Mike Aitken**

Capital Markets CRC

*Refer to page 56 for full profile.*



**Professor Terry Walter**

University of Sydney

*Refer to page 57 for full profile.*

### BANKING



**Professor Deborah Ralston**

Executive Director, Australian Centre for Financial Studies  
Professor of Finance, Monash University

**Profile:** Professor Deborah Ralston is the Executive Director of the Australian Centre and a Professor of Finance at Monash University. Previous appointments include Pro Vice Chancellor of the Division of Business Law and Information Science at the University of Canberra, and Director of the Centre for Australian Financial Institutions at the University of Southern Queensland. Deborah's academic background is in economics and financial management and she has taught in the areas of economics, corporate finance, credit risk management, financial statement analysis and financial institutions management.

Her research interests include the impact of financial regulation, the strategy and management of financial institutions and regional economic development. She has published widely in these areas and is a co-author of the text *Financial Institutions Management*.

Deborah is a Fellow of the Australian Institute of Company Directors, the Financial Services Institute of Australasia, and the CPA Australia. Deborah was formerly a Director of Heritage Building Society 1992-2003 and is currently a Director of the listed mortgage broking company Mortgage Choice.

### SUPER AND WEALTH



**Dr Scott Donald**

Deputy Director, Centre for Law, Markets and Regulation, UNSW Australia

*Refer to page 58 for full profile.*



**Professor Susan Thorp**

Professor of Finance and Superannuation, Finance Discipline Group  
Core Member, Centre for the Study of Choice  
Core Member, Quantitative Finance Research Centre  
University of Technology Sydney

*Refer to page 58 for full profile.*

**FOREIGN CAPITAL & INVESTMENT**

**Professor Justin O'Brien**

Professor of Law, Australian Research Council Future Fellow and Director, Centre for Law, Markets and Regulation, UNSW Law; Visiting Professor, Faculty of Business and Law, University College, Dublin; Visiting Network Fellow, Edmond J Safra Center for Ethics, Harvard University and Distinguished Visiting Scholar, Seattle University School of Law.

**Profile:** Professor O'Brien is a specialist in the dynamics of financial regulation, with particular reference to capital market governance. He has written extensively on the intersection between regulatory form and ethical considerations. He is the recipient of a range of major grants from the Australian Research Council and the Economic and Social Research Council in the United Kingdom.

He is the author of a trilogy of books on regulatory politics: *Wall Street on Trial* (2003); *Redesigning Financial Regulation* (2007); and *Engineering a Financial Bloodbath* (2009). In addition he has edited a series of collections on corporate governance, including *Governing the Corporation* (2005); *Private Equity, Corporate Governance and the Dynamics of Capital Market Governance and Corporate Business Responsibilities* (2009). He is co-editor (along with Iain MacNeil of the University of Glasgow) of a major volume on the legal, policy and regulatory implications of the Global Financial Crisis, *The Future of Financial Regulation* (2010).

Professor O'Brien has held appointments at Queen's University, Belfast, Charles Sturt University and Queensland University of Technology. He has been affiliated to the Center for the Study of Law and Society at the University of California, Berkeley as a Visiting Scholar and at the University of Glasgow, where he was Visiting Professor of Financial Regulation and Policy. He was an Adjunct Professor at the Australian National University division of the Centre for Applied Philosophy and Public Ethics from 2009-2012.

Prior to taking up a career in academia Professor O'Brien was an investigative journalist for a range of national and international broadcasters, including three divisions of the British Broadcasting Corporation - Network News and Current Affairs, BBC Northern Ireland and BBC World Service. He was also Editor, Television Current Affairs at Ulster Television in Belfast. He is a regular commentator on financial regulation to the national and international media and writes regularly for the Irish Times and the Australian Financial Review.

Areas of expertise:

Corporate Governance, Business and Professional Ethics, Regulatory Theory, Socio-Legal Studies in Corporate Law.


**Dr Megan Bowman**

UNSW Australia  
Research Fellow

**Profile:** PhD (The Australian National University, Canberra), LL.M. (McGill University, Montréal), B.A./LL.B. (honors) (Monash University, Melbourne Australia).

Dr. Megan Bowman is a Research Fellow in the Centre for Law, Markets and Regulation within the Faculty of Law. Her expertise focuses on international and transnational analyses of climate finance, corporate social responsibility, state capital foreign investment, and optimal regulatory design in corporate and environmental contexts which accounts for the levers and limits of both self-regulation and government intervention. She has published in high quality journals on these topics and taught at McGill University (Montréal), and Monash University and Victoria University (Melbourne). Most recently, Dr. Bowman was selected to present at the Harvard University Institute for Global Law and Policy on corporate financial power and global 'green' governance (2014).

Dr. Bowman has a PhD from the Regulatory Institutions Network (RegNet) at the Australian National University in Canberra. Her qualitative research on corporate climate finance and regulation has garnered international recognition. She was one of only eleven invited international scholars to present on this work at the 2012 Harvard/Stanford International Junior Faculty

1.30–3pm

## BREAKOUT SESSION TWO (CONCURRENT)

Forum at Stanford Law School, and was invited in 2013 to participate in the Forum as an alumna at Harvard Law School. She was also selected to represent the Australian National University at the C9/G8 Clean Energy symposium at Tsinghua University (Beijing, 2011) and to present her research results at the 4th Cambridge University Regulation and Governance conference (UK, 2012). In 2012 Dr. Bowman won first prize in the Business/Law division of the Australian Competitive Research Symposium (ACU).

Dr. Bowman articulated at the top-tier Australian commercial law firm of Allens Arthur Robinson where she practised as an attorney in environmental/planning law and corporate/commercial law. She subsequently practised as an attorney at the non-profit Environment Defenders Office (Vic) before completing a Master of Laws (Comparative International Law) at McGill University in Montréal where she specialised in international law and international relations and was awarded the Chief Justice R.A. Greenshields Memorial Scholarship. Most recently she was a lecturer in law at Victoria University in Melbourne, during which time she was an expert on the human research ethics committee, coordinated the University's Magistrates Court Program, and received the highest accolade of the Vice Chancellor's Peak Award for Leadership and Innovation in Teaching and Learning. Her first degree is in Arts/Law (cum laude) from Monash University, Melbourne, with a double major in Egyptian Archaeology and Japanese language.

Areas of expertise:

- Public-private finance for global climate change mitigation and adaptation ('corporate climate finance').
- Transnational corporate social responsibility, corporate law and directors' duties.
- Corporate (financial) power in global environmental governance.
- State capital investment, particularly by Chinese state-owned enterprises in foreign jurisdictions.
- Behavioural economics and 'nudging' regulation for optimal policy-making.



### Dr George Gilligan

UNSW Australia  
Senior Research Fellow

**Profile:** George's research interests centre on: governance; regulatory theory and practice, especially in relation to the financial services sector; climate change; white-collar crime; organised crime; and corruption. He has published extensively in these areas (see link to publications), conducted numerous field research projects examining the praxis of regulation and appeared as an expert witness before Commonwealth of Australia Senate and Joint Parliamentary Committees.

His major research projects in these core areas of research interest, (which have included commissions from government agencies as well as competitive research grants), have, over the last ten years in particular, centred upon normative issues in the regulation of the financial services sector and related developments in multi-lateral governance. These have given him the experience of successfully designing and conducting large-scale research studies in Australia and overseas.

George has been a Senior Research Fellow in UNSW's Centre for Law, Markets and Regulation since May 2012. Immediately before joining UNSW he was a Senior Research Fellow at the Department of Business Law and Taxation at Monash University after initially commencing at Monash as a Logan Research Fellow in December 1998. Also, during his time at Monash George taught in the postgraduate program of the Monash Law School and supervised several PhD students to successful completion of their PhD candidature. Prior to working at Monash University George taught and researched at the University of Cambridge, Exeter University and Middlesex University in the UK; and La Trobe University and the University of Melbourne in Australia.

George is based in Melbourne and also holds a Senior Research Fellow position with the Centre for Corporate Law and Securities Regulation in the Melbourne Law School at the University of Melbourne.

Areas of expertise:

Governance; Regulatory theory and practice, especially in relation to the financial services sector; Climate change; White-collar crime; Organised crime; and Corruption.

1.30–3pm

## BREAKOUT SESSION TWO (CONCURRENT)

### PORTFOLIO MANAGEMENT & DISCLOSURE



#### Professor David R. Gallagher

Chief Executive Officer, Centre for International Finance and Regulation (CIFR) and Professor, Australian School of Business, UNSW Australia

**Profile:** Professor David R. Gallagher was appointed Chief Executive Officer of the Centre for International Finance and Regulation (CIFR) in April 2013. He also holds a Chair at the Australian School of Business at UNSW Australia.

David previously held senior academic appointments at the Macquarie Graduate School of Management, The University of Texas at Austin, the Australian School of Business at UNSW Australia, and the University of Technology, Sydney. He has also served as a visiting scholar with the Investment Company Institute in Washington DC.

David's research interests and expertise are in the fields of investment management and capital markets. His research has led to industry and academic awards, together with competitively awarded research grants. He is well known in industry, and has undertaken research and consulting work for numerous organisations within the financial industry.

He is a Research Director at the Capital Markets CRC Limited, an Editor of 'Accounting and Finance' and serves on the advisory board of MARQ Services Pty Limited. David was awarded a PhD in Finance from The University of Sydney Business School in 2002.



#### Dr Zhe Chen

Post-doctoral Researcher, Centre for International Finance and Regulation (CIFR)

**Profile:** Zhe joined CIFR in September 2013 as a post-doctoral researcher. Zhe successfully completed his PhD thesis on emulation funds and mutual fund trading behaviour at Macquarie Graduate School of Management in December 2013. He has also completed a Bachelor's degree in Commerce (Finance) and a Bachelor's degree in Engineering (Bioinformatics) with First Class Honours from UNSW Australia. He was awarded the University Medal, the Australian School of Business Dean's Award, the Faculty of Engineering Dean's Award (for 4 consecutive years) and a number of academic scholarships. He has worked as a Tutor at UNSW Australia and The University of Sydney, as a research consultant at Capital Markets CRC, and as a software developer at SMARTS Broker Compliance (now part of NASDAQ).

3–4pm

## INTERVIEW PANEL – CONCLUDING REMARKS



#### Moderated by Professor Justin O'Brien

Director, Centre for Law, Markets and Regulation  
Professor of Law, UNSW Australia

*Refer to page 62 for full profile.*



#### Professor Kevin Davis

Panel Member, Financial System Inquiry

**Profile:** Kevin Davis is a member of the Financial System Inquiry Committee. He is currently a Professor of Finance at the University of Melbourne, a Research Director at the Australian Centre for Financial Studies and a Professor of Finance at Monash University. Professor Davis is also a part time member of the Australian Competition Tribunal and Co-Chair of the Australia-NZ Shadow Financial Regulatory Committee.

3–4pm

## INTERVIEW PANEL – CONCLUDING REMARKS



### Peter Kell

Deputy Chairman, Australian Securities and Investments Commission

**Profile:** Peter Kell commenced as Deputy Chair on 6 May 2013. Prior to this appointment he was Commissioner from 7 November 2011. From August 2008 Peter was Deputy Chair of the Australian Competition and Consumer Commission. He was President of the International Consumer Protection Enforcement Network in 2009-2010, and also served on the Consumer Policy Committee of the Organisation for Economic Cooperation and Development. Peter has been on the Australian Government Financial Literacy Board since its establishment, and is a member of the Commonwealth Consumer Affairs Advisory Committee. Before joining the ACCC, Peter was Chief Executive of CHOICE (the Australian Consumers' Association) and a board member of the global consumer organisation Consumers International. Between 1998 and 2004 he was ASIC's Executive Director of Consumer Protection and its New South Wales Regional Commissioner.



### Pauline Vamos

Chief Executive Officer, Association of Superannuation Funds Australia

**Profile:** Pauline Vamos is the chief executive officer (CEO) of the Association of Superannuation Funds of Australia (ASFA) and has over 25 years' experience in the financial services industry.

Pauline has been CEO of ASFA since 2007, and, prior to this, was a regulator, corporate counsel, head of compliance, and strategic risk consultant, as well as a trustee director for other organisations. In 2013, Pauline was recognised as one of the 'Australian Financial Review and Westpac 100 Women of Influence'. She is a qualified lawyer, as well as a member of the Australian Taxation Office's (ATO's) Superannuation Industry Advisory Group (SIAG), the peak superannuation consultative committee. Pauline is also on the board of the Banking and Finance Oath (BFO) group. In May 2012, Pauline was appointed to the Advisory Council for the newly established Centre for International Finance and Regulation (CIFR), an academic centre of excellence for research and education in the financial sector.



### Steve Münchenberg

Chief Executive Officer, Australian Bankers Association

**Profile:** Steven Münchenberg is the Chief Executive of the Australian Bankers' Association (ABA). He has over 20 years of experience in public policy in the private, public and not-for-profit sectors. Prior to his appointment as ABA CEO, Steven was Group Manager, Government Affairs & Public Policy at the National Australia Bank (NAB). In this role, he was responsible for managing the relationships between the bank and all levels of government in Australia.

Before joining NAB, Steven was Deputy Chief Executive of the Business Council of Australia, the public policy research and advocacy body representing the chief executives of the top 100 corporations in Australia.

Steven has also been CEO of a not for profit organisation charged with promoting the positive aspects of environmental management in the minerals and energy sectors. He has also worked at senior levels within the Australian Government. Steven has Honours degrees in Science from the University of Adelaide and Law from the Australian National University. Steven has also held board positions with a number of community organisations.

4pm

*Refreshment*

## CIFR / KPMG Financial System Inquiry Dinner

On 30 April 2014 CIFR and KPMG hosted a dinner at KPMG's Sydney office attended by senior members of the Australian financial industry, including government representatives, regulators, academics and other industry participants.

Professor David Gallagher, Chief Executive Officer, CIFR, welcomed attendees and provided a summary of submissions made to the Financial System Inquiry (FSI). He advised that CIFR is undertaking qualitative analysis of these submissions to identify common themes and patterns, noting that:

- 298 submissions have been received from 233 contributors.
- The submissions came from a broad range of sources, with the top three being Professional & Industry Associations (25%); Individuals (21%); and Listed Companies (17%).
- Areas of focus for specific groups included:
  - Regulation & Policy and Superannuation – Professional & Industry Associations; Listed Companies; Academics; Individuals.
  - Banking System and Regulation & Policy – Unlisted Companies.
  - Financial System Integrity and Regulation & Policy – Government & Regulators.

Moderated by CIFR Research Fellow Dr Kingsley Jones, a panel of industry experts highlighted a number of key issues addressed by these submissions. Their presentations are summarised below.



### **Dr Scott Donald**

Deputy Director, Centre for Law, Markets and Regulation, UNSW Australia

- 75 submissions (26%) addressed the topic of superannuation.
- Two of the major themes emerging in the public domain are:
  - Infrastructure investment within superannuation; and
  - Costs associated with superannuation.
- Both have been impacted by the decision, taken in 1993, to decentralise responsibility for decision-making to the trustees of each fund. This has a number of benefits, including:
  - Trustees can cater to niche needs;
  - It reduces (but does not eliminate) the 'too big to fail' issue; and
  - It creates more potential for innovation.
- But it also has some drawbacks:
  - The government cannot tell the trustees what to do; and
  - It is difficult to ensure that all trustees are competent and focussed on members' interests.

- So what about infrastructure? Two points are worth noting:
  - Many funds typically already have significant exposure to infrastructure (\$45 – 50 billion in total). This exposure is well in excess of comparable funds in most other countries.
  - Concerns have been raised in relation to the pricing of infrastructure investment. It is important to recognise that dumping mispriced infrastructure assets on super funds merely shifts the burden. If assets are priced appropriately, super funds will buy them.
- A number of submissions address the costs associated with superannuation, which are deemed to be high by international standards.
- International cost comparisons are not helpful, however, because most Australian funds are defined contribution funds with relatively high weightings to growth assets (including infrastructure and other alternative assets), extensive choice of investment options and advanced product features; while most overseas funds are defined benefit funds with lower weightings to growth assets, no investment choice and fewer product features.
- International cost comparisons in asset management and custody show costs in Australia to be in line with overseas competitors.
- Offering member investment choice is good for those members who exercise that choice wisely, however it comes at a cost to all members.
- When assessing the cost of superannuation, we need to distinguish between costs that are inherent in the design of the system, and economic rent. We need to look past the rhetoric and scapegoating to gain a clear understanding of the real issues.



### **Dr Gordon Menzies**

Associate Professor, UTS Business School

- Australia navigated its way through the Global Financial Crisis (GFC) relatively unscathed. It is worth considering whether this was due to the rigour of our regulatory framework or simply good fortune.
- Australia's situation was helped by a number of factors:
  - At the onset of the GFC, we had ample scope for fiscal policy adjustment.
  - A high percentage of borrowers had variable mortgages and therefore benefited from interest rate reductions.
  - Unlike many of their overseas peers, our banks did not have excessive exposure to poor quality home loans.
  - The failure of HIH Insurance in 2001 served as a timely lesson for regulators, who were well prepared when the GFC arrived seven years later.
  - Most of our major export destinations were comparatively less affected by the GFC.
  - Our floating exchange rate was beneficial, as the depreciation of the Australian dollar helped exporters.
- Moral hazard is an issue to be wary of post the GFC bailout era. Some market players may take on excessive risk in the expectation that if things go wrong, regulators will again come to their rescue.
- There is a strong argument in favour of strengthening, rather than reducing, financial regulation in the current environment.


**Andrew Dickinson**

Partner, KPMG

- KPMG’s submission to the FSI focussed on a relatively small number of implementable recommendations.
- Regulation should achieve a good balance between efficiency, growth and financial stability. Ultimately, there is a point at which further regulation negatively impacts the efficiency of the industry. When assessing the effectiveness of existing and proposed regulation, the costs (including second and third order costs) need to be considered, as well as the benefits.
- Australia is a relatively low risk country in which to conduct business, with a relatively high level of financial regulation by global standards. This suggests that we have a very low risk appetite for organisational failure. Given the cost of financial regulation, we should consider whether this stance is sensible.
- We need to view the cost of regulation in its totality, and not simply focus on the cost to individual entities. We also need to expand our assessment of costs to include more than just compliance costs.
- Financial regulators should be held accountable for their impact on the financial system. We should consider setting Key Performance Indicators for them.
- We should endeavour to achieve better regional integration of financial regulation.
- The current focus on superannuation funds’ funding of infrastructure should be broadened to examine how Australia’s longer term growth will be funded.
- We should also assess the impact on the financial system of tax concessions and imposts, such as concessional tax rates on capital gains and interest withholding tax on retail deposits.
- It may be worth considering allowing superannuation fund members to opt out of having a choice of investment options. Investment choice comes at a cost in that funds have to either limit investment in illiquid assets or retain a higher-than-optimal level of liquidity in order to manage investor switches in and out of illiquid asset classes.
- Members in the draw down phase of superannuation should be encouraged to use annuity investments to help manage longevity risk.


**Phil Coffey**

Deputy Chief Executive Officer, Westpac

- Westpac’s submission to the FSI focussed on 6 key issues. This presentation will address 5 of these issues: funding, regulation, competition, superannuation and technology.
- Funding: From time to time, there will be occasions when demand for credit will outweigh the banks’ available pool of funding. The traditional view has been that the forces of supply and demand will resolve this, but the way this occurs is also important. It could be that deposit and loan interest rates will be driven higher to a new equilibrium, or that new capital will be attracted from overseas, or other

permutations. Westpac believes banking is best placed to facilitate informed, broad-based distribution of credit and that the best solution is to improve the supply of high quality funding to the banking industry.

- **Regulation:** The GFC spawned a plethora of financial regulation. Westpac is devoting significant resources to ensure compliance with this regulation. Its compliance costs are 600% higher than they were 8 years ago. This regulation is producing unintended consequences, including increased costs and reduced productivity, which are pushing businesses into unregulated areas and creating potential longer term risks. We need a temporary moratorium on new regulation to enable the impact of current regulation to be evaluated.
- **Competition:** Australia has a strong, broadly-based and competitive financial system, which is not overly dependent on our banks. Banks comprise a smaller portion of our financial system than they do in most other developed countries. Having a concentrated banking sector is not necessarily bad, as concentration and competition can co-exist. The determining test is whether customers are disadvantaged. Imposing additional charges on the big 4 banks, such as the Financial Claims Scheme Levy, just penalises the higher rated players.
- **Superannuation:** Government policy measures have stimulated the growth of the superannuation industry in Australia. Despite this growth, there is little near-term likelihood that the system will achieve its objective of providing adequate retirement income to a significant proportion of retirees. It is a concern that the two highest growth areas of the superannuation system are default funds (in which the most disengaged members invest) and SMSFs (which are used by members who think they can do a better job of investing their retirement savings than professional fund managers). We need to reconsider the goals of the superannuation system, and the optimal amount of government intervention.
- **Technology:** Technology has significantly changed the way in which customers deal with their banks. This is particularly evident within the payments system, which is integral to the working of the broader economy. It is imperative that future technological innovations do not undermine confidence in the stability of the payments system.



**Dr Mike Aitken**

Chief Executive Officer, Capital Markets CRC (CMCRC)

- The fundamental role of security market regulators, as outlined in their published mandates, is to ensure that markets are fair and efficient. For this to be meaningful, regulators and those who would motivate changes in market design need to define and operationalize these concepts and provide clear evidence of how the proposed changes will affect fairness and efficiency. Indeed, regulators themselves need to use these measures to evaluate their own performance by comparing the fairness and efficiency of Australian markets to other world markets.
- An efficient market is one in which it is cheap to trade and trading prices reflect all available information. From this definition, transactions costs and price discovery are the key attributes that one needs to measure when measuring the impact of market design changes on the efficiency of a marketplace. A fair market is one in which prohibited trading behaviours is minimised. Key prohibited trading behaviours are insider trading, market manipulation and broker / client conflict.
- When formulating regulatory policy, it is imperative to adopt an evidence-based approach. This enables regulators to properly assess issues such as what impact high-frequency trading and dark pools have on the financial system. Understanding how these changes are affecting the fairness and

efficiency of markets requires us to understand how market design changes are affecting transaction costs, price discovery, insider trading, market manipulation and broker / client conflict.

- Gathering relevant evidence can be a time consuming and expensive process. CMCRC has spent 10 years and \$100 million building an evidence-based research capability to enable regulators anywhere in the world to analyse design changes to securities markets. Importantly, however, because the work has been conducted through the CRC program, this work has been cost neutral to the Commonwealth Government, with the CRC building commercial enterprises while building its market quality framework and software.
- From October 2014 new rules will enable the Australian regulator to identify the entity responsible for executing any individual trade. This information will be very useful to regulators seeking to identify prohibited trading behaviours but must also be made available to researchers on a de-identified basis in order to fully utilise the data.
- Agriculture represents 6% of Australia's GDP and has 6 funded CRCs. The financial services sector represents 10% of GDP and has one CRC. It's time to invest in further CRCs along the lines of the CMCRC in order to provide a continuous review framework for the insurance, banking and superannuation industries. This would reduce the need for intermittent financial system inquiries and ensure that the evidence required to inform such inquiries is readily available. A key aspect of CRCs is the active participation of government, industry and universities on an ongoing basis, which is a key ingredient in any inquiry.



### **Professor David Gallagher**

Chief Executive Officer, CIFR

- In summary, Australia has a well-functioning and well-regulated financial system that represents a large and growing part of our economy.
- Challenges for our financial system include:
  - Market structure issues;
  - Competition issues;
  - Small population size and concentration in a small number of urban centres spread across a vast continent;
  - The vulnerability of a small open economy to external shocks;
  - How we finance our future needs and grow our economy;
  - How we can successfully export financial services to the rest of the world;
  - Demographic issues, such as the impact of our ageing population on health care, taxation and retirement incomes;
  - Maintaining confidence in our superannuation system despite frequent budget-driven changes to the system;
  - Pressure to allow first home buyers to access their super to help them achieve home ownership;
  - Internationalisation issues, such as the potential for monetary integration;
  - Potential for greater integration of regulatory architecture and activities;
  - The importance of human capital, including education, in further developing the system; and
  - How to harness the best minds and evidence-based research to enhance the system.

## GOVERNING BOARD

---

**Mr Peter Mason AM**, (Chair), Chairman, CIFR

**Ms Jan Harris**, Executive Director, Markets Group, Commonwealth Government Treasury

**Mr Steve Harker**, Managing Director, Morgan Stanley Australia

**Professor Fred Hilmer AO**, Vice Chancellor and President, UNSW Australia

**Professor Geoff Garrett**, Dean, Australian School of Business, UNSW Australia

**Dr John Laker AO**, Chairman, Australian Prudential Regulation Authority

**Dr Alden Toevs**, Group Chief Risk Officer, Commonwealth Bank of Australia

**Professor S. Bruce Dowton**, Vice-Chancellor and President, Macquarie University

**Professor Ross Milbourne**, Vice-Chancellor and President, University of Technology, Sydney

## ADVISORY COUNCIL

---

**Mr Peter Mason AM**, (Chair), Chairman, CIFR

**Mr Steve Münchenberg**, Chief Executive, Australian Bankers Association (ABA)

**Dr David Lynch**, Executive Director, Australian Financial Markets Association (AFMA)

**Dr Andries Terblanché**, Senior Partner, KPMG

**Mr John Brogden AM**, Chief Executive Officer, Financial Services Council (FSC)

**Ms Pauline Vamos**, Chief Executive Officer, Association of Superannuation Funds of Australia (ASFA)

**Mr Charles Littrell**, Executive General Manager, Policy, Research and Statistics, Australian Prudential Regulation Authority (APRA)

**Mr Greg Medcraft**, Chairman, Australian Securities and Investments Commission (ASIC)

**Dr Malcolm Edey**, Assistant Governor Financial System, Reserve Bank of Australia (RBA)

## ADVISORY COUNCIL CONTINUED

---

**Ms Jan Harris**, Executive Director, Markets Group, Commonwealth Government Treasury

**Mr Tom Durick**, Senior Manager, Business Advisory & Industry Development, NSW Department of Trade and Investment

**Professor Roger Simnett**, Academic Director, Centre of Social Impact, UNSW Australia

**Professor Ross Buckley**, Scientia Professor and CIFR King & Wood Mallesons Chair of International Finance Law, UNSW Australia

**Professor Jennifer Hill**, Professor of Law, The University of Sydney

**Professor Stephen Taylor**, Professor of Accounting and Associate Dean (Research and Development), University of Technology, Sydney

**Professor Kevin Jameson**, Professor and Director of the Applied Finance Centre, Macquarie University

**Professor Veronica Taylor**, Director, Regulatory Institutions Network (RegNet) and Director, School of Regulation, Justice and Diplomacy, The Australian National University

**Professor Ian Ramsay**, Harold Ford Professor of Commercial Law, Melbourne Law School, and Director of the Centre for Corporate Law and Securities Regulation, The University of Melbourne

**Professor Mike Aitken**, Chief Executive Officer, Capital Markets Cooperative Research Centre Ltd (CMCRC)

**Dr Michael Briers**, Chief Executive Officer, Securities Industry Research Centre of Asia Pacific (SIRCA)

**Mr Ian Paterson**, Partner, King & Wood Mallesons

## MANAGEMENT TEAM

---

**Dr Zhe Chen**, Post-doctoral Researcher

**Associate Professor John Evans**, Executive Education Director

**Professor David Gallagher**, Chief Executive Officer

**Tim Gapes**, Centre Director

**Veronique Henrisson**, Events Manager

**Madeline Johan**, Research & Events Administrator

**Dr Kingsley Jones**, Research Fellow

**Evelyn Mike**, Research Manager

**Kala Miranda**, Research Coordinator

**An Nguyen**, Finance Officer

**Dr Camille Schmidt**, Post-doctoral Researcher

**Emily Stevenson**, Executive Assistant to the CEO

**Dr Geoff Warren**, Research Director

[www.cifr.edu.au](http://www.cifr.edu.au)



*[View Current Research Projects](#)*

## APPENDIX

Opening Session	David Gallagher Bob Officer AM Tom Karp Mike Callaghan AM
<b>SESSION ONE</b>	
Banking	Deborah Ralston Gordon Menzies Valentyn Panchenko
Super & Wealth	George Kudrna Xiaodong Fan Fedor Iskhakov Susan Thorp Geoff Warren
Insurance	Peter Carroll Insurance Discussion Questions
Financial Advice	Kinglsey Jones Geoff Kingston Dimity Kingsford Smith
Keynote	Transcript – Patrick Honohan interviewed by Justin O’Brien
<b>SESSION TWO</b>	
Markets	Joseph Barbara David Lynch
Banking	James Cummings Harald Scheule Richard Holden
Super & Wealth	Jacquelyn E. Humphrey Andrew Ferguson Rob Nicholls Mike Rafferty
Portfolio Management & Disclosure	Jim Minifie Zhe Chen

## Qualitative and Text Analytics Financial System Inquiry 2014 Making sense of the submissions...so far

Kingsley Jones  
Camille Schmidt  
David Gallagher

---

### Introduction

- The Financial System Inquiry aims to gather information in order to determine the future direction of Australia's financial system.
- Joe Hockey announced the inquiry's Terms of Reference, which call for a 'root and branch' review of the nation's financial system and outline key areas to consider when forming submissions.
- Submissions have been received from a range of sources these are available on the FSI's website: <http://fsi.gov.au/consultation/>
- The last Financial System Inquiry known as the Wallis Inquiry in 1997 led to streamlined financial services regulation, the creation of the Australian Prudential Regulation Authority (APRA), and the current form of the Australian Securities and Investments Commission (ASIC).
- It has been 17 years since the Wallis Inquiry thus, it is timely that another inquiry be undertaken, particularly in light of the Global Financial Crisis.

## FSI: Who Submitted?

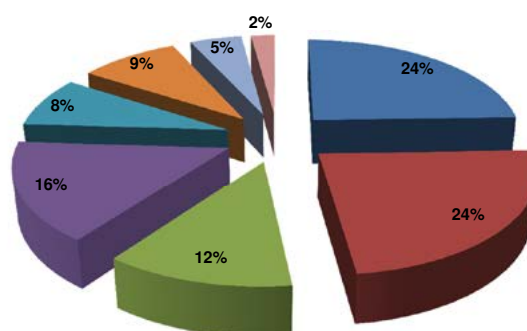
- There were 298 submissions in total (based on the fourth batch uploaded on the FSI website 02/05/2014)
- These were from 233 unique contributors

Contributor Classification	For example...	Total	Total (%)	Unique	Unique (%)
Professional/Industry Association	FINSIA, CFA, CPA, Actuaries Institute	74	24.83%	57	24.5%
Individual Person(s)	Joe Bloggs & Jane Doe	63	21.14%	55	23.6%
Listed Company	Big 4 Banks, Macquarie, IAG, QBE, CSR	52	17.45%	28	12.0%
Private Sector	KPMG, PWC, King & Wood Mallesons	39	13.09%	37	15.9%
Academic- University/Research Consortium	UNSW, RMIT, UTS, UWS, ANU, Monash	27	9.06%	19	8.2%
Government/Regulator	APRA, ASIC, RBA, Treasury	25	8.39%	21	9.0%
Unlisted Company	Dimensional, Ratesetter	12	4.03%	11	4.7%
Other	Charities, churches, political parties	6	2.01%	5	2.1%
<b>Total</b>		<b>298</b>	<b>100.0%</b>	<b>233</b>	<b>100.0%</b>

## FSI: Who Submitted?

### Top 3 Contributors:

- Professional/Industry Associations: 24%
- Individuals: 24%
- Private Sector: 16% \*although Listed Companies come in third based on total submissions



■ Professional/Industry Association     
 ■ Individual Person(s)     
 ■ Listed Company  
■ Private Sector     
 ■ Academic- University/ Research Consortium     
 ■ Government/Regulator  
■ Unlisted Company     
 ■ Other

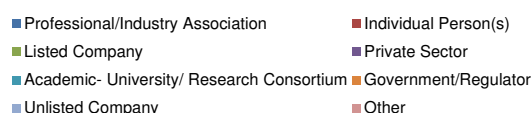
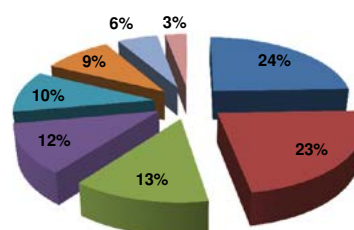
Based on number of unique contributors (n=233)

## Wallis Inquiry Comparison

- There were 237 unique contributors
- The number of total submissions is not able to be determined as all submissions are not available online
- The number of unique contributors & breakdown is very similar to that for the current inquiry

### Top 3 Contributors:

- Professional/Industry Associations: 24%
- Individuals: 23%
- Listed Companies: 13% \*followed closely by private companies with 12%



Based on number of unique contributors (n=237)

## FSI: Contributor Breakdown

### Professional/Industry Associations

- A quarter of the submissions were from professional or industry associations with 57 unique contributors developing 74 submissions.
- The associations represent a range of areas including banking and financial services, housing, building and construction, mining and exploration, management, seniors, consumers and small businesses.

### Individuals

- It's interesting that 24% of submissions were from individuals; of the 55 unique individual contributors, 21 provided some information as to their background. Specifically, the majority of these individuals were educated professionals characterised as current or former employees of firms within the financial services industry.

### Listed Companies

- There were 28 publically listed companies which contributed and these were predominantly from firms in the banking and financial services industry. In particular, the big 4 banks, a few regional banks and the major Australian insurance firms all contributed.

### Private Sector

- The majority of private sector submissions are from firms in the banking and financial services industry, including lending, investment and financial advisory/planning firms.

## FSI: Contributor Breakdown

### Government/Regulator

- This category comprises 21 unique contributors representing Government bodies such as the major financial regulators (e.g. APRA, ASIC), Treasury, RBA, Legal Aid and similar protective agencies, various state government bodies and organisations developed to focus on a specific initiative e.g. Infrastructure Australia and Innovation Australia.

### Academic- University/Research Consortium

- There were 12 unique submissions from academics affiliated with a range of universities across Australia. UNSW was affiliated with the most submissions followed by RMIT and UTS.
- This category also includes research consortiums, which conduct research in a variety of areas including finance and investments, policy, population ageing, superannuation, banking, data services and economic, social and environmental issues.

### Unlisted Companies

- This category comprises unlisted companies; all 11 unique contributors in this group were in the banking and financial services industry. Specifically, this includes member-owned banks and other providers of banking, payments and settlement services and a fund manager.

## Key Themes

A literature survey of the submissions revealed 12 common themes:

### **1) Banking System**

- Lack of competition between the big 4 banks
- Regulation
- Access to Funding

### **2) Challenges and Opportunities**

- Housing affordability
- Ageing population; Aged Pension
- Healthcare Costs; Budget Sustainability
- Social Inequity
- Growth of Asian economies
- Promoting Innovation

### **3) Financial Advice**

- Improving the provision of trusted advice
- Remuneration of advisors

## Key Themes

### 4) Financial Markets

- Development of the retail bond market / infrastructure debt markets
- Impact investing
- Unlisted property funds sector
- Derivatives

### 5) Financial System Integrity

- Financial literacy
- Financial inclusion
- Protection of vulnerable consumers

### 6) Funding

- Venture capital and private equity availability and alternative funding sources.
- Private capital markets
- Private funding of infrastructure
- Lack of funding access for SMEs

## Key Themes

### 7) Insurance

- Regulation
- Underinsurance and the impact on the social security system
- Lenders' Mortgage Insurance
- Life insurance

### 8) Legislation

- Specific legislative issues e.g. relating to the Corporations Act and Banking Act.

### 9) Payments System

- Online payment security
- Globalisation
- Regulation
- Transparency

## Key Themes

### 10) Regulation and Policy

- The role of the policy makers and regulators
- Policies to deal with an ageing population
- Competition
- Innovation
- Capital allocation
- Financial system stability

### 11) Superannuation

- Ageing population
- Aged Pension
- Retirement income
- SMSF
- Short-termism

### 12) General

- Includes submissions covering a variety of these topic areas and those which go through each of the Terms of Reference.

## Key Themes by Contributor Classification Category

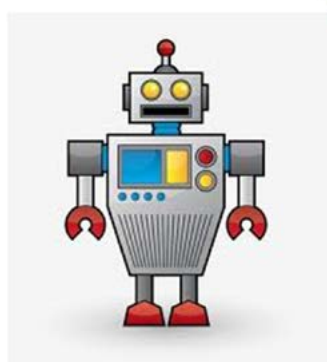
- The table on the next slide shows the number of submissions from each contributor group relating to each of the key themes identified.
- It is evident that **‘Regulation and Policy’** and **‘Superannuation’** are the most common themes across the groups with these comprising the top two in 7/8 and 4/8 of the groups, respectively. The **‘Banking System’** was the third most common topic.
- It is interesting to note that although superannuation was a hot topic only two superannuation funds submitted to the inquiry, namely, Industry Super and UniSuper.
- **Professional/Industry Associations, Individual Person(s) and Academic-University/Research Consortia** were all mainly concerned with **‘Regulation and Policy’** and **‘Superannuation’**.
- **Listed Companies** focused on **‘Superannuation’**, the **‘Banking System’** and **‘Insurance’**, whilst the **Private Sector** emphasised **‘Regulation and Policy’** and **‘Challenges and Opportunities’**.
- The contributors in the **Government/Regulator** group were mainly concerned with **‘Financial System Integrity’**, **‘Funding’** and **‘Regulation and Policy’**.
- **Unlisted Companies’** main concern was the **‘Banking System’** followed jointly by **‘Financial Markets’**, the **‘Payments System’** and **‘Regulation and Policy’**.

## Key Themes by Contributor Classification Category

Theme	Professional/ Industry Association	Individual Person(s)	Listed Company	Private Sector	Government/ Regulator	Academic- University/ Research Consortium	Unlisted Company	Other
Banking System	6	7	7	5	2	2	5	2
Challenges and Opportunities	7	7	2	6	2	1	0	0
Financial Advice	2	5	0	2	0	0	0	0
Financial Markets	4	1	0	5	1	1	2	0
Financial System Integrity	1	3	0	0	5	2	0	1
Funding	5	2	1	2	4	1	0	0
General	6	1	4	1	2	1	0	0
Insurance	5	0	7	1	0	0	0	0
Legislation	0	2	2	0	1	0	0	1
N/A	8	3	2	1	1	2	0	1
Payments System	2	3	4	1	1	0	2	0
Regulation and Policy	18	18	6	10	4	14	2	1
Superannuation	10	11	17	5	2	3	1	0
<b>Total</b>	<b>74</b>	<b>63</b>	<b>52</b>	<b>39</b>	<b>25</b>	<b>27</b>	<b>12</b>	<b>6</b>

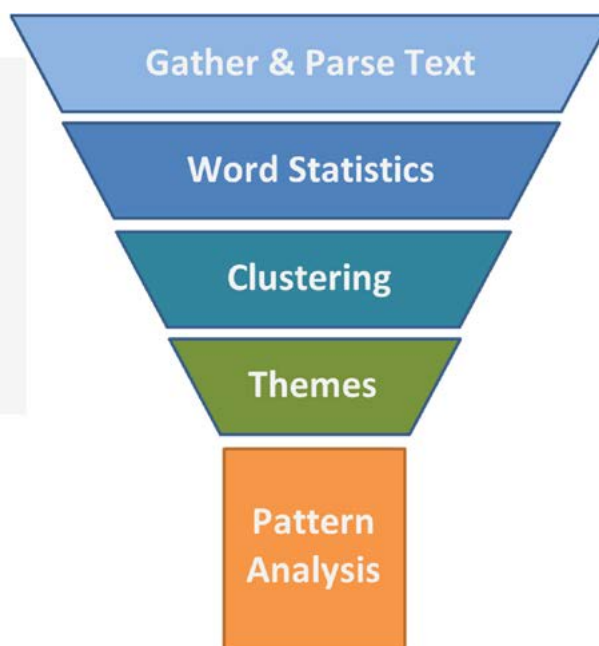
\*N/A indicates documents such as cover letters.

## Text Analytics Process



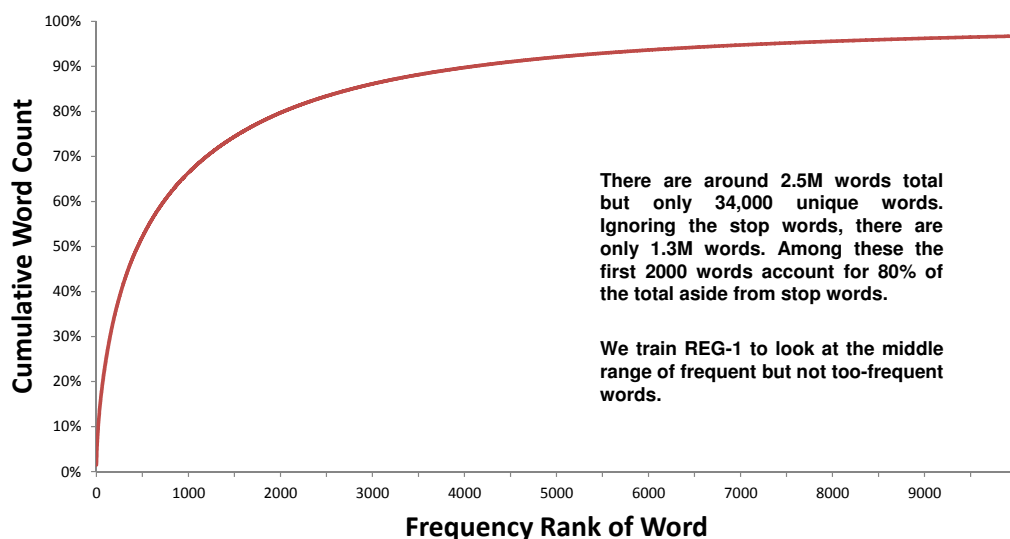
### Robot Text Analysis

- Word Counts
- Themes
- Patterns





## Training Classifier Robot (REG-1)



## Performance of Simple Classifier Robot (REG-1)

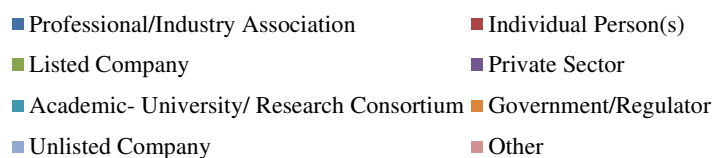
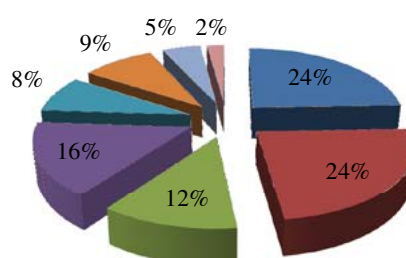
Classifier Performance Metric	Precision (percentage of correct category)	Recall (avoidance of false negatives)	F-1 Score (combined performance)	Number of Documents in Training Set
Payments System	57%	100%	73%	4
Superannuation	68%	65%	67%	20
Banking System	58%	44%	50%	16
Financial System Integrity	67%	40%	50%	5
Regulation and Policy	39%	66%	49%	32
Insurance	50%	40%	44%	5
Funding	20%	33%	25%	3
General	100%	14%	25%	7
Challenges and opportunities	33%	9%	14%	11
Financial Advice	0%	0%	0%	3
Financial Markets	0%	0%	0%	6
Legislation	0%	0%	0%	3
<b>Average / Total</b>	<b>48.0%</b>	<b>45.0%</b>	<b>42.0%</b>	<b>115</b>

## FSI Submissions- Contributors & Key Themes

### *Classification of Contributors*

- There were 298 submissions in total (based on the fourth batch uploaded on the website 02/05/2014).
- These were from 233 unique contributors.

<b>Contributor Classification</b>	<b>For example...</b>	<b>Total</b>	<b>Total (%)</b>	<b>Unique</b>	<b>Unique (%)</b>
Professional/Industry Association	FINSIA, CFA, CPA, Actuaries Institute	74	24.83%	57	24.5%
Individual Person(s)	Joe Bloggs & Jane Doe	63	21.14%	55	23.6%
Listed Company	Big 4 Banks, Macquarie, IAG, QBE, CSR	52	17.45%	28	12.0%
Private Sector	KPMG, PWC, King & Wood Mallesons	39	13.09%	37	15.9%
Academic- University/ Research Consortium	UNSW, RMIT, UTS, UWS, ANU, Monash	27	9.06%	19	8.2%
Government/Regulator	APRA, ASIC, RBA, Treasury	25	8.39%	21	9.0%
Unlisted Company	Dimensional, Ratesetter	12	4.03%	11	4.7%
Other	Charities, churches, political parties	6	2.01%	5	2.1%
<b>Total</b>		<b>298</b>	<b>100.0%</b>	<b>233</b>	<b>100.0%</b>



*N.B. If a firm is a subsidiary of a listed company then it is classified as a 'Listed Company'.*

### Professional/Industry Association

A quarter of the submissions were from professional or industry associations with 57 unique contributors developing 74 submissions. The associations represent a range of areas:

- Banking and financial services industries such as credit reporting, lending, payments, superannuation, financial planning, insolvency, actuaries, venture capital and private equity.
- Submissions from the housing, building and construction and mining and exploration associations were also received.
- Associations representing the interests of management such as CEOs, company directors and stock or derivative exchange executives.
- Associations representing the interests of individuals such as seniors and consumers and small businesses.

### Individual Person(s)

- It's interesting that 24% of submissions were by individuals; this category does not include individuals affiliated with a university, those are classified as 'Academic-University/Research Consortium'.
- Of the 55 unique individual contributors, 34 provided no further information as to their background.
- The 21 individuals who provided some information as to their background are educated professionals predominantly characterised as current or former employees of firms within the financial services industry, including;
  - 4 accountants
  - 3 in consulting (IT/Management/Financial Services)
  - 3 PhD holders
  - 2 financial planners/advisors
  - 2 individuals that had held a range of roles in finance
  - 1 derivatives and securities lawyer
  - 1 previous securities dealer
  - 1 individual qualified as a financial planner but not pursuing it as a career
  - 1 regulator
  - 1 non-executive bank director
  - 1 director of a research institute and;
  - 1 chartered fellow of the Royal Australian Chemical Institute.

### Listed Company

There were 28 publically listed companies which contributed and these were predominantly from firms in the Banking and Financial Services industry. In particular, the big 4 banks, a few regional banks and the major Australian insurance firms all contributed.

<b>Industry</b>	<b>N</b>
Banking & Financial Services	19
Consulting	1
Industrial	1
Insurance	5
IT	1
Retail	1
<b>Total</b>	<b>28</b>

### Private Sector

The private sector includes firms structured as a partnership, proprietary limited company or limited liability company. The majority of private sector submissions are from firms in the banking and financial services industry, which is not surprising. This included lending, investment and financial advisory/planning firms.

<b>Industry</b>	<b>N</b>
Banking & Financial Services	21
Consulting	6
Legal	6
Accounting	4
<b>Total</b>	<b>37</b>

### Public Sector

This category comprises 21 unique contributors representing Government bodies such as the major financial regulators (e.g. APRA, ASIC), Treasury, RBA, Legal Aid and similar protective agencies, various state government bodies and organisations developed to focus on a specific initiative e.g. Infrastructure Australia and Innovation Australia.

### Academic- University/Research Consortium

There were 12 unique submissions from academics affiliated with a range of universities across Australia. UNSW was affiliated with the most submissions followed by RMIT and UTS. Within these universities the submissions were associated with Finance/Business and Law faculties/schools/departments.

<b>University</b>	<b>N</b>
UNSW	4
RMIT	3
UTS	3
Monash	1
Victoria	1
UWS	1
Charles Sturt	1
UMelb	1
ANU	1

*N.B. the number of university affiliations does not equal the number of submissions for this category due to contributors having multiple affiliations.*

This category also includes the following research consortiums;

- Australian Centre for Financial Studies
- Centre for Policy Development
- CEPAR
- CSIRO Monash Superannuation Cluster focus
- Regional Banks
- SIRCA Limited
- The Australia Institute

These organisations conduct research in a variety of areas including finance and investments, policy, population ageing, superannuation, banking, data services and economic, social and environmental issues.

### Unlisted Company

This category comprises unlisted companies; all 11 unique contributors in this group were in the banking and financial services industry. Specifically, this included member-owned banks and other providers of banking, payments and settlement services and a fund manager.

### Other

This category comprises an anonymous submission, a political party, 2 charities and a religious organisation.

### ***Key Themes Emerging from the Submissions***

#### **1) Banking System**

- Lack of competition between the big 4 banks
- Regulation
- Access to Funding

#### **2) Challenges and Opportunities**

- Housing affordability
- Ageing population; Aged Pension
- Healthcare Costs; Budget Sustainability
- Social Inequity
- Growth of Asian economies
- Promoting Innovation

#### **3) Financial Advice**

- Improving the provision of trusted advice
- Remuneration of advisors

#### **4) Financial Markets**

- Development of the retail bond market / infrastructure debt markets
- Impact investing
- Unlisted property funds sector
- Derivatives

#### **5) Financial System Integrity**

- Financial literacy
- Financial inclusion
- Protection of vulnerable consumers

#### **6) Funding**

- Venture capital and private equity availability and alternative funding sources
- Private capital markets
- Private funding of infrastructure
- Lack of funding access for SMEs

#### **7) General**

- Includes submissions covering a variety of these topic areas and those which go through each of the Terms of Reference.

#### **8) Insurance**

- Regulation
- Underinsurance and the impact on the social security system
- Lenders' Mortgage Insurance
- Life insurance

#### **9) Legislation**

- Specific legislative issues e.g. relating to the Corporations Act and Banking Act

#### **10) Payments System**

- Online payment security

- Globalisation
- Regulation
- Transparency

#### **11) Regulation and Policy**

- The role of the policy makers and regulators
- Policies to deal with an ageing population
- Competition
- Innovation
- Capital allocation
- Financial system stability

#### **12) Superannuation**

- Ageing population
- Aged Pension
- Retirement income
- SMSF
- Short-termism

#### ***Key Themes by Contributor Classification Category***

- The table over the page shows the number of submissions from each contributor group relating to each of the key themes identified.
- The top two themes in each group are highlighted green.
- It is evident that 'Regulation and Policy' and 'Superannuation' are the most common themes across the groups with these comprising the top two in 7/8 and 4/8 of the groups, respectively. The 'Banking System' was the third most common topic.
- It is interesting to note that although superannuation was a hot topic only two superannuation funds submitted to the inquiry, namely, Industry Super and UniSuper.
- Professional/Industry Associations, Individual Person(s) and Academic-University/Research Consortia were all mainly concerned with 'Regulation and Policy' and 'Superannuation'.
- Listed Companies focused on 'Superannuation', the 'Banking System' and 'Insurance', whilst the Private Sector emphasised 'Regulation and Policy' and 'Challenges and Opportunities'.
- The contributors in the Government/Regulator group were mainly concerned with 'Regulation and Policy', 'Financial System Integrity' and 'Funding'.
- Unlisted Companies' main concern was the 'Banking System' followed jointly by 'Financial Markets', the 'Payments System' and 'Regulation and Policy'.

### Key Themes by Contributor Classification Category

Theme	Professional/ Industry Association	Individual Person(s)	Listed Company	Private Sector	Government/ Regulator	Academic- University/ Research Consortium	Unlisted Company	Other
Banking System	6	7	7	5	2	2	5	2
Challenges and Opportunities	7	7	2	6	2	1	0	0
Financial Advice	2	5	0	2	0	0	0	0
Financial Markets	4	1	0	5	1	1	2	0
Financial System Integrity	1	3	0	0	5	2	0	1
Funding	5	2	1	2	4	1	0	0
General	6	1	4	1	2	1	0	0
Insurance	5	0	7	1	0	0	0	0
Legislation	0	2	2	0	1	0	0	1
N/A	8	3	2	1	1	2	0	1
Payments System	2	3	4	1	1	0	2	0
Regulation and Policy	18	18	6	10	4	14	2	1
Superannuation	10	11	17	5	2	3	1	0
<b>Total</b>	<b>74</b>	<b>63</b>	<b>52</b>	<b>39</b>	<b>25</b>	<b>27</b>	<b>12</b>	<b>6</b>

N.B. N/A refers to submissions such as cover letters.



## Centre for International Finance and Regulation (CIFR)

### Workshop Address

**Bob Officer**

**7<sup>th</sup> May 2014**

#### ❖ Introduction – topics to be covered:

##### ➤ **Central banking and the role of insurance for bank liquidity and solvency.**

The best way to remove the moral hazard problem of ‘too big to fail’ is to have an insurance scheme for banks (and other ADI’s) that has premiums based on their risk.

##### ➤ **The ‘Four Pillars Policy’.**

This policy is an unnecessary constraint on a banking system that is competitive and open to international competition.

##### ➤ **Superannuation**

Claims that the Australian Super Industry is not cost efficient implies that it is uncompetitive. The ‘evidence’ brought to support such contentions is weak and the analysis weaker.

##### ➤ **Housing and the mortgage market.**

A lot of emotion is wasted on housing and claims that it is ‘overpriced’ and an inefficient use of resources, in particular, when it is claimed that it is investors who are the cause of the problem because of ‘negative gearing’. To disallow ‘negative gearing’ is to double tax debt, having got rid of double taxing equity why would we want to go back and double tax debt.

## The Central Bank (RBA)

### *Establishment of Central Banks:*

- Bank of England 1694, privately owned until nationalised in 1946
- US Federal Reserve, Dec.23<sup>rd</sup> 1913
- Australia – CBA in 1911, Treasury controlled note printing until 1924 then CBA, RBA took over from CBA in 1960

### **The Role of the Central Bank**

Central banks have their critics but no one could credibly argue that they (and associated regulators) do not have a role in limiting or preventing ‘bank runs’ and managing major bank insolvency to ensure financial stability. They do not have to be in the ‘frontline of action’ to be successful, they can direct from the sidelines. For example, not long before I joined the Board of the Bank of Melbourne, at the time of the collapse of the Pyramid Building Society, there was a run on the Bank of Melbourne which was an amalgamation of a former credit union and building society. Of course ‘the run’ was not publicised but other major banks were instructed by the RBA to supply the bank with credit until the ‘run’ stopped. It was successful and the ‘run’ was short lived.

The Global Financial Crisis (GFC) reinforced the importance of central banks. They were critical in the provision of ‘liquidity’ to financial systems, particularly the banks. A central bank such as the RBA provides liquidity during a crisis by buying some of the banks’ assets to provide the bank or banks with cash to meet the demands of depositors or other holders of the bank’s liabilities. A critical issue is what price should the central bank pay for such assets? It is not such a big call when the central bank purchases government issued securities because of the bank’s ability to control or at least have a significant effect on nominal interest rates. It is a much bigger call, as occurred during the GFC, when central banks extended their purchases beyond government issued securities to privately issued securities such as mortgage backed securities or the like which have a significant credit risk attached to them.

It is a judgement call but the central bank should price the securities at a price that it believes it can get out them at a later date – in this context it is a ‘commercial’ decision. If the bank e.g. the RBA were forced to discount the assets they are purchasing to a ‘significant’ degree the bank could be forced into insolvency. The discount could lead the value of the assets to fall to an extent that it extinguished the equity of the bank and its ability to meet creditors’ demands when they are due. In these circumstances, the provision of liquidity will extend to

handling the insolvency of a bank. If the RBA buys at a price that it cannot offload those securities at a later date, the RBA will not only lose on the transaction(s) they can encourage banks to adopt risky lending policies leading to a ‘moral hazard’ problem. In effect, encouraging banks to incorrectly pricing risk knowing an RBA will ‘bail them out’ – they are ‘too big to fail’.

Clearly, the quality of the assets of the bank is critical to whether the RBA has to handle a relatively simple liquidity problem or whether it is facing a bank insolvency problem.<sup>1</sup> It should be apparent that the provision of liquidity can extend from a relative simple problem to a major issue of bank solvency – they are different points on the continuum from short term liquidity problem through to insolvency. Moreover, it may not be clear when the central bank has to intervene whether it is facing a simple liquidity issue or a bank solvency problem.

Banks are not the only enterprises that face liquidity issues that may result from a short term mismatch between assets and liabilities and NOT poor quality assets, many companies can and do face these problems. Centro Properties now called Federation Centres is a case in point. But why should banks get special and apparently favoured treatment in these circumstances? It is because banks are critical to intermediation (allowing transactions) in the economy such that a problem with the banking system will embroil the economy even though it may be perfectly sound apart from the banking issue. However, the economy cannot be held to ransom by the banking system, its apparently favoured treatment needs to come at a cost to the banks and not just the rest of the economy, otherwise we have the ‘moral hazard problem’ previously referred to.

Conceptually, the cost to the banks for RBA’s provision of a ‘lender of last resort’ facility should resemble an insurance premium. The attempt to address this issue to date has been to give, under the Financial Claims Scheme(FCS), a guarantee to depositors (below \$250k) and charge the bank a set fee – it is depositor insurance. Such insurance, while it might prevent a bank run by one group of the bank’s liabilities, it does not protect the bank from poor quality assets and ultimately insolvency. So without a more general charge for the insurance against insolvency there is still the potential for ‘moral hazard’. In order to overcome this problem, under government direction, APRA and other members of the Council of Financial Regulators (CFR), including the RBA, have adopted a more interventionist approach. They specify certain financial constraints such as maximum leverage ratios and the likewith APRA

---

<sup>1</sup> In fact one of the reasons the RBA had to do little intervention during the GFC relative to other central banks reflected the quality of the assets of Australian banks which in turn reflected the relative strength of the Australian economy through the GFC.

assuming the main role of prudential supervision of banks and other approved deposit taking institutions (ADI's).

The approach is somewhat prescriptive and one could argue a constraint on the banking system from a more free market approach. The question is what is the least interventionist way of protecting the economy against bank illiquidity and default but allowing as much freedom to banks to determine their own destiny and the consequent benefits that are likely to arise from unfettered entrepreneurship and innovation?

My own preference is to re-introduce a version of the Australian Government Guarantee Scheme adopted during the GFC where banks' large depositors and wholesale funders were covered against default for a fee. It is far better to introduce such a policy when there is no pressure on the banking system than to do so in reaction to a crisis. Moreover, unlike the current FCS of a fixed rate, I would like to see a variable premium reflecting the risk assessed by the RBA working with APRA, along with Treasury and ASIC (in effect the CFR). I believe if the basis for the determination of the premium were known and the factors affecting the premium publically reported this would make the banking system more transparent and competitive. The risk of contagion if a bank had its premium increased is minimal under these circumstances since, like the share market price of banks, the banks' premiums and related financial statistics would be closely monitored by financial analysts and the financial media so that shocks are likely to be small, although more frequent than would occur under a more covert system of regulation.

## **Four Pillars Policy**

In 1990 the Keating government introduced, a 'six pillars policy' comprising of the four major banks plus insurers AMP and National Mutual. I believe its intention was to prevent a merger of ANZ and National Mutual but there was also speculation that ANZ and NAB could merge around that time. The policy has since morphed into a 'Four Pillars Policy'.

The objective of the policy was to preserve the strength of the major Australian banks against takeover by foreign interests and to prevent market power that could emerge with further amalgamations amongst the four majors.

A lot of changes in financial markets have occurred since the introduction of the policy and the Wallis Report (1997) recommended its termination. This is a view I subscribe to but from recent press reports it is at odds with the head of the current inquiry. I believe the onus should be on the government and therefore the Murray Inquiry to justify the policy since it clearly is

a constraint on the banks and therefore a constraint on potential developments in financial markets.

Although the banks may not have universal popularity amongst their clients there would be few who could mount argument that there is not competition amongst the banks. It is often contended that evidence of increasing competition is the reduction in the gross margins over the past 20 years. The emergence of mortgage originators in the early 90's is credited with pushing the banks into significant reductions in gross margins – from my observation they have reduced from around 4.5% to around 2-2.5%. Other-things- being equal we would expect this to have a significant adverse effect on bank profitability. However, this is not the case.

The major banks return to book equity has remained at around 15% over the same period of gross margin reduction. A number of reasons can explain this:

- Technological advances in banking arising from the IT and consequent communications revolution has enabled banks to significantly reduce the cost of delivering their services – when did you last visit your bank to conduct normal banking activities?
- Accompanying the IT advances has been a significant change in the type and level of services that banks offer. Many customers complain of the lack of personal service that they historically enjoyed from their bank and in their place there is often a fee for service.
- The above has also given greater economies of scale which has also favoured the majors. They are 8 to 10 times larger than the 'second string banks'.

Accompanying the changes in banking has been an increasing 'globalisation' of financial services. The internet has enabled foreign banks to establish here without a major branch network. 'Shadow banking' activities has increased to the extent we are seeing major retailers expanding their credit facilities to compete with banks.

It is argued that the 'four pillars policy' necessary to maintain competition in the domestic banking market? I would argue that it is not. An amalgamation between any two of the majors would be unlikely to lead to 'monopoly rent', market share is not necessarily a major indicia of market power, I believe the existing<sup>2</sup> and potential competitors to any attempt at 'rent seeking' would cause such an attempt to be short lived. At best, the amalgamation would enable economies of scale to give greater profit to the group but it would not enable the group

---

<sup>2</sup> These include smaller Australian banks, credit unions, building societies, non-financial company credit providers, subsidiaries and branches of foreign owned banks and other authorised deposit taking institutions.

to impose conditions on the market that would lead either to a decrease in service or, equivalently, an increase in cost or both than currently exists.

Australian banks, although a large proportion of the Australian equity market and large by Australian company comparisons, are not large by international standards. In terms of total assets (Bankers Almanac February 2014) the biggest of the Australian banks, the NAB ranks only 41<sup>st</sup> amongst international banks with the smallest (Westpac) ranking 48<sup>th</sup>. An amalgamation is unlikely to lead to a simple addition of the participants' assets but even then an amalgamation between the two biggest NAB and CBA would rank at 17<sup>th</sup>. Preventing an Australian bank from expanding through merging with another Australian major limits the export potential of banking services, an unnecessary constraint on our current account even if there are no further economies of scale domestically. Imagine the state of Swiss banking and the Swiss economy if they were similarly constrained.

Another major argument for the 'four pillars policy' has been to prevent the takeover of a major domestic bank by a foreign bank or group. The fear is that such a takeover would expose the bank and therefore the Australian banking system to foreign events leading to an increase in the risk to the Australian banking sector. One could argue that the increased globalisation of banking activities cannot insulate a domestic banking system from international influences nor should it if that industry is to be efficient and competitive. Moreover, there is no reason why a domestic subsidiary of an overseas bank cannot be exposed to exactly the same regulation as a domestic bank with the same outcome. Reliance on overseas funding is already significant amongst the major Australian banks without a significant exposure to exchange risk because of hedging such exposure, a foreign owned bank would be wise to adopt similar hedging policies if it wanted to protect the Australian assets it controls.

## **Superannuation**

A recent article in The Age newspaper (The Age, 23rd April, 2014) asked:

“... Why Australians pay higher fees on their superannuation than almost any other country in the Organisation for Economic Co-operation and Development. It has been estimated that paying just 1 percentage point more in fees results in a retirement benefit worth 20 per cent less over 30 years. Fees differ between superannuation sectors.”

A number of similar comments have been made in the light of the RBA Submission to the Financial Systems Inquiry. My reading of the RBA Submission, although raising the issue of fees' it did not suggest the fees were abnormally high but it did ask the rhetorical question of

whether the ‘disengagement of members’ lead to a lack of competitive pressures in the industry. It echoed the Cooper Report (2010) concerns, that report recommended the introduction of ‘My Super’ a low cost default fund for those that do not actively choose a fund. The recommendation has been introduced by the previous government but, in my opinion, it is too early to reach a conclusion from a benefit/cost analysis of the system.

The most recent of these criticisms of the level of fees being paid by investors in Superfunds is a recent Grattan Report . I will return to some specific comments on that report shortly.

There are many components to the decision to transact when a person is considering a superfund; they cannot all be captured in some simple cost analysis. To undertake an analysis on just this basis is a bit like choosing a suit simply on price, you just maybe interested in the quality of the cloth, tailoring etc. There are good reasons that could explain the apparent higher fees for the administration of superannuation funds in Australia relative to other OECD countries. The majority of Australian Superannuation Funds manage Defined Contribution (DC) for members in contrast to most OECD countries which have Defined Benefit (DB) pension schemes. DC schemes allow members considerable discretion in the asset types they can invest, the result is that chasing returns, members tend to take on a greater proportion of risk assets than DB schemes in the expectation they will be rewarded for the additional risk. DB scheme members do not have discretion and the trustees of such schemes are encouraged to adopt a ‘safety first’ to ensure their funds are fully funded. They invest in defensive assets typically with a high proportion of government securities.

The fees for the management of funds is highly correlated with the risk of the assets invested and even the range of fees in any general asset class varies enormously. However as an example, in Australia managers of listed microcap companies’ fees are around 100 basis points, large cap around 40 basis points and fixed interest around 20 basis points. Private equity is usually well above 100 basis points. Therefore, it is not surprising that the fees for the management of Australian super appear to be a lot higher than overseas pension funds when the asset classes are often quite different.

In fact, the variability of the types of investments that super funds can invest and the vastly different regularity and cultural systems means that it would be almost impossible to assess the competitive intensity of the industry on the basis of fees or performance across countries or jurisdictions. A far better indicia of any lack of competition would be what could be preventing competition, for example the presence of ‘barriers to entry’. If these cannot be identified, what may appear to be evidence of a lack of competition in performance indicators is more likely to reflect the stochastic nature of returns and differences in fees reflecting the different approaches that can be taken to fund management.

Returning to the Grattan Report: They blame the ‘disengagement’ of account holders, evidenced by the significant proportion of those who finish up in a ‘default fund’ for the ability of funds to get away with high costs. The solution they suggest is to have a government tender for ‘the default fund’ that would be managed by government, they suggest economies of scale and ‘better management’ would reduce fees. They may be right, there could be benefits in such a central default fund for ‘disengaged’ members of a fund since such a group self-select but to condemn the whole industry for ‘excessive’ fees is a ‘bridge too far’. The evidence Grattan bring to support their conclusion that there is a ‘Super Sting’ is far from impressive.

Even if two thirds of accountholders were ‘disengaged’ would not be sufficient to enable a lack of competition or ‘economic rents’ to survive in the industry. It is the marginal investor that determines price in an open and competitive market; therefore to support their contentions of a ‘Super Sting’ they need to show what is preventing such an investor or accountholder from causing competitive tension amongst the funds. Surveys of account holder attitudes or even average behaviour are not sufficient evidence.

To support their recommendation of a ‘central default fund’, they would need to show that the indifference or ‘disengagement’ allowed funds to charge such members fees which allowed ‘rent’ to accumulate and not be competed away with other services to such members. Moreover, insofar as members of Balanced Funds are a mixture of the ‘disengaged’ and the ‘engaged’, and to the extent there is competition amongst superfunds for members of Balanced Funds, would suggest that these fees are not excessive, at least for the ‘engaged’.

Further, to draw conclusions about the behaviour of fund management with as little as ten years of data (and frequently less) is dangerous with such a stochastic process as investment returns and the consequent performance of funds. The period they covered was a period of falling interest rates with the consequent great returns from investing in long bonds, on the basis of this period some have suggested that a portfolio of long bonds is what investors should be investing. The conclusions would be totally different if we examined investor experience over since the Second World War. We can usually find support for any hypothesis in fund management no matter how ridiculous if we are prepared to accept short time periods as evidence of how the market behaves.

## **Housing**

Housing loans account for over half of all total loans made by the banking system (RBA Submission p.78). This translates to about 40% of domestic bank assets. It is a large proportion by international standards (RBA, P. 85). Therefore, although the default rate on

home loans is very low in Australia, the proportion of home loans in banks' assets means they gets considerable attention by the RBA amongst other regulators.

Housing and house prices also get considerable attention from the Australian press and public which is not surprising since it is a considerable component of the assets and liabilities of all its citizens. There is often a lot of emotion attached to housing. There is a notion that housing is non-productive and therefore housing investment is somehow inferior to other forms of investment. This is nonsense! Housing is very much like another staple, food. A certain amount is necessary for production and therefore it is partly a production good, beyond that it becomes a consumption good but we should not need reminding that the whole point of production is consumption – production is not an end in itself nor despite the apparent policies of some politicians nor is consumption possible without production.

No one doubts that it is difficult for the RBA to manage monetary policy in a 'two speed economy' – low interest rates may encourage 'excessive' investment in housing but they can be necessary to stop industry from 'tanking'. Amongst the 'culprits' accused of 'distorting' the housing market are investors, particularly foreign investors. Whether the purchaser is a home owner or an investor should be irrelevant unless an externality can be shown for one group relative to the other. I am unaware of any such evidence but there is plenty of assertion. Arguments about 'crowding out' homeowners by investors could be reversed and we could argue that home owners 'crowd out' renters. While both assertions are probably correct, we would have to argue that there is some positive community externality in home ownership v's renting. There maybe but it has not been an argument advanced in support of 'limiting' houses as an investment. Further, to try and 'block' house prices from rising implies prices are 'too high', an intervention implying superior insight than the market that inevitably causes other forms of regulation and greater problems than the problem of rising house prices.

One of the mechanism advocated by those who believe there is too much investment in housing is the removal of 'negative gearing'<sup>3</sup> for investors. It would be a big mistake, theoretically and practically, to target investment in housing with such an action.

One of the basic principles of optimal resource allocation in an economy is to treat all asset classes the same way when applying a tax. As I have indicated above the only time that rule should be modified is if an asset class delivers a cost or benefit to the community that is not

---

<sup>3</sup>In the context of property, 'negative gearing' is when a property owner and investor borrows such that the interest cost offsets (or more than offsets) the income (rent) from the property so that there is no income tax liability. Effectively this converts the return from the property from rent plus capital gain to all capital gain. Moreover, capital gains are typically taxed at a lower rate than rental income.

borne/received by the owner of the asset, i.e. when there is a ‘social cost/benefit’ associated with the asset. A special tax or subsidy may be (but only may be) the best means of addressing this issue of ‘social cost’.

All asset classes, again as a generality, can be ‘negatively geared’ and in my opinion there is no good reason to single out housing for special treatment, to do so will result in a misallocation of resources. Removal of ‘negative gearing’ effectively double taxes debt capital since the interest is taxed in both the hands of the borrower and the lender. In a similar vein, we have been there with a ‘classical tax system’ which double taxes dividends but fortunately Australia has removed that flawed tax system.

The Campbell Committee (1981) recommended an ‘integrated tax’ system, the ideal system for company taxation. The introduction in 1987 of a full ‘imputation tax’ goes close to the ideal where company profits are only taxed in the hands of the owners and not taxed twice at both the company and owner levels. To remove ‘negative gearing’ on property which would result in a double tax on interest on debt is going backwards.

It is sometimes asserted that ‘negative gearing’ does nothing to increase the supply of housing because most investment property is for established dwellings. What causes ‘negative gearing’ to suspend the laws of supply and demand? To the extent that ‘negative gearing’ increases the demand by investors for housing, causing house prices to rise, resources will be attracted into housing, thus increasing the supply of housing. There are studies suggesting that our relatively high house prices is a supply issue, i.e. the lack of the release of land and the associated tax and regulatory cost of development cause the supply to be restricted because of the greater cost to adequately compensate for these imposts but this has nothing to do with ‘negative gearing’. It is a separate set of issues which should not involve a financial systems inquiry.



# Centre for International Finance and Regulation (CIFR) Workshop Address

*Bob Officer*

7<sup>th</sup> May 2014

1

## Introduction

❖ **Central banking: Role of insurance for bank liquidity and solvency.**

*The best way to remove the moral hazard problem of 'too big to fail' is to have an insurance scheme for banks (and other ADI's) that has premiums based on their risk.*

❖ **The 'Four Pillars Policy'.**

*This policy is an unnecessary constraint on a banking system that is competitive and open to international competition.*

2

### ❖ **Superannuation.**

*Claims that the Australian Super Industry is not cost efficient implies that it is uncompetitive. The 'evidence' brought to support such contentions is weak and the analysis weaker.*

### ❖ **Housing and the mortgage market.**

*A lot of emotion is wasted on housing and claims that it is 'overpriced' and an inefficient use of resources. Particularly, that it is investors who are the cause of the problem because of 'negative gearing'.*

3

### **Central banking: Role of insurance for bank liquidity and solvency.**

#### ***Establishment of Central Banks:***

- Bank of England 1694, privately owned until nationalised in 1946
- US Federal Reserve, Dec.23<sup>rd</sup> 1913
- Australia – CBA in 1911, Treasury controlled note printing until 1924 then CBA, RBA took over from CBA in 1960

4

## **Role of the Central Bank**

Central banks have their critics but no one could credibly argue that they (and associated regulators) do not have a role in limiting or preventing ‘bank runs’ and managing bank insolvency to ensure financial stability.

The GFC reinforced the importance of central banks. They were critical in the provision of ‘liquidity’ to financial systems, particularly the banks. They do this by buying some of the banks’ assets to provide the bank with cash to meet the demands of depositors or other holders of the bank’s liabilities.

A critical issue is what price should the central bank pay for such assets?

5

## **“Price” of Liquidity Provision**

It is a judgement call but the central bank should price the securities at a price that it believes it can get out them at a later date – in this context it is a ‘commercial’ decision. If the bank e.g. the RBA were forced to discount the assets they are purchasing to a ‘significant’ degree the bank could be forced into insolvency.

The provision of liquidity can extend from a relative simple problem to a major issue of bank solvency.

The quality of the assets of Australian banks which in turn reflected the relative strength of the Australian economy meant that there was little intervention through the GFC.

6

### **“Price” of Liquidity Provision**

Why should banks get special and apparently favoured treatment in these circumstances?

Without a cost such protection leads to a ‘moral hazard’.

The cost to the banks for RBA’s provision of a ‘lender of last resort’ facility should resemble an insurance premium.

The alternative is for the regulators to be far more interventionist with attendant problems.

7

### **Insurance for Banks (& ADI’s)?**

My preference is to re-introduce a version of the **Australian Government Guarantee Scheme** adopted during the GFC where banks’ large depositors and wholesale funders were covered against default for a fee.

I would like to see a variable premium reflecting the assessed risk of the financial institution. A premium that was transparent. The risk of ‘contagion’ is minimal if such a system is properly implemented.

8

## **Four Pillars Policy**

The objective of the policy was to:

- 1) prevent market power that could emerge with further amalgamations amongst the four majors and
- 2) to preserve the strength of the major Australian banking against takeover by foreign interests.

I believe the onus should be on the government to justify the policy since it clearly is a constraint on the banks and therefore a constraint on potential developments in financial markets.

9

## **Market Power Amongst the Majors**

An amalgamation between any two of the majors would be unlikely to lead to 'monopoly rent'.

Market share is not necessarily an indicia of market power, any attempt at 'rent seeking' would be short lived.

At best, the amalgamation could enable economies of scale to give greater profit to the group but profit alone does not necessarily reflect market power.

10

### **Market Power Amongst the Majors**

Australian banks are not large by international standards. The biggest of the Australian banks, the NAB ranks only 41<sup>st</sup> amongst international banks with the smallest (Westpac) ranking 48<sup>th</sup>. An amalgamation of the assets of two biggest NAB and CBA would rank at 17<sup>th</sup>.

Preventing mergers limits the export potential of banking services, an unnecessary constraint .

Imagine the state of Swiss banking and the Swiss economy if they were similarly constrained.

11

### **Preventing Foreign Bank Takeovers**

Increased globalisation of banking activities cannot insulate a domestic banking system from international influences nor should it if that industry is to be efficient and competitive.

Moreover, there is no reason why a domestic subsidiary of an overseas bank cannot be exposed to exactly the same regulation as a domestic bank with the same outcome.

Reliance on overseas funding is already significant amongst the major Australian banks without a significant exposure to exchange risk.

12

## Superannuation

*“... Why Australians pay higher fees on their superannuation than almost any other country in the Organisation for Economic Co-operation and Development. It has been estimated that paying just 1 percentage point more in fees results in a retirement benefit worth 20 per cent less over 30 years. Fees differ between superannuation sectors.”*  
(The Age, 23rd April, 2014) .

13

## Superannuation

There are many components to the decision to transact when a person is considering a superfund; they cannot all be captured or controlled for in some simple international cost comparisons

Examples of the possible parameters of choice and/or comparison between super (pension) plans are:

- Defined benefit (DB) or Defined Contribution(DC);
- Asset class – debt and equity and their many components;
- Insurance;

*and the following differ significantly between countries and affect super or pension comparisons*

- Regulation – the costs;
- Safety net provisions;
- Cultural attitudes.

14

## **Superannuation**

Abnormally high costs could only exist in a non-competitive environment. A far better indicia of any lack of competition is the presence or otherwise of 'barriers to entry'.

If these cannot be identified, what may appear to be evidence of a lack of competition in performance indicators is more likely to reflect customer preferences and the stochastic nature of returns and differences in fees reflecting the different approaches that can be taken to fund management.

15

## **Grattan Report on Super**

The Report blame the 'disengagement' of account holders for a 'Super Sting'.

The solution suggested is to have a government tender for a single 'the default fund' for the industry. They may be right.

There could be benefits in such a central default fund for the 'disengaged' but to extend that to conclude that the industry is engaged in a 'Super Sting' is a 'bridge too far' for the evidence they produce.

16

### **Grattan Report on Super**

It is the marginal investor that determines price in an open and competitive market; therefore to support their contentions of a ‘Super Sting’ they need to show what is preventing such an investor or accountholder from causing competitive tension amongst the funds. Surveys of account holder attitudes or even average behaviour are not sufficient evidence.

Further, to draw conclusions about the behaviour of fund management with as little as ten years of data (and frequently less) is dangerous with such a stochastic process as investment returns and the consequence performance of funds. We can find support for almost any hypothesis in fund management, no matter how ridiculous, if we are prepared to accept short time periods as evidence of how the market behaves.

17

### **Housing**

Housing loans account for over half of all total loans made by the banking system (RBA Submission p.78). This translates to about 40% of domestic bank assets. It is a large proportion by international standards (RBA, P. 85).

There is a notion that housing is non- productive and therefore housing investment is somehow inferior to other forms of investment. This is nonsense!

Housing is very much like another staple, food. A certain amount is necessary for production and therefore it is partly a production good, beyond that it becomes a consumption good.

18

## Housing

There are suggestions that investors in housing are inferior to home ownership or such investment is disrupting owner occupation.


Whether the purchaser is a home owner or an investor should be irrelevant unless an externality can be shown for one group relative to the other. I am unaware of any such evidence but there is plenty of assertion.

One of the mechanism advocated by those who believe there is too much investment in housing is the removal of ‘negative gearing’ for investors. It would be a big mistake, theoretically and practically, to target investment in housing with such specific action.

Removal of ‘negative gearing’ effectively double taxes debt capital since the interest is taxed in both the hands of the borrower and the lender. In a similar vein, we have been there with a ‘classical tax system’ which double taxes dividends but fortunately Australia has removed that flawed tax system.

19






# FINANCIAL SYSTEM INQUIRY

## CIFR WORKSHOP

Tom Karp  
7 May 2014



Centre for International  
Finance and Regulation  
CIFR Towards Financial System Integrity



- ▶ Personal Comments
- ▶ General
- ▶ Prudential Regulation
- ▶ International Experience
- ▶ Insurance
- ▶ Superannuation

# INTRODUCTION



Centre for International  
Finance and Regulation  
CIFR Towards Financial System Integrity

- ▶ Stocktake Inquiry Good
- ▶ GFC
  - ▶ Australia Passed
  - ▶ Twin Peaks
  - ▶ CFR
- ▶ Moral Hazard
- ▶ Disclosure not a Panacea

## GENERAL COMMENTS



Centre for International  
Finance and Regulation  
CIFR Towards Financial System Integrity

- ▶ Safety v Competition
- ▶ Legislation with Standards Making Powers
- ▶ Supervision v Regulation
- ▶ Integrated Supervision with Industry Requirements
- ▶ Supervisor Quality & Flexibility

## PRUDENTIAL REGULATION



Centre for International  
Finance and Regulation  
CIFR Towards Financial System Integrity



- ▶ Australia Should Influence International Regulation
- ▶ National Discretions
- ▶ Global Competitiveness – Local Issues drive Local Success
- ▶ Cultural Philosophies
  - ▶ Freedom with Publicity
  - ▶ Controlling Rules
  - ▶ Rules with Freedom
  - ▶ Pragmatic Rules & Supervision

## INTERNATIONAL EXPERIENCE



Centre for International  
Finance and Regulation

Towards Financial System Integrity



- ▶ Economic Shock Absorber
- ▶ Usually not Systemic
- ▶ Under Insurance
- ▶ Legacy Products

## INSURANCE



Centre for International  
Finance and Regulation

Towards Financial System Integrity

- ▶ Helped as a Shock Absorber
- ▶ Post-Retirement
- ▶ Infrastructure Investment
- ▶ SMSF Leveraging

## SUPERANNUATION



## **Financial System Inquiry Workshop**

### **Centre for International Finance and Regulation**

**Mike Callaghan**

**7 May 2014**

I will comment on three broad areas, and the main development influencing those issues being the global financial crisis. The points I will cover include:

- First, the need for this Inquiry to establish its own regulatory philosophy or analytical framework which will be the foundation of its approach and ultimately its recommendations.
  - Whether this involves 'refreshing' the philosophy underpinning the Wallis Inquiry, or going further, the Murray Inquiry has to clearly settle its own framework or philosophy.
  - To express this another way, many of the submissions start with a general statement that they endorse the current regulatory philosophy and framework. Well if they endorse it, they should be able to clearly articulate what it is.
- The second point is the importance of fully assessing the role and contribution of our regulatory arrangements for the performance of the Australian financial system during the crisis.
  - Many of the submissions to the Inquiry refer to the resilience of the Australian financial system in the crisis and see this as a testament to our good regulatory arrangements, with a conclusion that could be summed up as 'if it ain't broke, don't fix it'.
  - Before coming to that conclusion, it is necessary to draw all the lessons from the crisis in terms of the factors that contributed to our resilience.
  - And my basic point will be that the resilience of the Australian financial system depended on many factors that go well beyond the robustness of the financial regulatory framework.
- The third point I will cover is that one consequence from the crisis is the massive drive at the international level – though the Financial Stability Board and the G20 to strengthen financial regulation.

- One theme that comes up in many of the submissions is a questioning of relevance of all these initiatives, which are largely responding to developments in Europe and North America, to the Australian financial system.  
  
--The response to such questioning is to say that since we are a capital importer and our financial institutions operate internationally, there is little capacity to ignore these global standards. But the official response goes on to say that it is important to work through the G20 and international standard setting bodies to ensure that the new standards are right for Australia.
- 
- Australia is chairing the G20 in 2014 and as the government keeps saying, this gives us a unique opportunity to influence the international economic agenda. So the question to ask is, how is Australia exercising this 'unique' opportunity to ensure that the global standards are appropriate for Australia, not only this year but on an ongoing basis?

I will briefly elaborate on these three issues.

On the first point, this inquiry needs to establish a clear philosophy or analytical framework that will underpin its approach to financial regulation. Others have also said this, but it is worth repeating because it is fundamental. But it is hard. And the Inquiry also has to have some concept of the shape and structure of the financial system it is aiming to achieve.

By way of context, Oliver Blanchard, the IMF Chief Economist, in commenting in 2012 on the international efforts to strengthen financial regulation in the wake of the crisis, observed that while there was intense activity in establishing new standards post crisis, this was not done against any agreed vision of what the financial system should look like.

The desire was to prevent another crisis, and as such there was a generally shared view that banks needed more and better capital, be less interconnected and make no further calls on taxpayers' funds.

But there was no agreement on the 'right' role for such things as securitization, the right scope for derivatives, the role of shadow banking, and there was even uncertainty and disagreement about effects of increased capital requirements on bank funding costs.

There certainly was no discussion of the consequences of essentially seeking to reduce the amount of financial intermediation being done by banks, which is a consequence of increasing capital requirements and introducing leverage ratios.

Blanchard concluded that in the efforts to strengthen financial regulation we were 'navigating by sight'. We could not rely on over the horizon navigational aids because we did not know what future financial system we were aiming for, and by implication, we had no agreement on the appropriate role and application of financial regulation.

It would be good if the current review of the Australian financial system ensured that we are not ‘navigating by sight’ when it comes to where we want the financial system to go, and the role regulation will play.

The Wallis Inquiry spent a lot of time and energy on the issue of establishing a regulatory framework. The Government adopted its recommendations for a regulatory arrangement that moved from a more institutional base, to one where the regulatory framework was based on regulatory functions

- Regulation of market integrity, disclosure, consumer protection and corporations – the domain of ASIC
- Prudential regulation of deposit taking institutions, life and general insurance and superannuation – APRA
- Preventing anti-competitive behaviour- ACCC. And
- Monetary policy, protection of the payments system and overall stability of the system- the responsibility of the RBA.

But a major challenge Wallis faced was where to draw the prudential regulatory perimeter. That is, targeting the institutions for prudential supervision. Factors that came into play included ‘moral hazard’.

When the Government starts regulating the activities of an institution, the concern was that there was an implication that the Government stood behind that firm in the minds of the public. This was against the background at the time of the widespread public perception that the government guaranteed all banks.

And moral hazard has not gone away. It has probably been enhanced since we identify some banks as being ‘domestically systemically important’, which seems to be identifying them as being too big to fail.

Related to the concern over moral hazard was a concern in the official family over the position of superannuation. The government was forcing people put money into superannuation (and as such raising moral hazard issues), but it simply could not be seen to be standing behind all superannuation funds.

The other issue that I believed concerned many at the time was the importance of maintaining a risk spectrum when it came to the provision of finance. In achieving the balance between ensuring financial stability while supporting the needs of the economy, there needed to be the capacity to finance ‘risky’ activities.

The outcome from Wallis was to identify those institutions performing certain functions and subject them to prudential regulation, while the rest of the financial system was largely left to market integrity, and disclosure requirements.

In drawing the regulatory barrier for institutions subject to prudential regulation, the Wallis report focused on the ‘intensity of the promise’.

Wallis recommended that the focus of prudential regulation should be on institutions making promises of highest intensity. A high intensity promise was one that was inherently difficult for an institution to honour, where the credit worthiness of the institution making the promise would have adverse consequences, particularly for financial stability.

This approach resulted in banks, insurance companies and superannuation funds being subject to prudential regulation, while the rest of the financial sector subject to disclosure requirements.

As such Wallis reinforced regulation based on disclosure, a way to minimise moral hazard and to ensure that more risky investment options could be financed – namely, disclose the risks and let investors, particularly sophisticated investors able to assess risks, make their own choices and they should then live with the consequences of their choice, rather than attempting to seek to protect all investors from risk.

How has this approach performed over the past 17 years? Is it a regulatory framework that can be largely endorsed, which seems to be the approach of many submissions without examining what is the framework.

Many have said that the problem in the lead-up to the crisis was that risk was not appropriately priced, and there seems to be a general view that the concept of relying on the market to provide discipline and self-correct, is misplaced. The concept that the so-called sophisticated investor can look after him or herself in all circumstances is also misplaced.

Successive ASIC chairman have called for a re-think of a disclosure only based approach. To quote from ASIC's submission to the this Inquiry, *'the assumption that underpinned much of retail financial services regulation since the Wallis Inquiry – that disclosure was the best tool in almost every instance to fix market failure- has not been borne out in practice'*.

But if you move away from the disclosure philosophy, what do you replace it with. Increase the perimeter for prudential supervision?

And as we have seen in other countries during the crisis, non-prudentially regulated institutions can be systemically important.

But the existing regulatory approach does not appear to ensure the availability of finance to all sectors of the economy. As noted in many of the submissions, there are financing gaps – more 'riskier' activities have difficulty in obtaining finance – such as small business and start-up ventures. And some say there is a problem in the availability of large project finance.

Are all these market failures that require government intervention, or are the problems in the design and application of the regulatory structure?

The bottom line is that the Inquiry is going to have to give a lot of thought in clarifying what it believes should be the philosophy for financial regulation.

The second point I wanted to cover is the importance of delving into the contribution of regulation to the relative resilience of the Australian financial system during the crisis.

It is important to a good understanding of all the factors contributing to financial stability and to ensure that there is not complacency. As I mentioned, there is a tendency to ascribe the relative resilience of the Australian financial system to our regulatory framework.

One lesson that has come from the crisis is that the various arms of economic policy are interlinked.

Fiscal sustainability will depend on the strength and stability of the financial sector.

Similarly the ability of a government to support a financial sector under stress will depend on the strength of the government balance sheet. The stability of the financial sector in turn will depend on the existence of macroeconomic imbalances, particularly excessive credit growth and also the magnitude of the economic cycle.

In short, stability of the financial system does not solely depend on the quality of financial supervision and financial regulation. It is all inter-linked.

APRA clearly moved away from a 'light touch' approach to supervision in the wake of the collapse of HIH. But what was the contribution of prudential supervision to minimising any toxic assets in bank balance sheets prior to 2008? And Ian Macfarlane has made some relevant comments on this point.

He notes that there were plentiful lending opportunities in Australia and there was no need to chase risky investments and business elsewhere. He also says that because Australian banks partly funded themselves overseas, this meant that they were under international scrutiny. But that scrutiny did not appear to be effective for overseas banks.

MacFarlane also says that there was a 'long-standing and deep-seated characteristic of our banking system that predisposed it to stability'. I am not sure what is the origin of this apparent long standing conservatism of our bankers. And is it always a positive? Is the trade-off of the long standing conservatism of Australian bankers that we have funding gaps?

A couple of other important points include the fact that our major banks were not under threat of takeover because of the Four Pillars Policy. They did not have to drive their balance sheet into risky assets as a defence to a takeover.

The Four Pillars Policy was originally introduced and perceived as supporting competition and the Wallis report recommended the abolition of the policy.

But now the Four Pillars is perceived as an important contributor to maintaining stability in the system. As such, an issue that the inquiry will have to confront is the trade-off between promoting competition and ensuring stability.

The other important factor that contributed to the stability of the Australian financial system was that we avoided a recession because of prompt monetary policy response, which still had traction because we had positive interest rates, and a rapid fiscal expansion. Macroeconomic stability is a key component; it may be the most important contributor to the stability of the financial sector. This should not be over looked.

My third point referred to the global wave of regulatory change that has occurred since the crisis via the FSB and the G20.

As noted, many of the submissions have questioned the relevance of this additional regulatory burden to the Australian financial system.

If our more intensive approach to prudential supervision was considered to be a major contributor to the resilience of the Australian financial system during the crisis, then logic would seem to suggest that there is not the same need to strengthen the regulatory requirements here compared with other jurisdictions.

Moreover the more intensive supervision of the Australian supervision brought with it **costs** to the Australian financial system and these costs have been increased with the additional regulatory requirements.

To approach this another way, in the absence of the international efforts to strengthen regulation, would we have increased financial regulation to the same extent we have.

One answer, which I will come back to, is that we had no option. We had to comply with the global standards. But if that is the case, what is the rationale for adopting even more stringent regulatory approach than the new minimum global standards? This is what APRA has done.

.I mentioned previously that while the official response is that we have no option but to adopt the global standards, it goes on to say that it is important that Australia work through the G20 and international standard setting bodies to ensure that the new standards are right for Australia.

This is absolutely right. And it is something we have in common with many other countries, particularly in Asia, who are concerned that the international regulatory response being largely a response to a North American and European event.

Australia is chairing the G20 and it should do everything possible to use this opportunity to establishing better processes in the G20 and FSB to ensure that the positions of all countries are appropriately taken into account in establishing new global standards, that there is more effective oversight on the implementation of the standards, and an ongoing review of their impact and any unintended consequences.

To date Australia has said its priority as G20 chair is to complete core aspects of the design phase in Basel III, ending too big to fail, monitoring shadow banking and regulating OTC derivatives. This is the FSBs work plan. The design phase is one thing, but as we are already seeing, the big challenge is the consistent and effective implementation of these new standards, and that will be take place over many years and will require ongoing review.

The handling of the implementation of these standards will have major implications for the Australian financial system. The government does not appear to be seizing the opportunity as G20 chair to help establish an ongoing process that will review the impact and implications of the implementation of this wave of new regulatory standards.

One last point. The inquiry should also consider how to ensure better on going oversight of the appropriateness of the regulatory framework of the Australian financial system. Is the only option to have an external inquiry every 17 years? The performance of the financial system is critical to the performance of the economy. It would seem prudent to have more effective ongoing oversight.

This is something that should be beyond the remit of the Australian Financial Regulators. They are part of the subject matter that should be reviewed on a more regular basis than 17 years.



# The Financial Claims Scheme

Australian Centre for Financial Studies  
CIFR FSI Workshop  
Sydney  
7 May 2014

Presenter: Deborah Ralston

- Rational for deposit insurance
- The financial claims scheme (FSC) in Australia
- Competitive distortions
- Impacts
- Possible remedies

## Rational for deposit insurance

Generally seen as core feature for bank financial stability. Introduced to:

1. Reduce the potential for “runs” and contagion or spillover risk, and
2. Provide a “safe haven” for uninformed retail investors (hence a “cap”).

Relates to the “special” role of banks

## The FSC in Australia

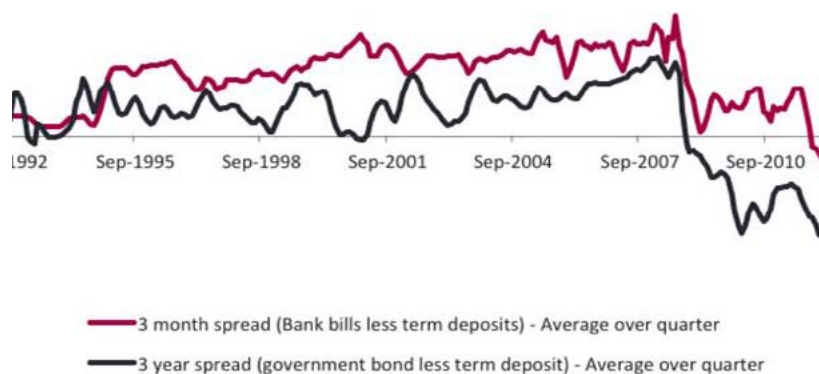
- Australia has had no such scheme – rejected by Wallis due to depositor preference
- Davis Report on FCS in 2004
- Introduced due to GFC in October 2008 capped at \$1m – reduced to \$250k in 2012
- August 2013 – levy announced of 5-10 bp to be paid into Financial Stability Fund
- APRA can recover funds

## Competitive distortions

- FSC gives banks a comparative advantage over other competitors:
  - for retail deposits (magnified by other regulatory and competitive changes that have increased demand for such deposits)
  - For loans - Lower cost of funds relative to other lenders
- Potential for moral hazard

## Impacts - pricing issues

- Bank risk-free rate on deposits sets benchmark



## Impacts

- Difficult to assess the impact of FCS but there are competitive issues with respect to:
  - Cash management trusts
  - Non-bank finance companies – debentures
  - Annuities (can be replicated by a string of term deposits)
  - Investment in corporate bonds
  - Mortgage and property trusts
  - SMSFs v. institutional super

## Possible remedies

- Remove the FCS – strengthen depositor protection
- Increase the size of the guarantee fee – better reflect the benefits – competitive neutrality
- Reduce the cap from \$250k to \$50k (estimated to cover 99.2-99.8% depositors)
- Limit the guarantee to ‘at call’ deposits or similar short term savings at all institutions
- Alternative “safe haven” – retail CGS

# Costs and Benefits of Financial Regulation

Associate Professor  
Gordon Menzies  
UTS

## Acknowledgments

- Other team members
  - Prof Ron Bird, UTS
  - Prof Peter Dixon, CoPS
  - Assoc Prof Peter Docherty, UTS
  - Dr Timo Henckel, ANU
- FSI
- CIFR funding
  - E003: The costs and benefits of financial regulation
  - in response to the FSI

## Outline

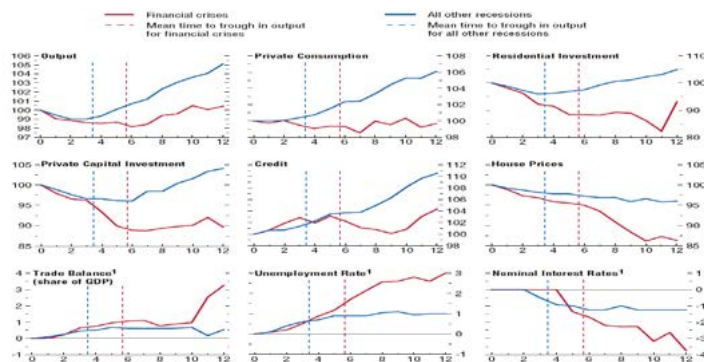
1. Inherent difficulties with cost benefit analysis for the financial sector
  - ‘to whom’? ‘for whom’? ‘what model?’
2. Policy and Modelling Context for the FSI
3. Costs of regulation misallocation (prelim results)
4. Benefits of regulation

## Cost-Benefit Difficulties: for whom?

- Financial output is hard conceptually
  - Multi-functional, network, service
- Cost-benefit analysis of regulation is difficult
- In keeping with the social role of finance, it is important to measure societal benefits and costs, and that is our approach
- Main regulation benefit – reduced chance of GFC event

**Figure 3.8. Recessions and Recoveries Associated with Financial Crises and Other Shocks**  
*(Median = 100 at t = 0; peak in output at t = 0; data in real terms unless otherwise noted; quarters on the x-axis)*

Recessions associated with financial crises are longer and more severe than other recessions. During recoveries, private demand, credit growth, and asset prices are particularly weak. Historically, net exports have led the recovery.



Source: IMF staff calculations.  
<sup>†</sup> Difference from level at t = 0, in percentage points.

## Cost-Benefit Difficulties: to whom?

- Financial output is hard conceptually
  - Multi-functional, network, service
- Cost-benefit analysis of regulation is difficult
- In keeping with the social role of finance, it is important to measure societal benefits and costs, and that is our approach
- Main regulation benefit – reduced chance of GFC event
- Main regulation cost – the misallocation of capital  
 (Implementation costs are part of FSI Research project)

## Policy and Modelling Context: what model?

- Where is the pendulum?

### Laissez-faire

High probability of crisis  
Innovation  
Creative destruction  
High risk high return activities financed

### tight rein

Low probability of crisis  
little financial innovation  
Stability  
Risky projects not financed

- Does this mimic the modelling world?

Minimal structure

Eg. 4-5 equation DSGE models

No financial structure

No financial accelerator

CGE + finance

extensive structure

eg RBI model

financial detail

## Costs of ~~regulation~~ misallocation

- FSI submission (Bird and Dixon)
- Bird, R., Dixon, P., Menzies, G. and M. Rimmer (2010), 'The Economic Costs of US Stock Mispricing', *Journal of Policy Modeling*, 33(4).
- Menzies G., Bird R., Dixon P. and M. Rimmer (2011) 'Asset Price Regulators, Unite: You have the Macroeconomy to Win and the Microeconomic Losses are Small', *Economic Record*, 87(278), 449-464.

## Surprises

- Bird, R., Dixon, P., Menzies, G. and M. Rimmer (2010), 'The Economic Costs of US Stock Mispricing', *Journal of Policy Modeling*, 33(4).
- Too much capital (absolute stock mispricing)
  - Big recession was very costly (not surprising)
  - In one scenario, capital completely worthless
  - Just like worst GFC stimulus projects, but funded OS
  - Since no bringing forward, no 'end of resources boom' downturn
  - Circular flow effects vs supply side effects

## (No) Surprises

- Menzies G., Bird R., Dixon P. and M. Rimmer (2011) 'Asset Price Regulators, Unite: You have the Macroeconomy to Win and the Microeconomic Losses are Small', *Economic Record*, 87(278), 449-464.
- Allow US capital to move in such a way as to equalize returns. Implicitly taking all the distortions which lead to different rates of return as an upper bound on regulation distortions.
- James Tobin: "It takes a heap of Harberger triangles to fill an Okun's gap."

## Cost Limitations

- The mathematical structure of the economy used in CGE (and most economic models) is such that when a firm (or worker, or any other sort of agent) is 'close' to an optimal choice, the effects of being away from the optimum by a small degree are likely to be small (envelope theorem).
- US results
- The shocks are historical averages, whereas the model results might become unrealistic for extreme events, especially if institutions change (Lucas critique, and linearity).
- The misallocation of funds away sectors with high potential growth rates could increase costs of a less innovative (and highly regulated) financial sector a lot
- The costs are not created by regulation but by other factors

## Cost Limitations

- The mathematical structure of the economy used in CGE (and most economic models) is such that when a firm (or worker, or any other sort of agent) is 'close' to an optimal choice, the effects of being away from the optimum by a small degree are likely to be small (envelope theorem). **Make economy inflexible?**
- US results, but we expect similar **Australian** results
- The shocks are historical averages, whereas the model results might become unrealistic for extreme events, especially if **institutions change** (Lucas critique, and linearity).
- The misallocation of funds away sectors with high potential growth rates could increase costs of a less innovative (ie highly regulated) financial sector a lot **cf dynamic/static costs**
- Explore **costs of particular regulations**, such as counter cyclical capital buffers

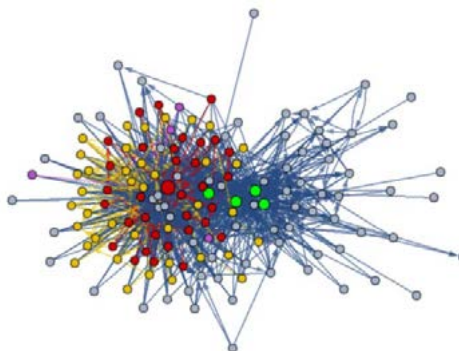
## Benefits of Regulation

- Build a CGE model with financial flows and sectoral balance sheets
- Quantify size of losses from a financial recession
- Quantify how regulations change the probability of such a recession
- Discuss how regulation changes expectations
  - Rules vs discretion; compare inflation targeting and countercyclical capital buffers



## Too central to fail: financial networks, risks and policy responses

Team:  
 Valentyn Panchenko, UNSW  
 Mikhail Anufriev, UTS  
 Paolo Pin, U Siena/Stanford  
 +  
 cooperation with  
 Ed Tellez, RBA



## Project objectives

- Reconstruction of financial network of Australian banks and financial institutions
- Policy guidelines: focus on systemic risk issues

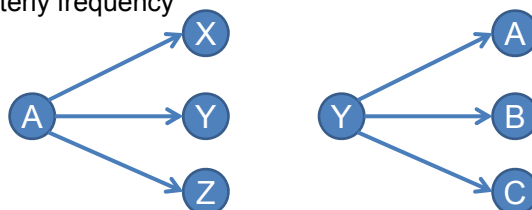
## Reconstruction of network of exposures of Authorised deposit-taking institutions\* (ADIs)

- Data source

APRA '**large** exposures' data ("form 221.0")

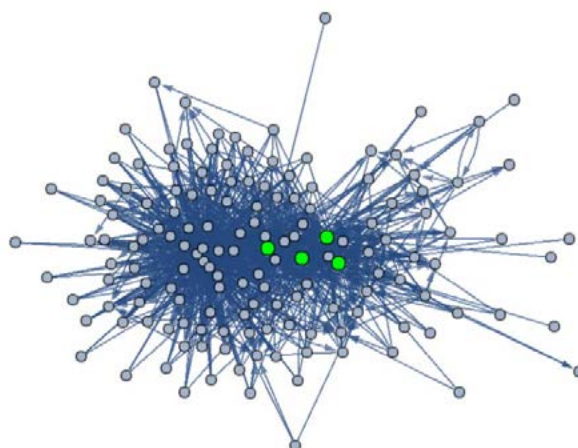
- 10 largest exposure or all exposures >10% of capital

- quarterly frequency

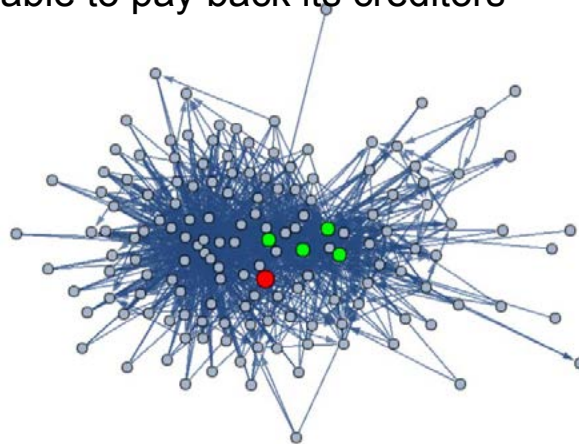


\*Australian-owned banks; Foreign Subsidiary Banks and Branches of Foreign Banks; Credit unions; Building societies

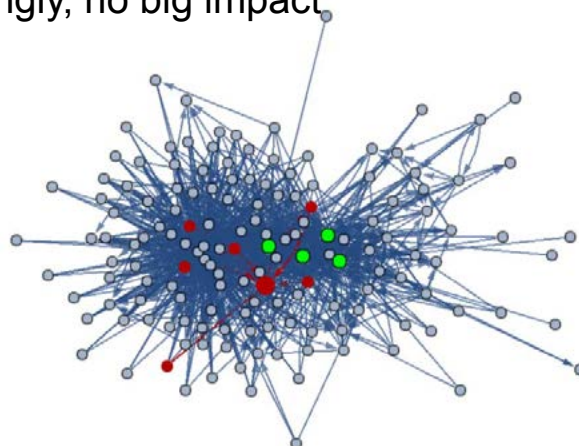
## Network of exposures of ADIs



Scenario: “red” ADI (build. society) is in trouble  
 – unable to pay back its creditors

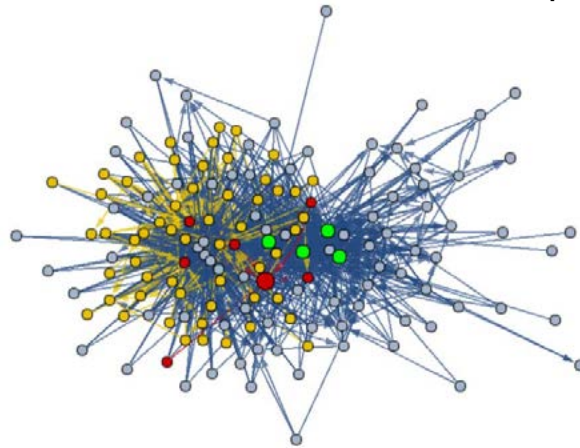


Only **3% of ADIs** are exposed  
 Seemingly, no big impact

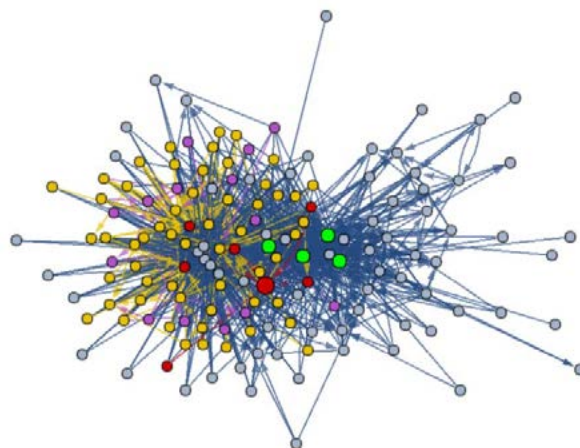


No big impact?

**41%** of ADIs have 1<sup>st</sup> and 2<sup>nd</sup> order exposures

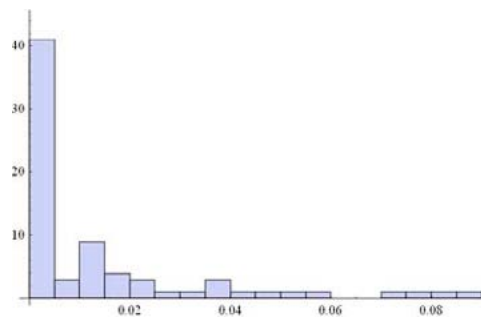


**50%** of ADIs have 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> order exposures



## How to capture systemic importance?

Eigenvalue centrality – includes higher order effects and loops

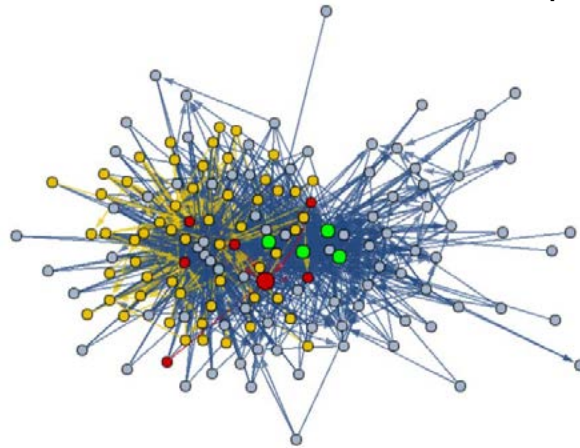


## Related literature and further ideas

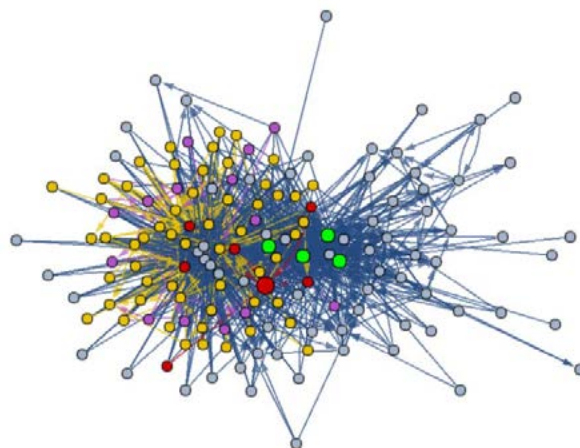
- Elliott, Golub and Jackson, 2012
  - contagion , cascades of default
  - integration – inside exposures vs outside exposures
  - diversification
  
- Acemoglu, Ozdaglar, Tahbaz-Salehi, 2013
  - resilience of the network
  - importance of structure
  
- Alvarez, 2013
  - Optimal disclosure for interconnected banks  
– why do we need stress tests?

No big impact?

**41%** of ADIs have 1<sup>st</sup> and 2<sup>nd</sup> order exposures

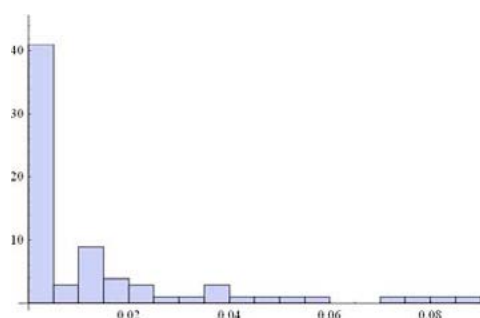


**50%** of ADIs have 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> order exposures



## How to capture systemic importance?

Eigenvalue centrality – includes higher order effects and loops



## Related literature and further ideas

- Elliott, Golub and Jackson, 2012
  - contagion , cascades of default
  - integration – inside exposures vs outside exposures
  - diversification
- Acemoglu, Ozdaglar, Tahbaz-Salehi, 2013
  - resilience of the network
  - importance of structure
- Alvarez, 2013
  - Optimal disclosure for interconnected banks  
– why do we need stress tests?

## Macroeconomic and Welfare Effects of the 2010 Changes to Mandatory Superannuation

George Kudrna and Alan Woodland (CEPAR/UNSW)

Presented at the CIFR Financial System Inquiry Workshop in Sydney

May 2014



### Superannuation changes examined

- Analysis of the changes to mandatory superannuation announced in the 2010 federal budget (Treasury, 2010):
  1. **Gradual increases in the mandatory superannuation guarantee (SG) rate** from 9% to 12% in 2019
    - *Initial increments of 0.25 percentage points in July 2013 and July 2014 and further increments of 0.5 percentage points applied annually up to 2019, when the SG rate will reach 12% of gross earnings;*
  2. **Low income superannuation contribution** of up \$500 for workers with annual income of up to \$37,000 from July 2012
    - *Effective removal of 15% tax on SG contributions for these low income workers.*



## Rationale for superannuation changes

- **Adequacy of the SG rate** - Low net replacement rate of 56.4% for Australia, compared to 69% average across OECD countries (OECD, 2009).
  - Highly sensitive to modelling assumptions - AFTS (2010) calculated 71% replacement rate, using a higher fund earnings rate.
- **Equity of superannuation taxation** - No or negligible tax concessions for 2.4 million individuals, while 5% of individuals accounted for 37% of tax concessions (AFTS, 2010).

## Related literature

1. **Econometric analysis** of compulsory superannuation (FitzGerald (1993), Connelly and Kohler (2004), Connelly (2007))
  - Superannuation offset of around 38 cents (Connelly and Kohler, 2004) and smaller for low income households (Connelly, 2007).
2. Analysis with **micro-simulation projection models** (Gallagher (1996) and Kelly and Morrison, 2008)
  - Positive effects of compulsory superannuation on national savings and replacement rates.
3. Analysis of superannuation changes with **lifecycle optimisation models** (Guest and McDonald (2002), Creedy and Guest (2008a, 2008b)).

## Model overview

- Extended version of the general equilibrium OLG model developed by Kudrna and Woodland (2011) that consists of five sectors:
  1. **Household sector** - 70 generations of 5 income types of households;
  2. **Pension sector** - main aspects of two publically stipulated pillars;
  3. **Production sector** - profit maximising firms producing single output;
  4. **Government sector** - described by a balanced budget;
  5. **Foreign sector** - small open economy with exogenous interest rate.

## Modelling of Australia's pension policy

- **First pillar - Age pension**
  - Non-contributory, funded through general tax revenues;
  - Paid to households of eligible age pension age;
  - Subject to means test that includes income and asset tests.
- **Second pillar - Mandatory superannuation**
  - Superannuation assets accumulated through mandatory superannuation contributions made by firms;
  - Concessional taxation of mandatory contributions and fund earnings;
  - Assumption of tax-free lump sum payouts at age 60.

## Model stylised to Australian economy

- Values assigned to model parameters
  - calibrated for most *production function parameters*;
  - taken from related literature for *utility function parameters*;
  - match the data in 2010 for *tax and pension parameters*.
- Five household income types with different exogenous earnings ability and social benefits:
  - **Earnings ability** based on estimated age wage function (Reilly *et al.*, 2005) and the income distribution parameter derived from ABS (2007);
  - **Social benefits** paid to households in the lowest to fourth quintile younger than 65 and derived from ABS (2007).

## Comparison of benchmark steady state with data

Variable	Benchmark model	Australia 2006-10
<i>Expenditures on GDP (% of GDP)</i>		
- Private consumption	55.27	56.22
- Investment	27.03	27.38
- Government consumption	15.78	17.88
- Trade balance	1.93	-1.3
<i>Government indicators (% of GDP)</i>		
- Age pension expenditure	2.78	2.7
- Social transfers	4.14	4.75
- Personal income taxes	12.41	11.49
- Corporation taxes	5.27	5.27
- Consumption (GST) taxes	3.89	3.89
- Superannuation taxes	1.14	0.8
<i>Net income share</i>		
- Lowest quintile	0.070	0.075
- Third quintile	0.185	0.171
- Highest quintile	0.380	0.401
Gini coefficient	0.324	0.326

## Policy simulations

- Simulations of the 2010 reform to mandatory superannuation:
  1. Gradual increases in the SG rate to 12% phased in from 2013
  2. Contribution tax removal from low income households in 2012
- The simulation results presented in terms of
  - **Macroeconomic effects** - changes in per capita variables relative to their benchmark values.
  - **Welfare effects** - policy effects on individual's welfare (based on *equivalent variation*) and aggregate efficiency (using *LSRA*);



## Macroeconomic effects of superannuation reform

Percentage changes relative to benchmark steady state

Variable	2010	2015	2030	2050	Long run
Labour supply	-0.25	0.28	0.77	-0.28	-1.25
Wage rate	0.11	-0.95	-2.82	-2.64	-2.68
Domestic assets	0.00	0.04	4.26	13.38	18.29
- Ordinary private	0.00	-0.40	-6.88	-5.82	2.56
- Superannuation	0.00	0.47	15.19	32.74	34.45
Consumption	-0.06	-0.16	-0.41	-0.18	1.22
Age pension	-0.03	-0.14	-0.37	-0.87	-4.65
Personal income	-0.17	-1.07	-3.76	-4.68	-5.10
Superannuation	-0.09	-3.69	12.82	18.64	18.43
Tax rate [a]	1.41	4.60	7.14	8.93	7.90

Note: [a] This is consumption tax rate that balances the budget.



## Policy simulations

- Simulations of the 2010 reform to mandatory superannuation:
  1. Gradual increases in the SG rate to 12% phased in from 2013
  2. Contribution tax removal from low income households in 2012
- The simulation results presented in terms of
  - **Macroeconomic effects** - changes in per capita variables relative to their benchmark values.
  - **Welfare effects** - policy effects on individual's welfare (based on *equivalent variation*) and aggregate efficiency (using *LSRA*);

## Macroeconomic effects of superannuation reform

Percentage changes relative to benchmark steady state

Variable	2010	2015	2030	2050	Long run
Labour supply	-0.25	0.28	0.77	-0.28	-1.25
Wage rate	0.11	-0.95	-2.82	-2.64	-2.68
Domestic assets	0.00	0.04	4.26	13.38	18.29
- Ordinary private	0.00	-0.40	-6.88	-5.82	2.56
- Superannuation	0.00	0.47	15.19	32.74	34.45
Consumption	-0.06	-0.16	-0.41	-0.18	1.22
Age pension	-0.03	-0.14	-0.37	-0.87	-4.65
Personal income	-0.17	-1.07	-3.76	-4.68	-5.10
Superannuation	-0.09	-3.69	12.82	18.64	18.43
Tax rate [a]	1.41	4.60	7.14	8.93	7.90

Note: [a] This is consumption tax rate that balances the budget.

## Long run macro effects of two components

Percentage changes relative to benchmark steady state

Variable	Higher SG rate	Contribution tax change	Reform as a whole
Labour supply	-1.16	0.05	-1.25
Wage rate	-2.68	0.00	-2.68
Domestic assets	15.37	1.02	18.29
- Ordinary private	0.79	-1.08	2.56
- Superannuation	30.37	3.16	34.45
Consumption	0.89	0.20	1.22
Age pension	-3.51	-0.29	-4.65
Personal income	-5.13	-0.09	-5.10
Superannuation	29.05	-8.16	18.43
Tax rate [a]	5.96	2.19	7.90

Note: [a] This is consumption tax rate that balances the budget.

## Welfare effects of superannuation reform

- Welfare effects of superannuation reform on selected cohorts of 5 income types and aggregate efficiency effects.

Income type		Age in 2010				
		80	60	40	20	-80
Lowest	%	-0.10	-0.12	0.04	0.14	0.29
Second	%	-0.10	-0.11	0.12	0.34	0.49
Third	%	-0.10	-0.12	-0.08	0.10	0.28
Fourth	%	-0.10	-0.12	-0.04	0.15	0.34
Highest	%	-0.09	-0.11	0.01	0.23	0.47
Average	%	-0.10	-0.12	0.01	0.19	0.37
Efficiency	%	0.00	0.00	0.00	0.80	0.80
Efficiency	\$	0	0	0	11,753	11,753

## Long run welfare effects of two components

- Long run welfare effects of the two components of the reform on selected cohorts of 5 income types and efficiency effects.

Income type		Higher SG rate	Contribution tax change	Reform as a whole
Lowest	%	-0.10	0.32	0.29
Second	%	-0.06	0.35	0.49
Third	%	0.16	0.06	0.28
Fourth	%	0.39	-0.05	0.34
Highest	%	0.51	-0.05	0.47
Average	%	0.18	0.13	0.37
Efficiency	%	0.73	0.01	0.80

## Sensitivity analysis

### Long run macroeconomic effects

- **Endogenous income tax** - proportional changes to the income tax balancing the budget.
- **Endogenous interest rate** - interest rate adjusted to changes in foreign debt to output ratio.

Variable	Endogenous income tax	Endogenous interest rate
Labour supply	-0.47	1.03
Domestic assets	-1.06	-5.11
Consumption	-0.69	1.14
Age pension	0.39	3.62
Tax rate	4.13	0.00
Interest rate	0.00	-6.64

Note: Results presented as deviation from baseline results.

## Sensitivity analysis

Long run welfare and efficiency effects

Income type	Endogenous income tax	Endogenous interest rate
Lowest	0.10	0.33
Highest	-0.27	0.30
Average	-0.05	0.34
Efficiency	-0.25	0.13

Note: Results presented as deviation from baseline results.

## Concluding remarks

- Lifecycle model analysis of the 2010 reform to mandatory superannuation
  - gradual increases in the SG rate to 12%;
  - removal of contribution tax for low income earners.
- Simulation findings showing
  - (i) significantly large total assets through greater superannuation asset accumulations;
  - (ii) improved self-funding in retirement with lower government expenditures on the age pension;
  - (iii) increases in long run welfare for all household types with higher income types benefiting from increased contributions, while lower income types from the contribution tax removal;
  - (iv) aggregate efficiency gains, indicating that the reform is potentially Pareto improving.

Thank you

**Thank you for your attention!**

Paper published:  
Economic Record (2013), Volume 89, Issue 287, pp.445-468

Contact: George Kudrna  
[g.kudrna@unsw.edu.au](mailto:g.kudrna@unsw.edu.au)



*Back*

## Retirement Savings: A Tale of Decisions and Defaults

I. Dobrescu<sup>1</sup> X. Fan<sup>1</sup> H. Bateman<sup>1</sup> B. Newell<sup>1</sup>  
A. Ortmann<sup>1</sup> S. Thorp<sup>2</sup>

<sup>1</sup>University of New South Wales

<sup>2</sup>University of Technology Sydney

Super & Wealth, CIFR Workshop, 2014  
Presented by Xiaodong Fan (x.fan@unsw.edu.au)



- 1 Motivation
- 2 Our Model and Estimation
  - UniSuper
  - Model and Estimation
  - Policy Experiments
- 3 Summary



## Too much freedom?

- Individuals are more involved in decision making.
  - shifts from Defined Benefit to Defined Contribution;
  - portfolio allocation.
- Financial decisions are becoming increasingly complex.
- Individuals might delay making decisions, or rely on default options.
- We try to understand why and to what extent defaults are relevant.

## Choices in UniSuper

- Pension type choice:
  - Defined benefit (DB)
  - Accumulation or Defined Contribution (DC).
  - Within the first year, non-reversible
- Contribution choices:
  - *Employer contribution*
  - Standard contribution
  - Voluntary contribution
- Investment choice: different return/risk.

Motivation      Our Model and Estimation      Summary

UniSuper

## Default choices in UniSuper

% of individuals in default options	Males		Females	
	Permanent	Casual	Permanent	Casual
Pension plan (DB)	71%	N/A	79%	N/A
Voluntary contributions	80%	93%	84%	94%
Investment allocation	45%			



Motivation      Our Model and Estimation      Summary

Model and Estimation

## Our method

- In our life-cycle model, a typical individual
  - survives from one year to the next with some probability;
  - starts working for one of the UniSuper employers;
  - if permanent, chooses DB vs DC plan during the first year;
  - if casual, separates with some probability;
  - receives stochastic wage income;
  - chooses voluntary contribution level each year;
  - chooses investment option for DC component;
  - consume and save;
  - retires and withdraws UniSuper balance at age 65.
- We solve such a model, and generate moments to fit data moments from the UniSuper data.
- We pick the best fit and claim the estimates.





% of individuals choosing:	DC plan	Positive VC	Default invest.	% change in pension wealth
<b>Males</b>				
Baseline	0.293	0.202	0.449	—
Default: DC plan	0.297	0.202	0.446	0.101
Default: Low risk	0.247	0.201	0.401	−1.241
Default: High risk	0.361	0.197	0.942	3.529
<b>Females</b>				
Baseline	0.213	0.112	0.448	—
Default: DC plan	0.214	0.112	0.447	0.003
Default: Low risk	0.211	0.111	0.355	−0.024
Default: High risk	0.225	0.113	0.969	0.536

◀ ▶ ⏪ ⏩ ⏴ ⏵ ⏶ ⏷ ⏸ ⏹ ⏺ ⏻ ⏼ ⏽ ⏾ ⏿ 🔍 ↻

- Default options are relevant and important.
- Varying default options result sizable wealth change.
- Model limitations and next step
  - Heterogeneity in switching costs;
  - More relevant policy experiments.
- **Comments are much appreciated!**

◀ ▶ ⏪ ⏩ ⏴ ⏵ ⏶ ⏷ ⏸ ⏹ ⏺ ⏻ ⏼ ⏽ ⏾ ⏿ 🔍 ↻

## Choices over life annuities: optimal decisions for Australian Retirees

Hazel Bateman<sup>1</sup>   Fedor Iskhakov<sup>1</sup>   Susan Thorp<sup>2</sup>

<sup>1</sup>The University of New South Wales

<sup>2</sup>The University of Technology, Sydney

CIFR Workshop May 7, 2014



## Policy informed research questions

**① Why don't Australians buy life annuities?**

- Strong theoretical evidence for annuitization, yet low take-up
- Many possible explanations including bequest motive, illiquidity, behavioural effects
- Australian setting with means-tested Age Pension is hard

*Our answer: theoretical evidence for annuitization is weaker in Australian context*

**② Should people be compelled to annuitize?**

- Yes, according to previous theoretical evidence
- Maybe not, due to existence of Age Pension

*Our answer: No, optimal annuitization depends on individual preferences, and in presence of means-tested Age Pension annuitization is only optimal for high wealth individuals*



## Main findings

- ① Strong “crowding out” effect of Age Pension on purchases of life annuity
- ② Means-testing makes the effect weaker (less distortional) for high wealth individuals
- ③ The monetary value of making wrong annuitization decision may be relatively small



## Numerical calibrations of life annuity purchase decisions

- ① Repeated **consumption/savings choices** during retirement
- ② Annuity purchase decision **once** at the time of retirement
- ③ Savings choices are independent of annuity, in particular *part of annuity payment can be saved*
- ④ **Credit constraint:** wealth at the end of period can not fall below zero
- ⑤ Rational forward-looking decision maker
- ⑥ Discrete time: age **65** up to 110  
Survival probabilities: from *Australian Life Tables*
- ⑦ Accumulation phase not modelled: retirement wealth  **$W$**   
No bequest motive:  $W$  is **net of bequest**  
No asset composition:  $W$  is **consumable wealth**

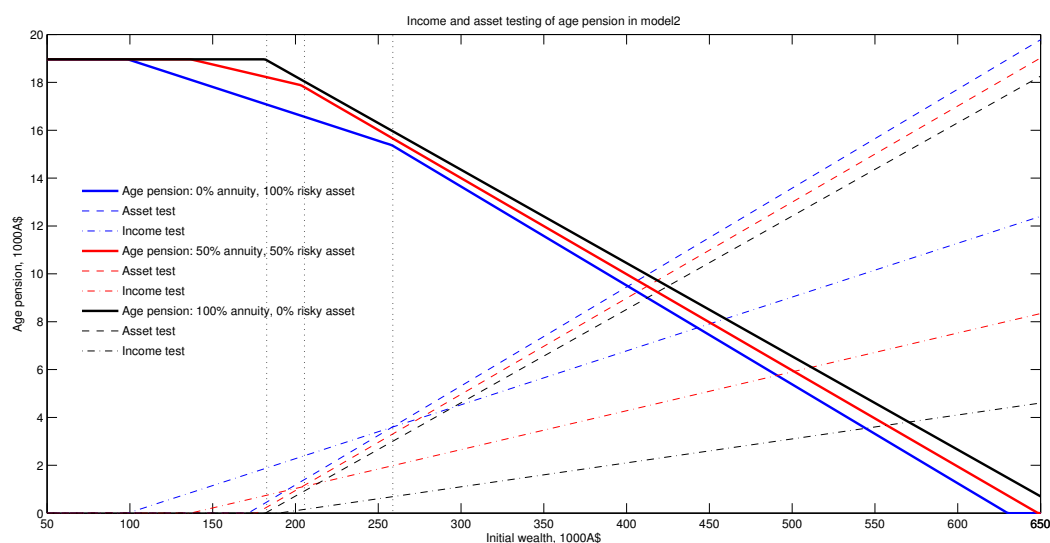


## Australian institutional settings

- Annuity is priced using risk free rate  $r = 2\%$ , actuarially fair
- Savings are invested to a **risky** portfolio with random return
  - Disregard risk free investment (dominated in 2 period model)
  - Real return 6% with a standard deviation of 9% p.a.
- Means-testing of Age Pension is accurately modelled
  - Income test: no labour income + deemed income from savings + annuity payment less the deduction for the return on capital
  - Asset test: beginning of period wealth + assessment of the income stream product (annuity)
  - This version uses 2011 thresholds and rates



## Annuitization decision and means testing



Intro 00      Lifecycle model 000      Numerical simulations ●○○○○○○○      Conclusions 00

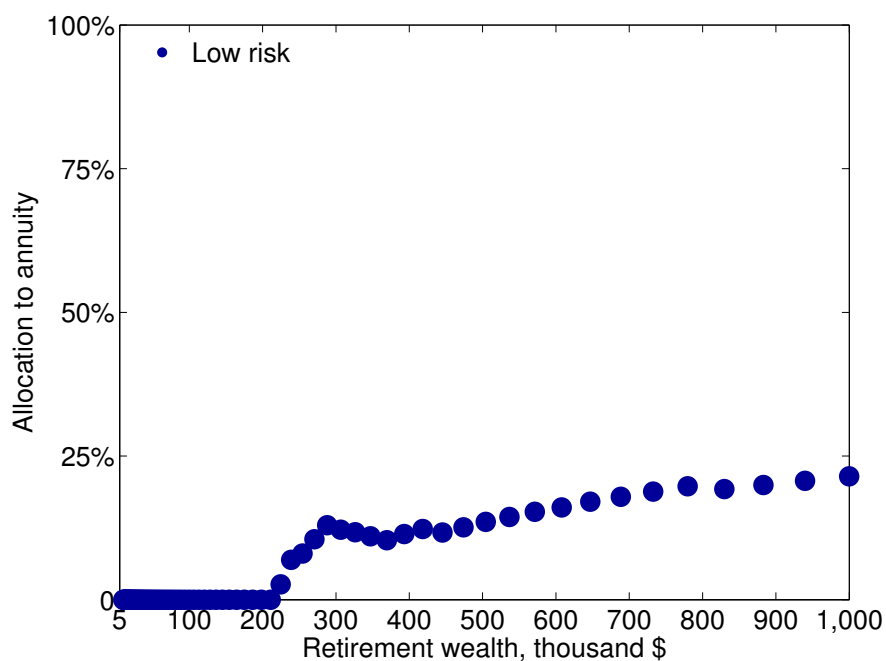
## Calibrated parameter values

- Retirement age: 65
- Survival probabilities: male
- Risk free rate: 2%
- Risk aversion (CRRA):
  - ① baseline: 1.0
  - ② high risk aversion: 2.5
- Discount factor: 0.95
- Real gross return on risky portfolio:
  - ① low risk: 6% (risk premium 4%) with standard deviation 9%
  - ② high risk: 3% (risk premium 1%) with standard deviation 15%

◀ ▶ ⏪ ⏩ ⏴ ⏵ ⏶ ⏷ ⏸ ⏹ ⏺ ⏻ ⏼ ⏽ ⏾ ⏿ 🔍 ↻

Intro 00      Lifecycle model 000      Numerical simulations ●○○○○○○○      Conclusions 00

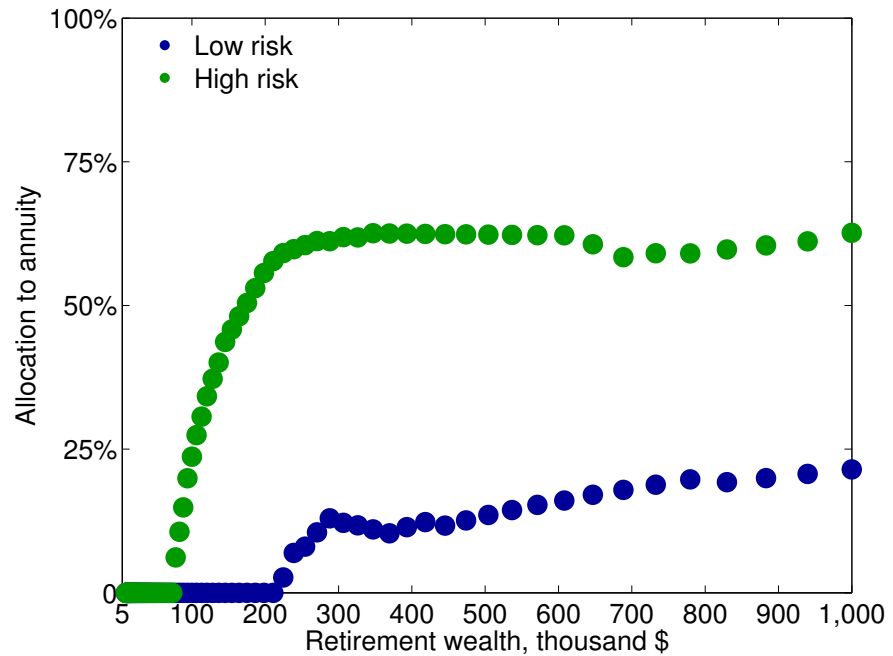
## Baseline simulation



◀ ▶ ⏪ ⏩ ⏴ ⏵ ⏶ ⏷ ⏸ ⏹ ⏺ ⏻ ⏼ ⏽ ⏾ ⏿ 🔍 ↻

Intro 00    Lifecycle model 000    Numerical simulations 00●000000    Conclusions 00

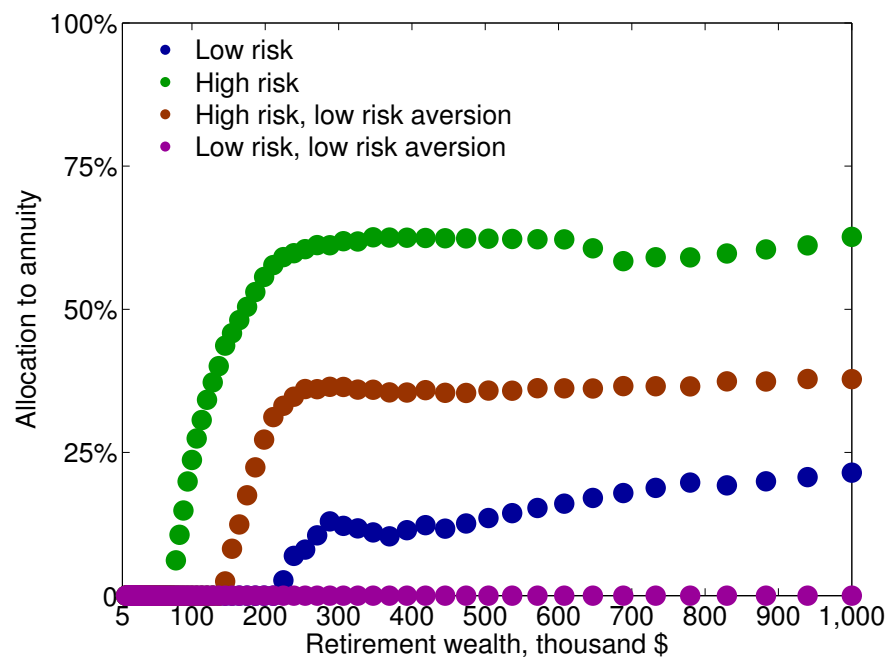
## Baseline simulation



Navigation icons: back, forward, search, etc.

Intro 00    Lifecycle model 000    Numerical simulations 00●000000    Conclusions 00

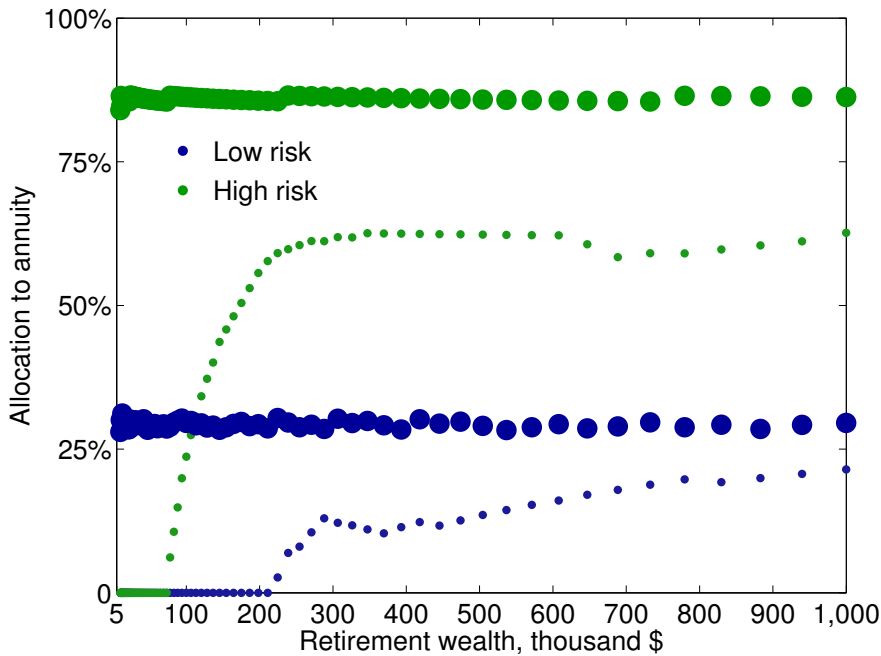
## Baseline simulation



Navigation icons: back, forward, search, etc.

Intro 00      Lifecycle model 000      Numerical simulations 0000●0000      Conclusions 00

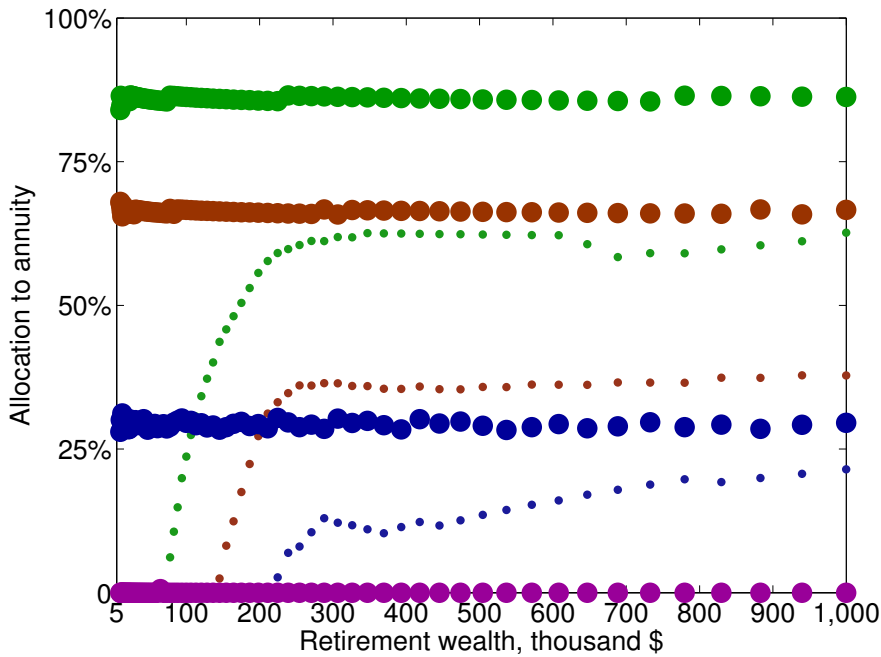
## The role of age pension



Navigation icons: back, forward, search, etc.

Intro 00      Lifecycle model 000      Numerical simulations 0000●0000      Conclusions 00

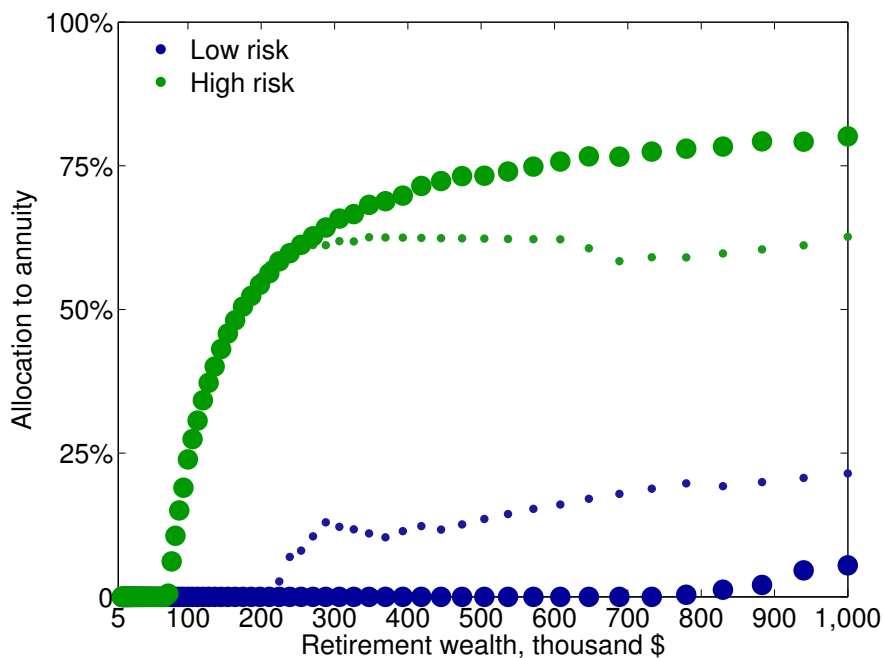
## The role of age pension



Navigation icons: back, forward, search, etc.

Intro 00    Lifecycle model 000    Numerical simulations 000000●00    Conclusions 00

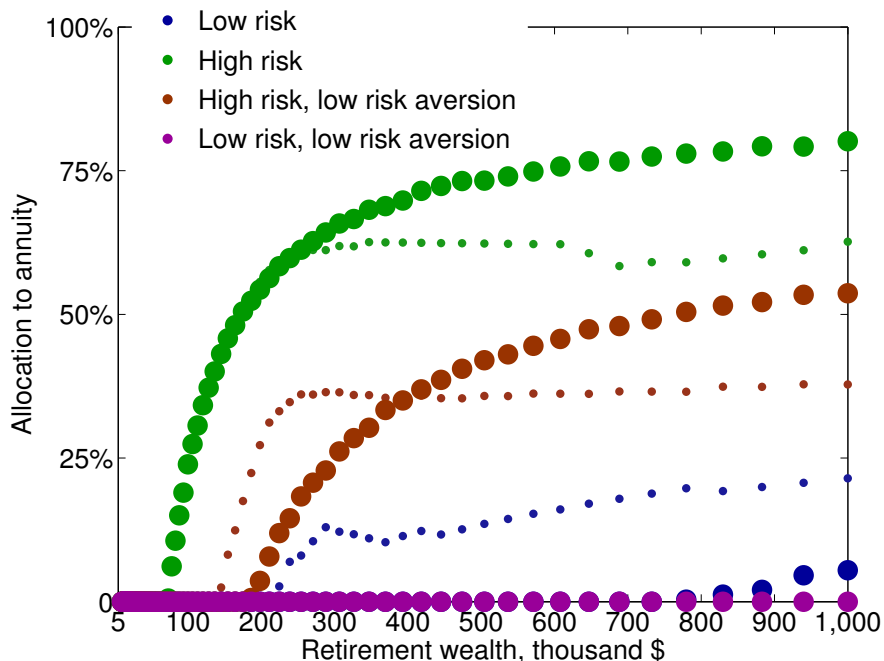
## The role of means testing



Navigation icons: back, forward, search, etc.

Intro 00    Lifecycle model 000    Numerical simulations 000000●00    Conclusions 00

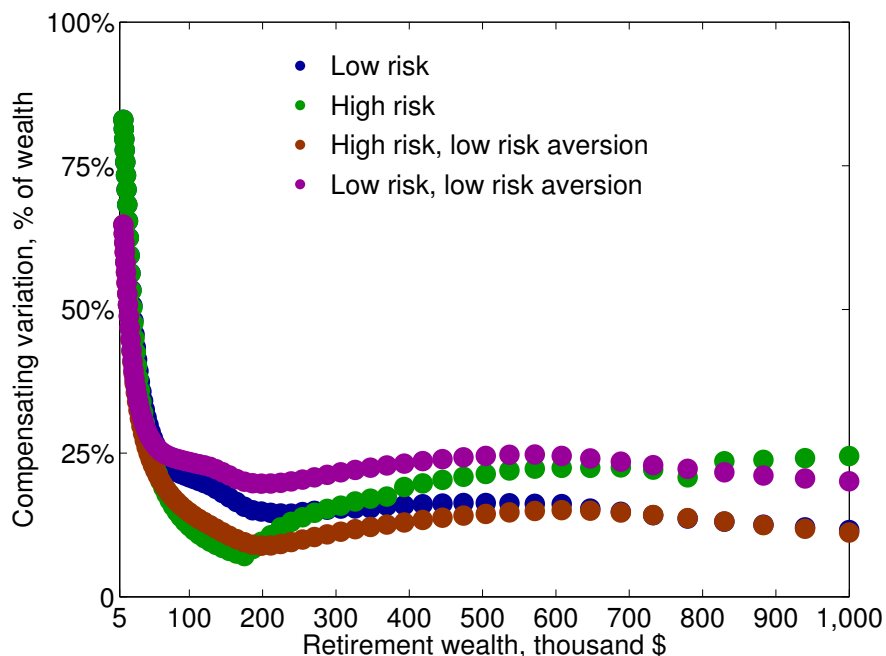
## The role of means testing



Navigation icons: back, forward, search, etc.

Intro ○○      Lifecycle model ○○○      Numerical simulations ○○○○○○○●      Conclusions ○○

## Wrong decisions may be not too costly



◀ ▶ ⏪ ⏩ ⏴ ⏵ ⏶ ⏷ ⏸ ⏹ ⏺ ⏻ ⏼ ⏽ ⏾ ⏿ 🔍 ↺

Intro ○○      Lifecycle model ○○○      Numerical simulations ○○○○○○○○      Conclusions ●○

## Conclusions

- ① Existence of Age Pension greatly reduces annuity purchases: Theoretical evidence against annuitization in Australian context.
- ② Means-testing differentiates low and high income groups: Annuitization decisions of low income group are more distorted. Annuitization decisions of high income group are less affected by the crowding out effect.
- ③ Monetary value of the “wrong” annuitization decisions may be relatively small: Higher than actuarial fair price can further deter annuitization. Level of loadings becomes an important factor.

◀ ▶ ⏪ ⏩ ⏴ ⏵ ⏶ ⏷ ⏸ ⏹ ⏺ ⏻ ⏼ ⏽ ⏾ ⏿ 🔍 ↺

## Policy implications

### ① Why don't Australians buy life annuities?

*There are theoretical reasons not to annuitize — even in absence of bequest motive and unforeseen expenditures.*

### ② Should people be compelled to annuitize?

*No, because optimal annuitization is individual specific.*

*For lower wealth individuals: mistakes are relatively more costly, yet optimal decision may well be 0% annuitization due to existence of Age Pension.*

*For high wealth individuals: mistakes are relatively less costly, yet optimal annuitization is subject to individual risk aversion and time preferences.*



Back



## Default and Diversification Heuristics in Annuity Choice

*Hazel Bateman, Christine Eckert,  
Fedor Iskhakov, Jordan Louviere,  
Steve Satchell and Susan Thorp*



### Increasing individual responsibility for a critical financial decision

- Retirement income stream choice:
  - Characterised by high stakes, multiple risks, irreversibility, long horizons, complex regulation
  - Decision makers need strong financial competence
- Strong theoretical reasons for annuities but low uptake in real markets
- Why? Bequests, loadings, public pensions, illiquidity; wealth illusion, complexity, framing, loss aversion

### People simplify hard decisions (like retirement income choice) by using heuristics (shortcuts).

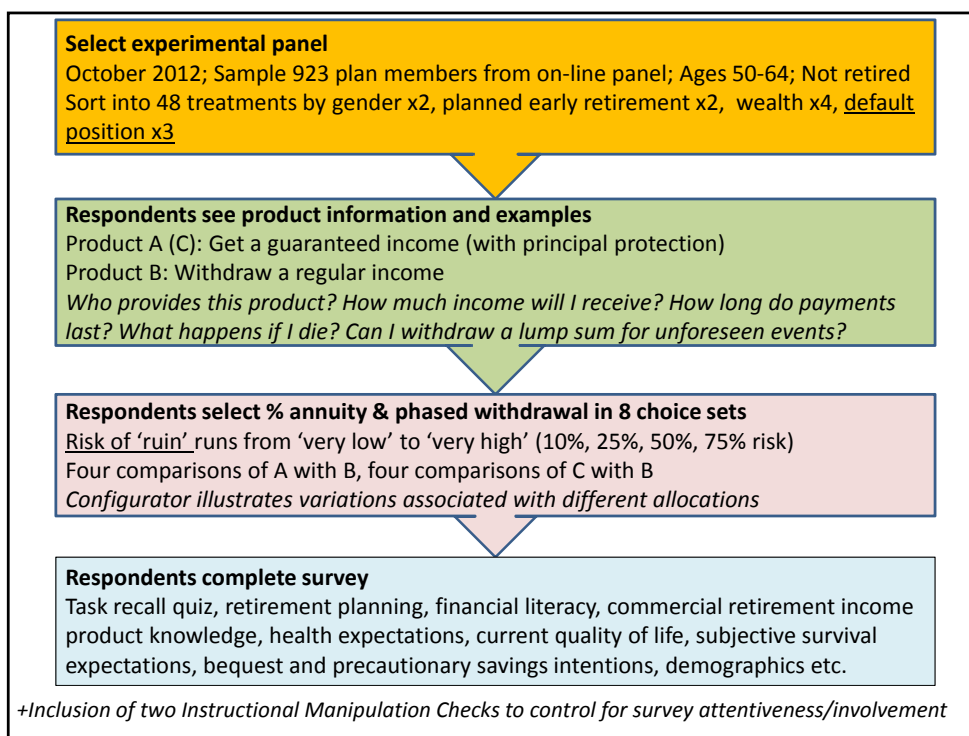
- Do Australian retirees use **heuristics** when choosing income streams?
- Does this depend on **consumer characteristics**?

→ Answer questions such as

- determining “true” demand for annuities
- designing annuity offers (i.e. choice environment and description of options)
- protecting vulnerable consumers

### Basic Idea of Empirical Study

- Respondents **allocate wealth** between phased withdrawal (allocated pension) and immediate life annuity
- Control for **rational drivers** of choice (fair pricing of products, eligibility for Age Pension, bequest motives)
- Control for **behavioral and psychological explanations** (products described in plain English, no previous knowledge necessary to make choice, availability of products)
- Experiment varies risk of exhausting phased withdrawal and receiving lower income (risk of ruin)



## Screenshot of Allocation Task


Now imagine you are at retirement and you have \$1 million of super and savings to use to purchase either Product A or Product B, or a combination of both

Please use the slider to allocate your wealth to Product A and Product B.

Product A

50%

100% in A



100% in B

Product B

50%

1. Your expected annual income: **\$72,360**
2. Guaranteed part of your expected annual income: **\$49,680 of \$72,360**
3. Share of wealth you can withdraw as a lump sum: **50%**  
*(You can only withdraw from Product B)*

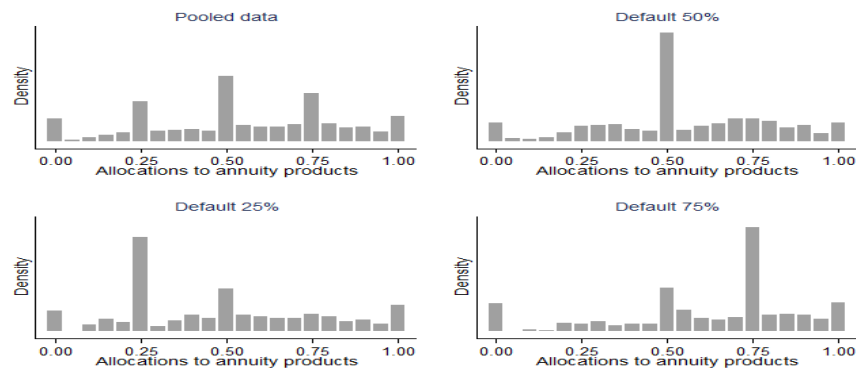
The chance your income from Product B will run out during retirement, that is, your chance of receiving **ONLY** the guaranteed part of income is:

**VERY LOW (1 in 10)**

• Hover over "Product A" and "Product B" for more information

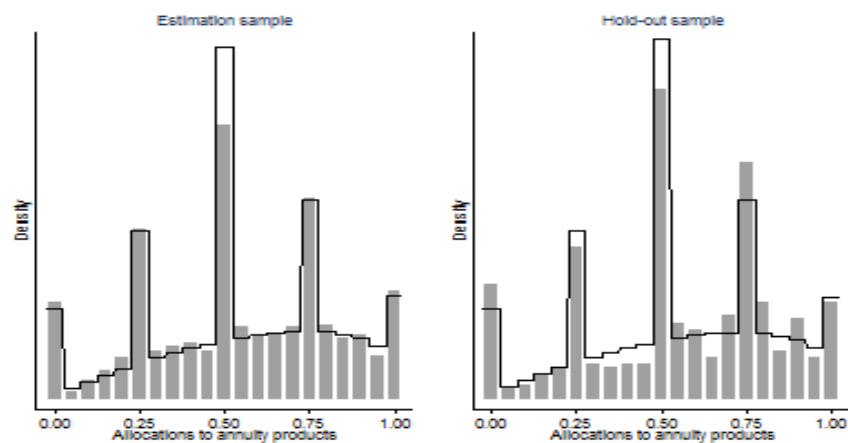
>>

## Observed Allocations Pooled Across Risk Levels and Lifetime Annuities



- Large **peaks** at *default* heuristic, *diversification* heuristic, *extremes*
  - No noticeable additional mass in **neighbourhood** of extremes
- Confirm reliance on heuristics to **simplify** decision task

## Model Fit

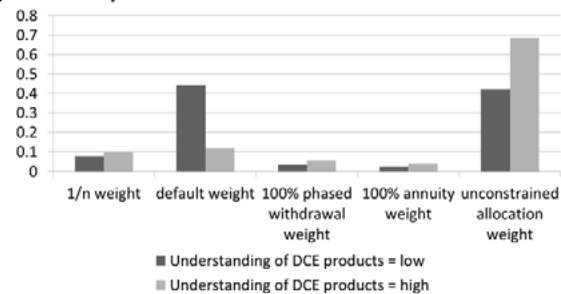


## Finding 1: Relative Influence of Heuristics on Annuity Choice

- More than 30% of choices are based on default or diversification (50:50) heuristics

Weights of decision strategies				
Unconstrained allocation	1/n heuristic	Default heuristic	100% phased withdrawal	100% annuity
59%	10%	22%	5%	4%

- Weights vary with covariates



## Finding 2a: Characterizing Vulnerable Consumers; Users of Default Heuristic

- When is default heuristic used?
    - Higher understanding of income stream products (=task engagement & processing capacities)
    - Higher education
    - Higher risk
    - Survey attention (=involvement?!)

} Decrease use of heuristic

  
  - +/- Wealth: very rich and very poor rely more on heuristic
- } U-shaped relation

Confirms previous findings, Contradicts previous findings, Extends previous findings

## Finding 2b: Characterizing Vulnerable Consumers; Users of 1/n heuristic

- When is 50:50 heuristic used?
  - + Higher risk of ruin
  - + Intention to leave bequest
  - + Intention to retire early
  - + No principal protection for annuity} Increase use of heuristic
  
- High basic financial literacy
  - High knowledge of products on the market} Decrease use of heuristic

Confirms previous findings, Contradicts previous findings, Extends previous findings

## Finding 3: What Drives Annuitization

- + Married
  - + higher understanding of DCE products  
(=task engagement & processing capacities)
  - + higher education
  - + survey attention (=involvement?!)
  - + higher risk associated with phased withdrawal
  - Higher self assessed financial literacy (over-confidence?!)
  - intention to leave bequest
- }
- Increase allocation to annuity

+/- Higher numeracy decreases annuitization, but higher numeracy interacted with higher risk increases annuitization

}

Decrease allocation to annuity

Confirms previous findings, Contradicts previous findings, Extends previous findings

## Implications

- Annuity uptake can be easily increased by **offering of both options** at the same time
- Annuity uptake can be increased by explaining annuities **in plain English**, without referring to the word “annuities” and by also explaining risk of outliving expenses in plain English
- High self-assessed financial literacy may lead to **overconfidence**, so knowledge test before choice is made might help to ground these people

Thank you!

Questions?

[susan.thorp@uts.edu.au](mailto:susan.thorp@uts.edu.au)

## Experimental Instructions

*In the next few questions we will ask you to complete 4 sets of choice tasks about 2 financial products. On leaving the workforce, most people need to use money from their superannuation and other savings to cover their spending. Industry and Government are looking for simple financial products to help Australians manage their superannuation and savings during retirement. The retirement income products we are going to show you are designed by large financial firms, like insurance companies and superannuation funds, to cover spending and manage financial risks in retirement.*

## Experimental Product Description: Product A (Annuity)

### **Product A: Get a guaranteed income.**

- Who provides this product? *It is supplied by large life insurance firms. These firms have to meet strict government regulations to be allowed to sell this product.*
- How much income will I receive? *You will receive a fixed regular income.*
- How long do payments last? *You will receive the regular income for as long as you live, regardless of how long or short that is.*
- What happens if I die? *If you die, payments stop.*
- Can I withdraw a lump sum for unforeseen events or changes of plans? *No. To purchase this product, you pay a lump sum to the insurance firm in exchange for the income stream and you cannot get it back. Your beneficiaries do not get the lump sum back if you die.*

## Experimental Product Description: Product B (Withdrawal Account)

### **Product B: Withdraw a regular income**

- Who provides this product? *It is supplied by superannuation funds. Your money is held in an account and invested in financial assets like shares and bonds.*
- How much income will I receive? *You can decide how much of your balance to withdraw each year. Your account balance will fluctuate each year with financial markets. You will pay fees each year to the fund that manages your account.*
- How long do payments last? *There is no guarantee you will have a lifetime income. How long payments last depends on investment returns, fees and your withdrawals.*
- What happens if I die? *If you die, remaining money in your account goes to your dependents or your estate.*
- Can I withdraw a lump sum for unforeseen events or changes of plans? *Yes. You can take all or a part of any remaining money out, but if you do it will not be available to pay you income in the future.*

## Experimental Product Description: Product C (Annuity with Guarantee Period)

### **Product C: Get a guaranteed income with a fixed term payment period.**

- Who provides this product? *It is supplied by large life insurance firms. These firms have to meet strict government regulations to be allowed to sell this product.*
- How much income will I receive? *You or your beneficiaries will receive a fixed regular income.*
- How long do payments last? *You personally will receive the regular income for as long as you live, regardless of how long or short that is. If you die within the fixed term period, the regular income continues to be paid to your beneficiaries or estate up to the end of the 15th year.*
- What happens if I die? *Payments are guaranteed to you or your beneficiaries for the first 15 years, even if you die within that period. Payments are guaranteed only to you after that time.*
- Can I withdraw a lump sum for unforeseen events or changes of plans? *No. To purchase this product, you pay a lump sum to the insurance firm in exchange for the income stream and you cannot get it back. Your beneficiaries do not get the lump sum back if you pass away*

## Correlation of Financial Literacy Measures

	Numeracy	Basic financial literacy	Sophisticated financial literacy	Self-assessed financial literacy
Numeracy	1			
Basic financial literacy	.37	1		
Sophisticated financial literacy	.32	.42	1	
Self-assessed financial literacy	.13	.15	.15	1

## Assessing Financial Literacy

### Numeracy:

- Imagine that we rolled a fair, six-sided die 1,000 times. Out of 1,000 rolls, how many times do you think the die would come up with even numbers? *(74.4% correct)*
- In a lottery, the chance of winning a \$10 prize is 1%. What is your best guess about how many people would win a \$10 prize if 1,000 people each buy a single ticket to the lottery. *(68.9% correct)*
- In a raffle, the chance of winning a car is 1 in 1,000. What percent of tickets in the raffle win a car? *(60.3% correct)*

### Basic Financial Literacy:

- Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years how much do you think you would have in the account if you left the money to grow? *(90.2% correct)*
- Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account? *(85.3% correct)*

### Sophisticated Financial Literacy

- When an investor spreads his money among different assets, does the risk of losing money increase, decrease, or stay the same? *(71.3% correct)*
- Please tell me whether this statement is true or false. 'Buying a single company's shares usually provides a safer return than a share managed fund.' *(75.7% correct)*

### Other Interesting Findings

- People tend to underestimate their life expectancy by an average of 4.5 years (median)
- Survey attention (IMC1 = proxy for involvement?!)

		IMC 2		
		Correct	Incorrect	Total
IMC 1	Correct	234	193	<b>427</b>
	Incorrect	29	467	<b>496</b>
Total		<b>263</b>	<b>660</b>	<b>923</b>

### More Information on Survey

- Median duration DCE: 18 minutes
- Median duration survey: 32 minutes
- Incentives: for each correct answer in quiz questions, respondents entered a lottery; 3 prizes with \$A50 each



Centre for International  
Finance and Regulation  
Towards Financial System Integrity

## Long-Term Investing: Overview of CIFR Project T003

CIFR  
7 May 2014

Geoff Warren  
Research Director, CIFR

---

### Introduction

- Joint project between CIFR and the Future Fund
- Long-term investing from perspective of institutional investors
- Comprises three papers:
  - Paper 1 substantially completed; awaiting approval for release
  - Remaining papers and project launch planned for late-2014
- Public policy relevance: supply of long-term finance
  - Also on G20 agenda (Australia has presidency in 2014)



Centre for International  
Finance and Regulation  
Towards Financial System Integrity

2

## Project Overview

Paper	Topic	Covers
One	Determinants of Investment Horizon	<ul style="list-style-type: none"> <li>• Definition of long-term investing</li> <li>• Debate over short-termism vs. long-term investing</li> <li>• Determinants – a literature review</li> </ul>
Two	Benefits of Long-Term Investing	<ul style="list-style-type: none"> <li>• Conceptual foundations</li> <li>• Illiquidity premium – what is known?</li> <li>• Specifying and estimating the benefits of full discretion over trading, i.e. dynamic strategies</li> </ul>
Three	Fostering Long-Term Investing	<ul style="list-style-type: none"> <li>• Overview of recommendations from the literature</li> <li>• How might you build a fund management organization to take a long-term perspective? <ul style="list-style-type: none"> <li>– The Future Fund for guidance / case study</li> </ul> </li> <li>• Public policy recommendations</li> </ul>

## Characterizing Long-Term Investing

- No clean and tidy definition. No underlying theory either.
- We propose two indicators:
  1. Discretion over trading
  2. Approach to investing, especially information used
    - Focused on drivers of near-term price changes (*'trading'*); versus drivers of long-term value and returns (*'investing'*)
- *Why not holding period?* Long-term investors need not hold for a long period. They only need to set their sights on the long-term. (The optimal path needs not be buy and hold – see Merton, etc)

## Twelve Influences on Investment Horizon

*Influences related to investor circumstances:*

1. Nature of funding or liabilities
2. Trade discretion and tolerance for illiquidity

*Influences related to the design of the investing environment:*

3. Organizational structures
4. Performance evaluation and remuneration practices
5. Financial market structures and financial liberation

*Influences related to investor choice:*

6. Investment philosophy and process
7. Information sets employed
8. Behavioral effects
9. Decision maker attributes

*Other influences:*

10. Cultural
11. Limits to arbitrage
12. Diversification via alternative assets (a push factor)

## Short-Termism Debate

- Case for pervasive and detrimental short-termism is *not* clear cut.
- Mix of short-term and long-term investors is a good thing. Issues:
  - Balance (. . . and if this out of kilter . . .)
  - What opportunities are there for long-term investors?

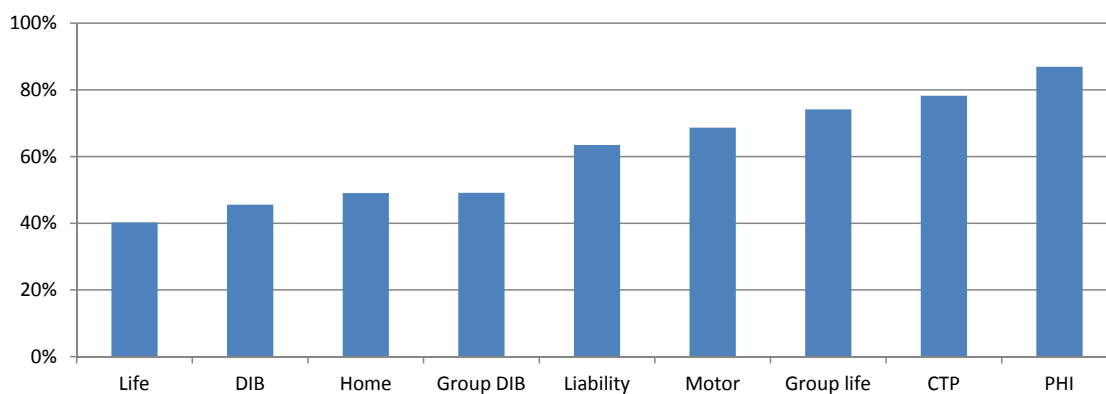
Short-termism – Purported Effects	Counter-arguments
• Market inefficiency (mis-pricing)	• ST and LT behaviour hard to distinguish
• Excess volatility	• Short-term behavior is not all bad
• Pro-cyclicality	• Links to corporate myopia are unclear
• Induces corporate myopia	
• Impedes good corporate governance	
• Impacts the efficiency of financial intermediation (costly; less LT funding)	

## Benefits of Long-Term Investing

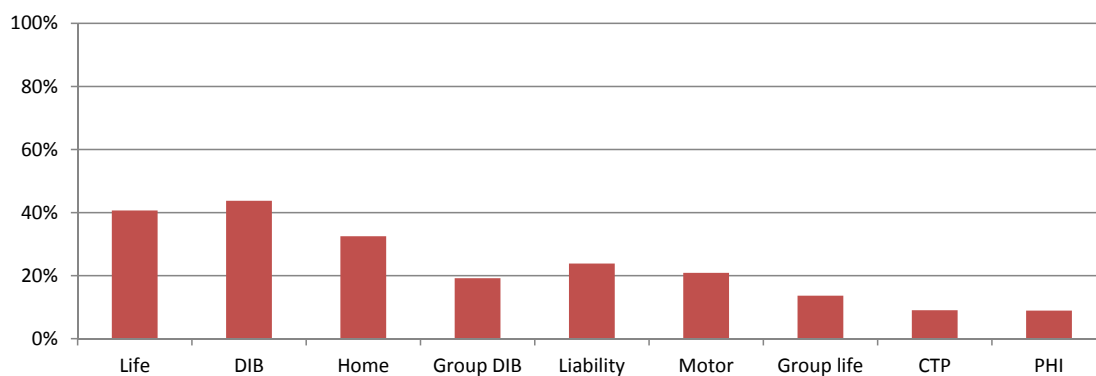
- Public benefits:
  1. Stabilizing force in the market
  2. Engaged, responsible asset owners
  3. Financing long-term productive activity
- Private benefit:
  - *The subject of Paper 2*



PETER CAROLL



**Expenses/premiums 2013**



## INSURANCE DISCUSSION QUESTIONS

- \*What are the issues involved in setting the right balance between ensuring competition and stability in the insurance sector?
- \* What effect has the acquisition of insurance companies by the major banks had on competition?
- \* What effect have international insurers had on the insurance sector?
- \* Has the insurance sector provided adequate capacity for industry and consumers to mitigate risks?
- \* Will current regulation ensure stability in the insurance sector?
- \* Why hasn't the insurance sector developed innovative products for the post retirement market?
- \* Is the insurance sector an efficient provider of capital to the Australian economy?





Centre for International  
Finance and Regulation  
Towards Financial System Integrity

## Financial Advice FSI Workshop 2014

Kingsley Jones

### New Patterns of Financial Advice

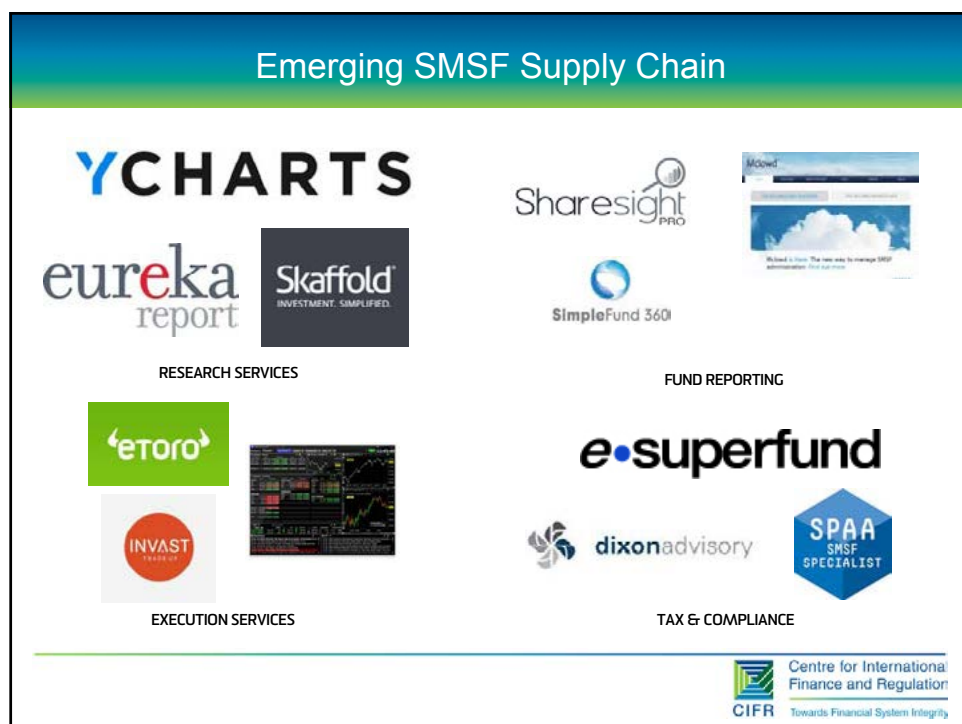
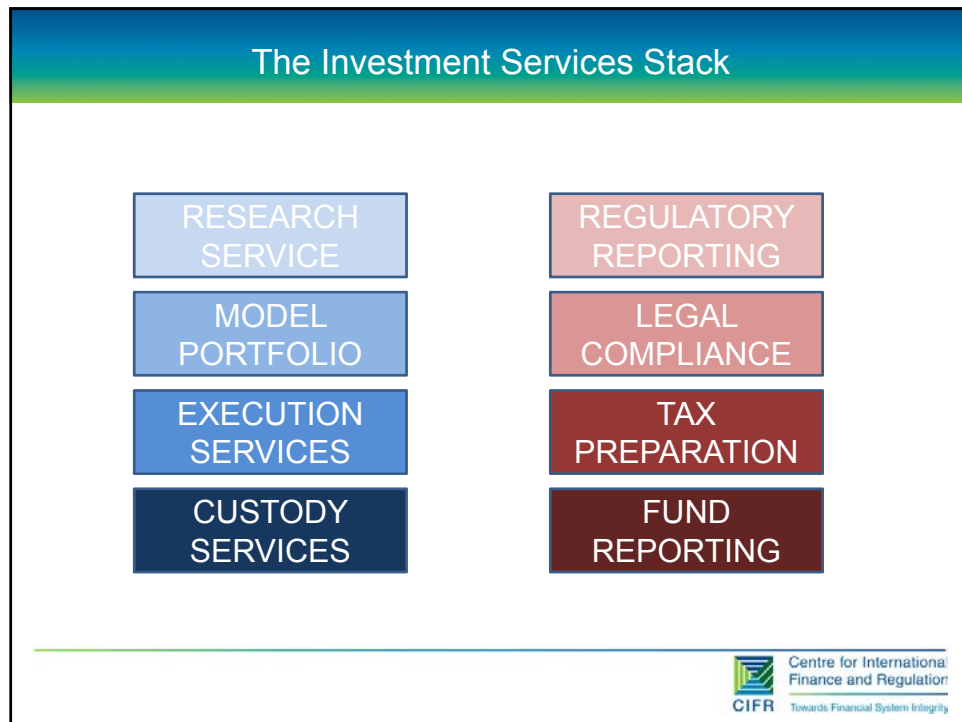
---

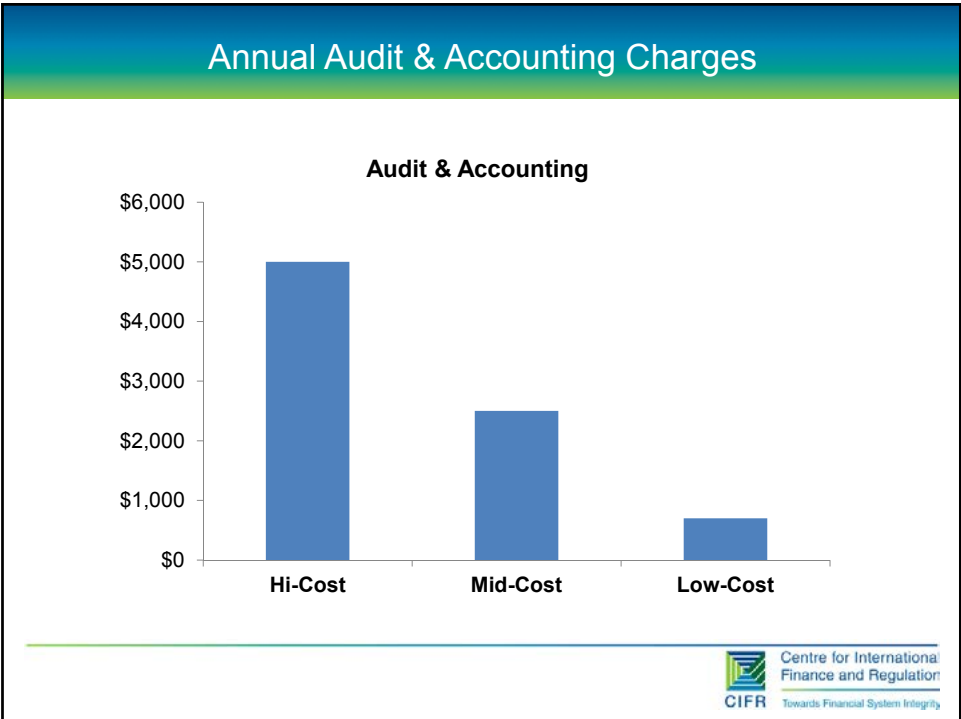
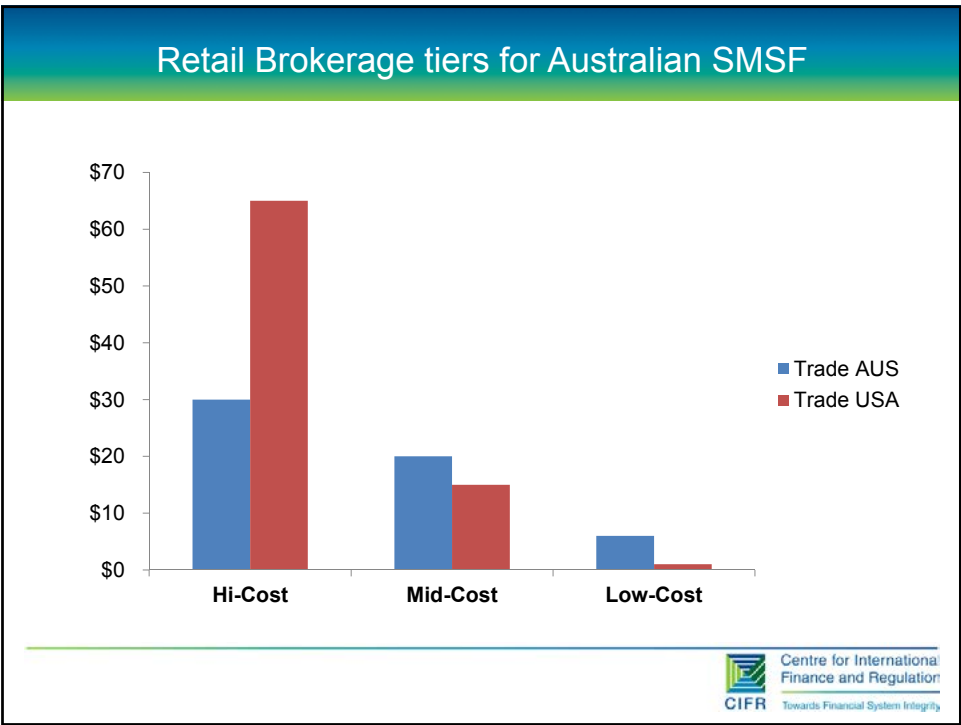
## Context and Agenda

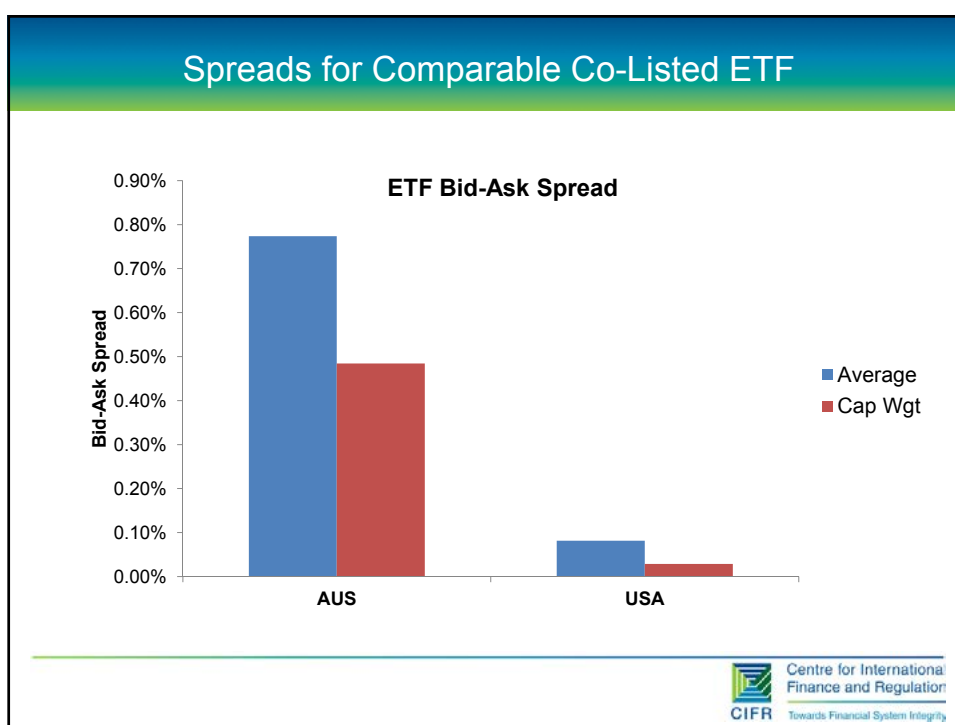
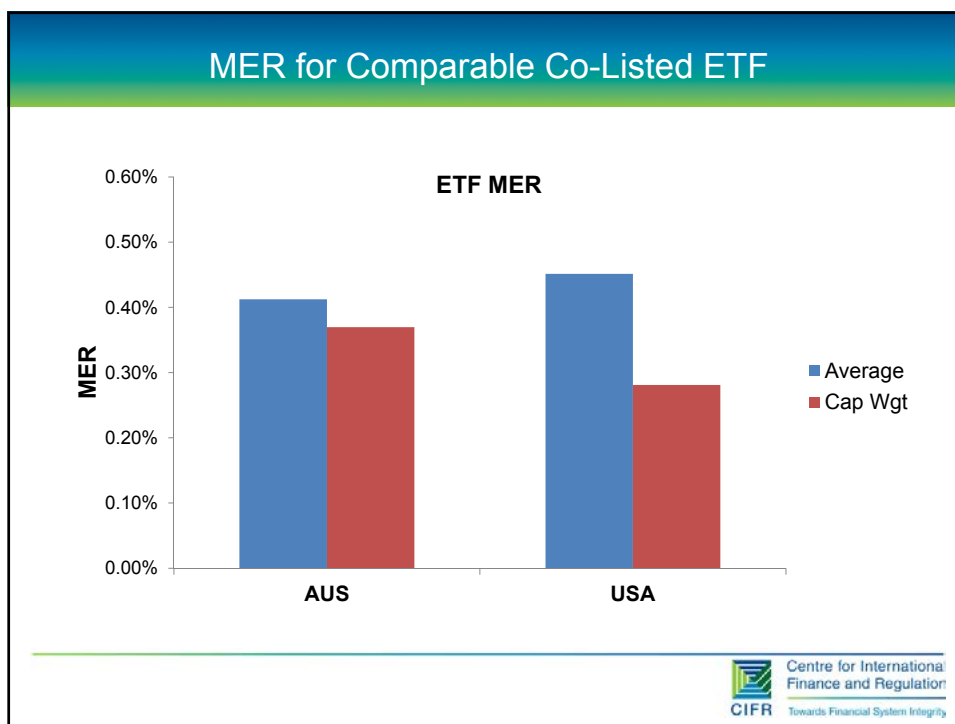
- Electronic trading
- Online fund accounting
- Exchange Traded Funds (ETF)
- Continued growth in SMSF Investing
- Emerging digital delivery of scaled advice
- Shift to offer general over personal advice
- Where are we headed for Financial Advice?
- What are the implications for the FSI?
- What research do we need to do?



Centre for International  
Finance and Regulation  
Towards Financial System Integrity







### ASX Focused Fund (Average SMSF)

#### ASX Focused DIY (Average SMSF)

Brokerage (20 Trades @ \$30)	\$600.00
Newsletter Service	\$300.00
Market Data Service (ASX)	\$600.00
ATO Supervisory Levy	\$259.00
ASIC Trustee Company Registration	\$236.00
Accounting & Audit Services	\$2,400.00
Implied ETF Fee (\$1M at 0.35%)	\$3,840.00
<b>Total Fee</b>	<b>\$8,235.00</b>
AUM Base	\$960,000.00
ETF MER (AU Based)	0.40%
Implied ETF Fee	\$3,840.00
Total Fee	\$8,235.00
Effective MER	0.86%

### Global Exchanges Focused Fund (Average SMSF)

#### Global DIY (Average SMSF)

Brokerage (20 Trades @ \$15)	\$300.00
Newsletter Service	\$300.00
Market Data Service (Global)	\$1,200.00
ATO Supervisory Levy	\$259.00
ASIC Trustee Company Registration	\$236.00
Online Fund Administration	\$700.00
Implied ETF Fee (\$1M at 0.35%)	\$3,360.00
<b>Total Fee</b>	<b>\$6,355.00</b>
AUM Base	\$960,000.00
ETF MER	0.35%
Implied ETF Fee	\$3,360.00
Total Fee	\$6,355.00
Effective MER	0.66%

### ASX Focused Fund (Small SMSF)

#### ASX Focused DIY (Small SMSF)

Brokerage (20 Trades @ \$30)	\$600.00
Newsletter Service	\$300.00
Market Data Service (ASX)	\$600.00
ATO Supervisory Levy	\$259.00
ASIC Trustee Company Registration	\$236.00
Accounting & Audit Services	\$2,400.00
Implied ETF Fee (\$1M at 0.35%)	\$1,400.00
<b>Total Fee</b>	<b>\$5,795.00</b>

AUM Base	\$350,000.00
ETF MER (AU Based)	0.40%
Implied ETF Fee	\$1,400.00

<b>Total Fee</b>	<b>\$5,795.00</b>
<b>Effective MER</b>	<b>1.66%</b>

### Global Exchanges Focused Fund (Small SMSF)

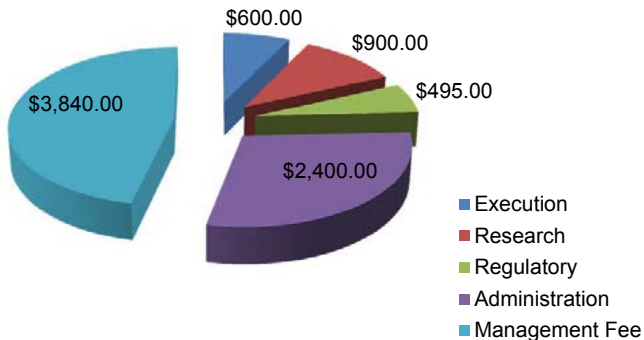
#### Global DIY (Small SMSF)

Brokerage (20 Trades @ \$15)	\$300.00
Newsletter Service	\$300.00
Market Data Service (Global)	\$1,200.00
ATO Supervisory Levy	\$259.00
ASIC Trustee Company Registration	\$236.00
Online Fund Administration	\$700.00
Implied ETF Fee (\$1M at 0.35%)	\$1,225.00
<b>Total Fee</b>	<b>\$4,220.00</b>

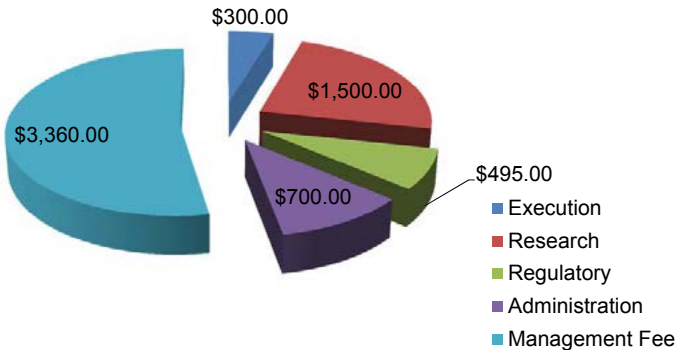
AUM Base	\$350,000.00
ETF MER	0.35%
Implied ETF Fee	\$1,225.00

<b>Total Fee</b>	<b>\$4,220.00</b>
<b>Effective MER</b>	<b>1.21%</b>

### Split for Average SMSF (ASX DIY)



### Split for Average SMSF (Global DIY)



## Summary

- Growth of the Adviser-Manager
- Blurring of the Stock Broker Role
- Rise of the Self-Directed Investor
- Need for Scalable Fund Administration
- Importance of Foreign Trade Accounting
- Regulatory Reform: Redefining the Advice Role



CIFR Workshop

Financial System Inquiry

Westin Hotel, Sydney

7 May 2014

**CIFR-Supported Research on Financial Advice: Faculty of  
Business & Economics, Macquarie University**

Geoff Kingston  
Department of Economics  
Macquarie University

[geoff.kingston@mq.edu.au](mailto:geoff.kingston@mq.edu.au)

## Retirement risk zone

1. Geoff Kingston & Lance Fisher, 'Down the Retirement Risk Zone with Gun and Camera' *Economic Papers*, 2014, in print.

2. Jack Ding, Geoff Kingston and Sachi Purcal, 'Dynamic Asset Allocation when Bequests are Luxury Goods', *Journal of Economics and Control*, 2014, pp67-71.

- Risk zone: a fragile period in the life cycle of people in DC super.
- Runs something like 5 to 10 years either side of the retirement year.
- Primarily affects people of middle means--a lifelong high weight to growth assets matters less for people at the extremes.

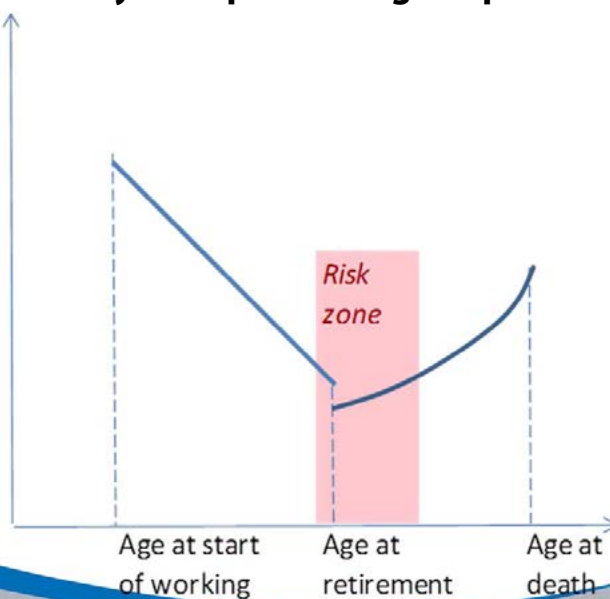
### Risk zone terminology

- *Sequencing risk*: sensitivity of living standards to the timing of poor investment returns.
- *Aggressive constant-mix*: allocate a high and stable share of the portfolio to growth assets.
- ❖ In Australia this share tends to be fixed at 70% to 90%--depends on your definition of 'income' assets.

### Risk zone countered by a 'displaced-V' glide path

Share of  
growth assets

Percent



### Risk zone: assumptions for retirees

- Financial wealth taken into retirement: \$1 million.
- Household's retirement span: 30 years
- Expected real return to growth assets: 5% pa.
- Volatility of returns to growth assets: 20% pa.
- Real return to safe assets: 2% pa.
- Risk aversion parameter: 1.7.
- *Bequest preference parameter*: \$20,400.
- Propensity to bequeath: 0.92.
- Expenditures on essentials: \$2,900 pa.
- Rate of time preference: 3.7% pa.

### Risk zone numerics

Assume retired household either retains full financial-reasoning capabilities or has suitable advisers.

Years into retirement	Spending/wealth ratio	Growth assets/wealth ratio
	Expected, per cent	Expected, per cent
0	4.8	45
5	5.2	47
10	5.8	49
15	6.7	51
20	8.0	55
25	10.5	62
29	14.7	73

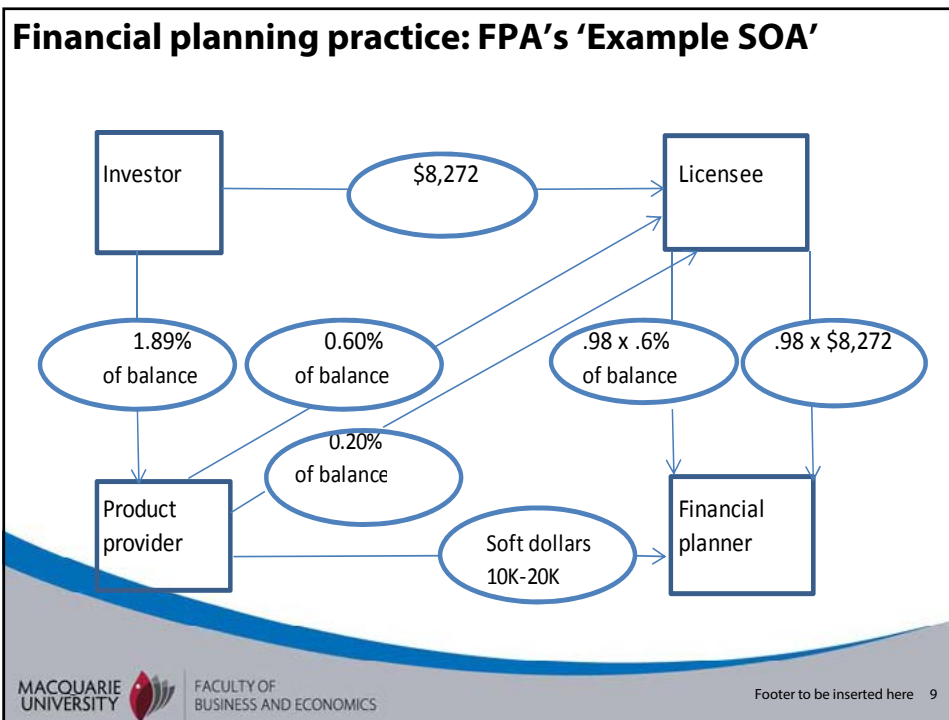
### Risk zone numerics: discussion

- Retirement spending is \$48,000 pa, or \$8,000 pa higher than under the '4 per cent rule'.
- Can implement via a *bucket strategy*: finance early retirement mostly by interest-bearing assets; finance late retirement mostly by growth assets.
- Expected estate: \$285,027. Could use instead for an unexpectedly long life, or unexpectedly low returns, or uninsurable late-life health setbacks.

### Agency theory and financial planning practice

Geoff Kingston & Haijie Weng, 'Agency Theory and Financial Planning Practice', *Australian Economic Review*, in print, 2014 (September issue).

- Optimal contract between an investor and an active adviser-manager whose effort level cannot be verified:
  1. Carve out the total 'protected' wealth of the investor and the adviser-manager.
  2. Subject the remaining wealth of the investor to a flat fee, & two asset-based fees, including a 'fulcrum' fee.



### Concluding comments

- There's a taxpayer interest in displaced-V glide paths:
  - “Pension applications in December 2008 were around 50% higher than the number recorded in October of the same year” (Harmer 2009).
- Consider mandating fulcrum fees for actively-managed super accounts of disengaged investors whenever the fund charges a regular asset fee > 1%.

MACQUARIE UNIVERSITY FACULTY OF BUSINESS AND ECONOMICS  
 Footer to be inserted here 10



## CIFR – Financial System Inquiry Academic Workshop

Never Stand Still

Dimity Kingsford Smith,  
Professor of Law  
Faculty of Law,  
University of New South Wales, Sydney, Australia  
[www.law.unsw.edu.au](http://www.law.unsw.edu.au)

### AIMS OF RESEARCH

- **Integrate legal and socio-economic approach with traditional economics**
- **Widening the lens**
- **Empirical evidence and ‘clinical’ and policy-making experience**
- **Practical recommendations with regulatory/legal implementation in mind**



## THE 'FINANCIAL CITIZEN'

- **The 'Financial Citizen' and financialisation**
- **Extending values we bring to the financial consumer discussion**
- **Restructuring, responsabilisation, risk allocation**
- **The capabilities of the financial citizen: literacy and behaviouralism**

## POLICY RESPONSES

- **Limited approach to identification of market failure**
- **Fine-tuning disclosure**
- **Education and financial literacy**
- **Improving the quality of advice**

#### RETHINKING THE POLICY VALUES

- **Efficiency, information and ‘end-user’ products**
- **Democratisation of high finance, innovation and suitability**
- **‘Investor protection’ or ‘investor confidence’?**
- **Caveat emptor or caveat vendor?**
- **Fairness**



#### RETHINKING THE POLICY RESPONSES

- **Disclosure is important – ‘stepped’ disclosure and online delivery**
- **Addressing vertical integration**
- **Unsuitable products and product intervention powers**
- **Training, competence and professionalization of advisors**
- **General compensation scheme**



## CONCLUSION

- **‘Financial citizen’ is political, social and financial**
- **Regulatory philosophy different in the retail sector, especially involving compulsion**
- **Evidence and experience suggest ‘financial citizen’ needs both support and protection**
- **Innovation to *benefit* the financial citizen**
- **International trend to greater protection**
- **More research and better implementation**



## CIFR – Financial System Inquiry Academic Workshop

Never Stand Still

Dimity Kingsford Smith,  
Professor of Law  
Faculty of Law,  
University of New South Wales, Sydney, Australia  
[www.law.unsw.edu.au](http://www.law.unsw.edu.au)

## Transcript

I/V Patrick Honahan and Justin O'Brien  
1<sup>st</sup> May 2014, Dublin

**[00:00:11.06]**

**Governor Honahan, thanks very much indeed for joining us. Ireland I suppose went through the Global financial crisis perhaps in a worse state than many other countries, what accounts for that?**

[00:00:23.14]

Well thanks for having me Justin and I'm aware that I have to think myself and I have been thinking myself into Sydney on a May lunchtime and eh, try to create the climactic effects here but it's a bit drizzly as people may be able to see behind me. But I'm in Sydney and I'm talking to your em, to your audience here but em

**[00:00:48.08]**

**And the storm clouds are outside**

[00:00:51.04]

We've had a terrible financial crisis here it has been one of the worst if not the worst in terms of overall impact on the economy in this wave of financial crises and one of the worst ones ever - what type of a crisis has it been? Has it been different to others? This has been a classic boom and bust crisis here em, based over lending on property em, so we can go back into many many historic examples and we see the patterns exactly the same so it it had no complexity of financial instruments it didn't involve subprime it didn't involve slicing and dicing any of that. It was just a classic construction boom and it was a boom associated not just with prices but with extensive construction so there was a volume as well as a price effect leaving a huge amount of over indebtedness

**[00:01:50.26]**

**So it would have happened irrespective of whether or not the global financial crisis happened? In other words the collapse was inevitable?**

[00:01:58.02]

The collapse was definitely inevitable, it was... already the boom had peaked well before Sept 2008 house prices had ..... bank share prices had been falling for 18 months and indeed a fiscal adjustment was already underway as everybody began to realise how how em overleveraged the economy had become and how over dependent Govt tax revenues had become on revenue from the construction boom capital gains tax, value added tax from furnishings of houses and so on and so forth stamp duties....

**[00:02:38.25]**

**But to what extent then does this suggest that what happened in Ireland wasn't just a banking crisis it was a wider crisis it was also a political crisis?**

[00:02:47.07]

Eh, yea the whole economic structure became distorted but driven by over lending by the banks so I don't want to suggest in any way that the banking was a side show the banking was central to the whole process of overleveraging and of overdependence on construction. The number of... the proportion of the population working in construction rose from its normal 6,7,8% to 13/14% at the top of the boom and that doesn't count ancillary activities that were spinoffs from construction and so forth

**[00:03:23.23]**

**In that sense then why did nobody shout stop?**

[00:03:27.12]

Nobody shouted stop because as usual there seems to be something different in any bubble that takes place there's a narrative that sustains a belief that we are into a new era. I would identify 3 or 4 factors, which were quite influential in keeping this going so far this bubble getting so out of control.

The first was the very rapid recovery in the 1990s of the Irish economy from an earlier, fiscal crisis of the 1980s. The rapid recovery back up to the production frontier and to full employment was really unprecedented and led to a long period of very high rates of sustainable economic growth based on competitiveness based on exports based on on on solid and sustainable things that took the economy to around 2000 but it led to a degree of over optimism that a new era had begun and people couldn't see why it wouldn't continue even though the production structure changed in 2000 and became, emphasising housing and eh the construction of office blocks and so forth so , so, the fact that there had been the Celtic tiger boom up to 2000 people thought the Celtic Tiger was still roaring but in fact the character of production had changed dramatically

[00:04:51.12]

The second factor was of course Euro entry - interest rate - high interest rates had been a characteristic of Irish as well as UK monetary policy for years and years partly in Irish case because of the association with the Euro exchange rate mechanism but over the years Irish interest rates were 2 -2.5 percentage points higher - exchange rate movement adjusted - than in Germany over the period of adherence to Euro exchange rate mechanism up to 1999. But when we started to move into the new the Euro that interest premium dropped so the cost of capital much lower, also access of the banks to funding - they could borrow from abroad with out taking any exchange risk and of course that was an open ended eh,... so the banks really were able to source money at low interest rates so Euro very important factor

[00:05:53.17]

Third factor I would say was the demonstration effect of similar property bubbles in the UK in parts of the US and other places which were... especially UK and US... very influential in the thinking of bankers "there's no problem now.." "Financial engineering has eliminated risk" "there's everything can be managed , you can get as much money as you like" so global financial boom helped keep it going

[00:06:26.01]

And finally but also very important I think the light touch regulation em, to summarise a very complex story, light touch regulation meant that financial regulation from this building that we are sitting in here was em, pretty ineffective during that period

**[00:06:43.20]**

**And that leads us to the question of the underpinning regulatory philosophy - throughout this period there was this belief in light touch regulation. Principles were better than rules etc but to what extent ultimately do you think was that not necessarily economically rational but ideationally constructed?**

[00:07:00.29]

Well I think that I would emphasise two main aspects of that the first thing is that we have an off shore financial centre here via IFSC which grew from the 1980s very substantial - now it's full of solid companies em but in order to attract those companies a definite effort was made to say "We are going to be a friendly regime to incoming companies" so that created an atmosphere - I've had that removed - it's not a goal of the Central bank it had been a goal of the Central bank to develop the financial sector that has been removed from the legislation - that's not there I want to emphasise that but it was there at that time so it influenced that "we want to get foreign companies in - our own banks of course will be alright so we don't have to worry about that"

[00:07:54.02]

Secondly in the way in which regulation was imagined taking from examples in other countries the regulatory approach was to say 'the market really works' 'all you've got to make sure is that the firms in the markets are properly governed and have the proper eh incentive and management structures in them so the emphasis in any kind of supervision was "are there good internal rules in the regulated entity?" and "are they being adhered to?'. Very little emphasis on "Well let's look at their balance sheet" "let's look at where they are making money" "let's look at the risk profile of that' very little quantification of that. So that of course if a bubble gets way out of hand then it does matter that you actually look at the numbers and say "I don't care about the basic principles here - this is so far off the scale that it must be wrong".

**[00:08:49.06]**

**And of course there was a problem in 2006/7 when the New York Times described Dublin as "the wild west of global finance" - you mentioned that there was a concern about the IFSC but the domestic banks would be fine but just last week we had a really quite scathing judicial criticism of that regime - was that regime justified?**

[00:09:11.26]

No the criticism was justified and indeed when I came into this job I was asked by the Government "look here we want to have a report from you, a backward looking report on regulation". And I took the opportunity to really dig deep not just into regulation but to some extent into the regulated entities

and em, that is actually quite (although I say it myself) there's a lot of interesting meat in that for anyone trying to study how regulation can go wrong. We tried to be as open and em, detailed as possible without actually identifying particular institutions which would be entitled to confidentiality so people could look at that report

**[Justin ; So, the problem.....]**

[00:09:56.00]

So I've been as critical as the judge last week in my report of 4 years ago. So there's nothing new from that point of view in this idea that a regulatory system was really not fit for purpose

**[00:10:07.10]**

**And so this is a cultural problem as well as a structural problem would you say?**

[00:10:10.26]

Well it's cultural not in the sense that we can never get Irish people to do a thing like this properly at all but it's an institutional culture was developed around a 'we're here to attract foreign companies into the IFSC and we can be quite confident that the good old traditional 200 year old Irish banks will be ok. Well actually they weren't as somebody pointed out a former CEO of one of the of the biggest banks - Bank of Ireland – he said “it took BoI 200 years to get a balance sheet of 100 million, 100 billion euros and (I can't remember) 5 years or 6 years something like that to double that again” so em, that em that was the situation that was allowed to happen because and overall environment of well you're not going to question what Bank of Ireland are doing because \*phew\* it's obvious that they're going to be alright

**[00:11:03.02]**

**So as a consequence of that mismanagement mismanagement within individual institutions and perhaps a flawed belief in market ordering - em Ireland very famously had to go into that Ruairi Quinn (Irish Minister) had to go into that period of stewardship - it's now out of that stewardship - has it regained it's sovereignty do you think?**

[00:11:24.18]

Well I mean as someone who has been in and out of the Reddinwoods (?) Institutions over the years they don't seem to me as great big ogres taking away country's sovereignty. It became the the financially and quantitatively the challenges became too big and the Govt. was (the former Govt.) was determined to adjust the fiscal imbalance that had occurred to fix the banks to inject capital into them and they had gone down that road but they were at the limit of their financial capacity to do that and that was seen by the market. And the markets said 'wait a minute this could get too extreme" and the spreads went too high so we went to the IMF we went to the European institutions and the package was put together and as you said it's been a 3 year package and it has underpinned - of course it has.... as you know these missions come around every few months and they say "oh haven't you done all these things?"

All the things that were done were the things that were agreed to by the Irish Govt. in fact built on a pre-existing policy framework. But it's easier to get these things done if the Troika are going to come next month and say "you said you'd do it, by the end of April and it's now the end of May..."

**[00:12:51.05]**

**So you have a political excuse so to speak**

[00:12:53.14]

You have a political excuse, you have the momentum, you have no opportunity for second guessing which is always something that delays action so we accelerated a lot of reforms that "we" the administrative and political system actually wanted to do even though there might have been some hesitations and doubts and they would have happened more slowly. It helped push things along in a direction that was already broadly accepted by the main political parties

**[00:13:24.02]**

**So if one wanted to look at the future of banking regulation in Europe - is Ireland a good place to look at?**

[00:13:30.11]

I hope so - em, because we've done a lot to change how we conduct financial regulation here and of course as you know banking regulation and supervision is becoming centralised in the Euro area and possibly in future other countries of the EU who might want to join the Euro area for that purpose and so the main banks here - the ultimate responsibility of their supervision will pass from this building to Frankfurt although of course the main work will still be done by Central Bank of Ireland staff. Em, in the past 5 years we have em done a lot of things to change the way we work. em, of course we have increased the staff considerably, maybe that won't be effective but it very hard to argue against the need, when you consider the costs of the previous failure, it's very hard to argue against properly funded and sufficiently staffed regulation so there's been a very substantial increase in the staff of supervision

**[00:14:41.17]**

**Is it a more intrusive regulatory regime**

[00:14:43.29]

It is intrusive but I want to go beyond that to say you need to do a number of things - you can't just say "Well we've changed the label here and it's now intrusive instead of light touch" but actually we have the same people and the same competences and the same way of dealing with things - top staff hired completely in from outside the organisation

**[00:15:04.26]**

**And indeed outside the country**

[00:15:04.26]

And indeed outside the country and then through the organization staffing up at all levels, bottom level, middle level, top level. We also had an examination of the way we work as an organization - our principles and behaviours. We had extensive consultations and discussion groups which maybe sounds a little touchy feely but to make people aware that we have to behave in a different way in our communication to each other - up, down, sideways so that people know what's going on. So that the economists know what the supervisors know and vice versa and there's interaction of information and that if people have some doubts that they have the confidence to speak up and challenge their bosses and say "I'm not ... I don't think you are doing enough there". So we conducted that cultural change within the organisation em, we've codified a lot of behaviours for the bank especially in the management of mortgage arrears - we have of course a role in consumer protection but, both on the consumer protection and the prudential side and we have been laying out targets and codes of conduct in managing this which is of course their biggest challenge of the moment

[00:16:22.18]

**So in many ways, in summary you've got a situation where Gordon Brown the former British PM said at a very early stage in this crisis that there was a need for a new social compact with banking. Has there been a new social compact with banking in Ireland?**

[00:16:41.18]

Em well... eh, I think the .... I think this is unfinished business. There is still a great deal of anger about what went wrong not only with people who bought houses at the top of the boom and paid undertook unaffordable loans in some cases but everybody who has been hit by the increased taxes, by the increased unemployment em, by lower wages, the public service wages have been lowered in several steps quite considerably in nominal terms - there is a lot of anger and it is all directed, or most of it, is directed towards the banks. So is there a new social compact with the banks? It doesn't look like a social compact to me but eh, I think the banks recognise that they they owe a lot to society and they they need to work sensitively in what's continuing to be a very protracted work out of distressed and impaired loans.

[00:17:45.14]

**Well that then finally leads one to the question of what the optimal size of a financial sector could or should be. Has the financial sector in Ireland been cut down to an appropriate size?**

[00:17:59.02]

It certainly has shrunk dramatically I would warn people against looking at some headline numbers because we still have some very large firms plus a large number of smaller firms in the IFSC that tend to swell the eh, overall Ireland banking assets to GDP ratio so we have big firms like Merrill Lynch which has a huge operation of European scale here - there's Zurich insurances so a number of firms make that ratio much higher than it really is in terms of the institutions that deal with the domestic economy.

Now those institutions at the time of the em, even though they had already started to deleverage at the time of the bail out em, they had loan to deposit ratio in the 170 - 180% and (laughs) I remember nights negotiating with the Troika people who said "look not only have you got to put in more capital into the banks to convince the markets that there's going to be enough but you've got to get the banks to deleverage faster" - pressure in that case particularly coming from the ECB side which had been financing the bank's position because the bond holders were being repaid and the foreign depositors were being repaid and this all being replaced with Central Bank money

[00:19:22.14]

Em so a target was set for the loan to deposit ratio em for the banks and we.. I remember one number was proposed and we said I'm not sure we can get it that fast in 3 years - we proposed back on the Irish side another number so the final number was 122 and a half - so that's where the half comes from because it was half way between the two proposals.

Very dramatic deleveraging - they are now below that ratio probably definitely more to go eh, loans are being repaid faster than new loans are being made and I'd like to see new loans being made a little bit faster - the economy... economic recovery needs more lending and lending is cautious here as it is in all of the peripheral Euro countries but the banking system will be smaller and that's in quantification terms of total assets but also number of banks and here we've seen a shrinkage in the number of banks dealing with the domestic economy. There have been some exits some of the foreign owned banks have exited altogether eh, others are in a way treading water - they're here, they've shrunk and they're not doing that much new business so in terms of active lending banks we don't have enough actually.

So I would say we've overdone the shrinkage in terms of number of entities so I'd like to see the situation stabilise with a larger number of retail banks able to and willing to do business here and they will come because the surge of confidence which has come back into the economy now will attract those ... foreign institutions particularly after the European stress test and they say "well that's over with now what can we buy?". I can see foreign entities will come in - when or how I'm not sure but there's money to be made obviously out of Irish banking

[00:21:24.02]

**Rahm Emanuel the former chief of staff for President Obama now the Mayor of Chicago very famously once said you should never let a crisis go to waste – a crisis is an opportunity - do you think Ireland has grasped the opportunity of the crisis?**

[00:21:36.17]

Well of course when you are in the Central Bank you can always complain and gripe that the Government doesn't do enough and doesn't take enough opportunity but em a lot has been done in terms of taking the opportunity to get a lot of reforms implemented em, clearly on the banking side we've done an enormous amount of work but that has been not just dealing with longer term reforms it's been dealing with correcting a crisis situation.

In non-banking a lot has been done I would like to see more done of things which would make the economy work more effectively for all the members of the of society so em we'll have to do that in non-crisis times

**[00:22:16.28]**

**So a work in progress?**

[00:22:18.11]

Oh it's always a work in progress!



**[00:22:20.07]**

**Governor Honahan - thank you very much indeed for joining us**

[00:22:22.11]

Thanks very much

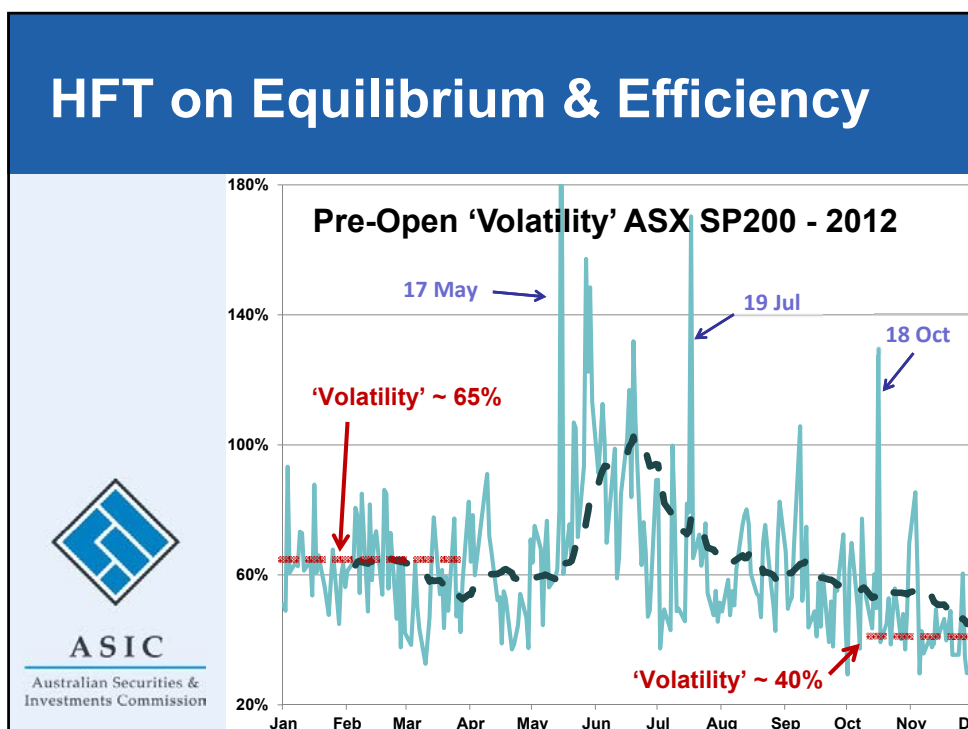



  
  

  
**ASIC**  
Australian Securities & Investments Commission

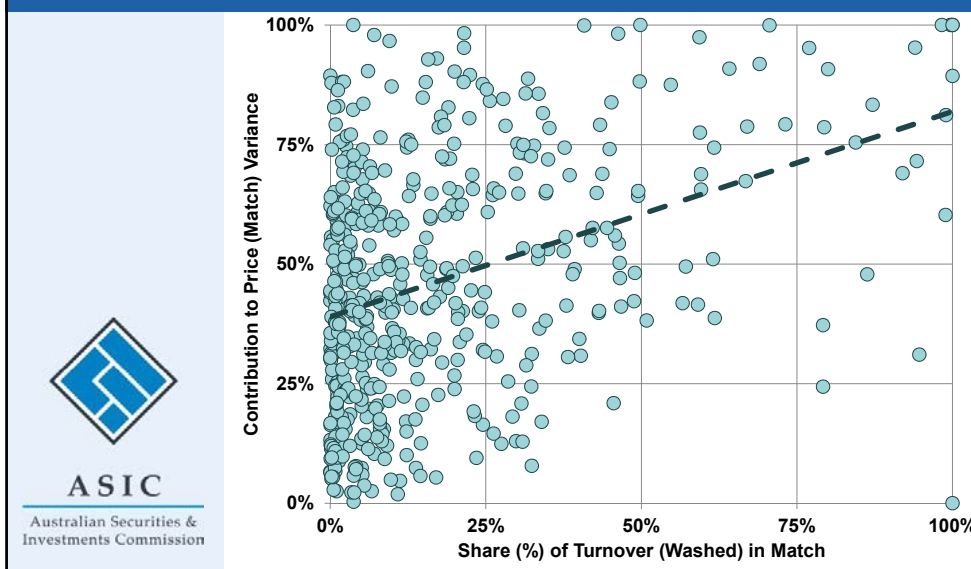
## Evidence Based Policy Development for High Frequency Trading

Joseph Barbara

April 2014



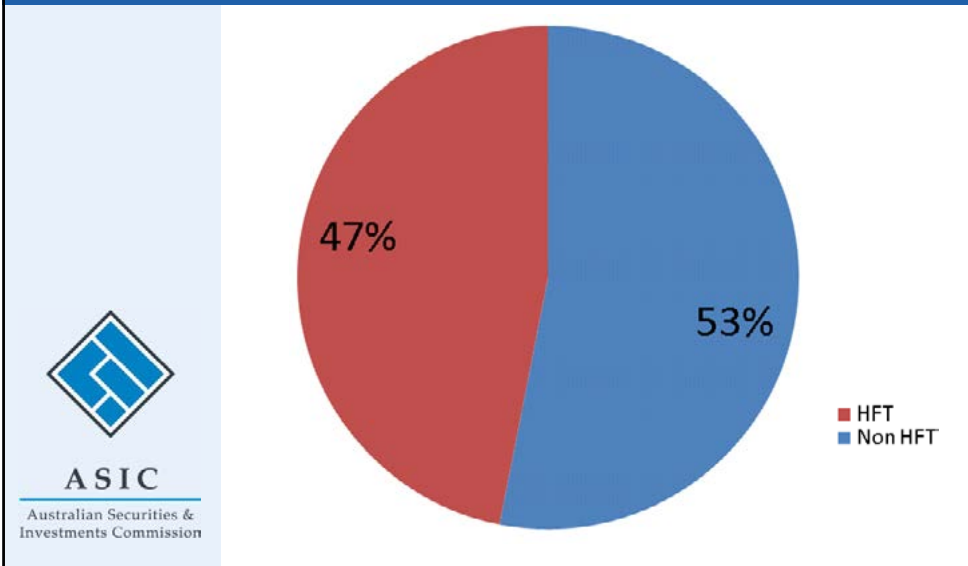
## Unwanted, Reckless, Intentional?



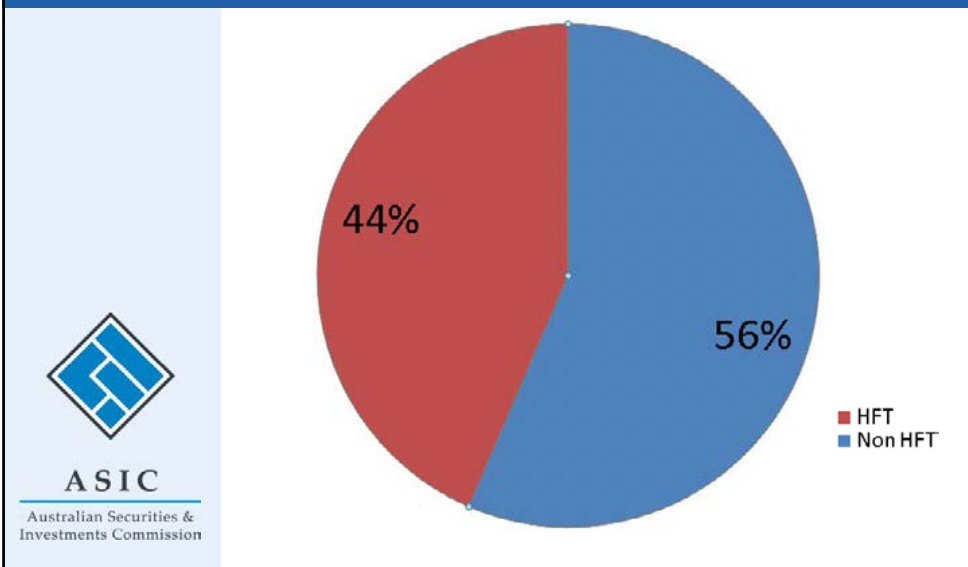
## Defining HFT

- High Order to Trade Ratio  
=  $\text{Num Trading Messages} / \text{Num Trades}$
- Percent Holding Traded  
=  $1 - \text{Value Residual} / \text{Value Turnover}$
- Turnover  
=  $\text{Value Bought} + \text{Value Sold}$
- Low Latency  
=  $\text{Number Events} < 40 \text{ ms}$
- Holding Time  
=  $\text{Average Value Weighted Time (ms)}$
- At Best Ratio  
=  $\text{Num Best Orders} / \text{Num Total Orders}$

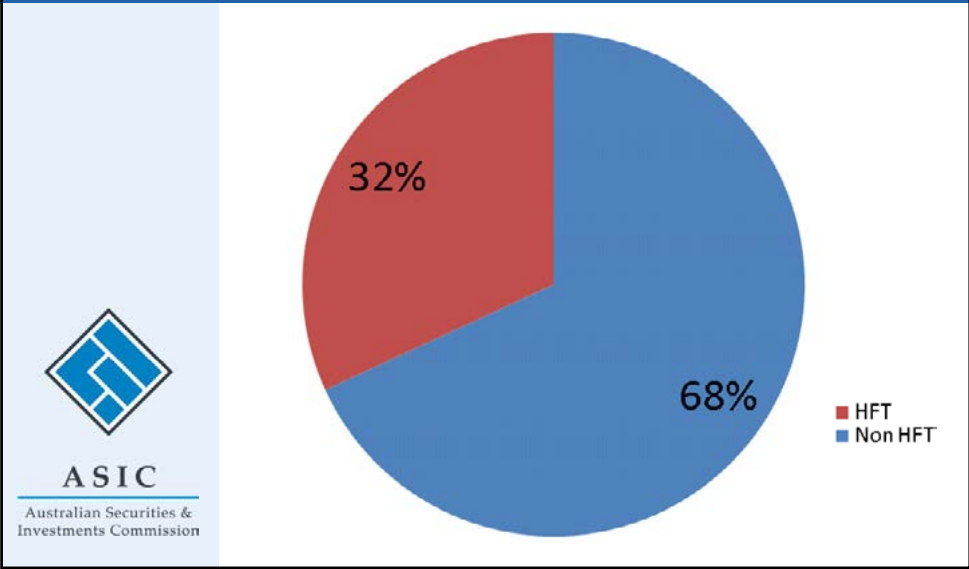
## Breakup of Order Book Changes



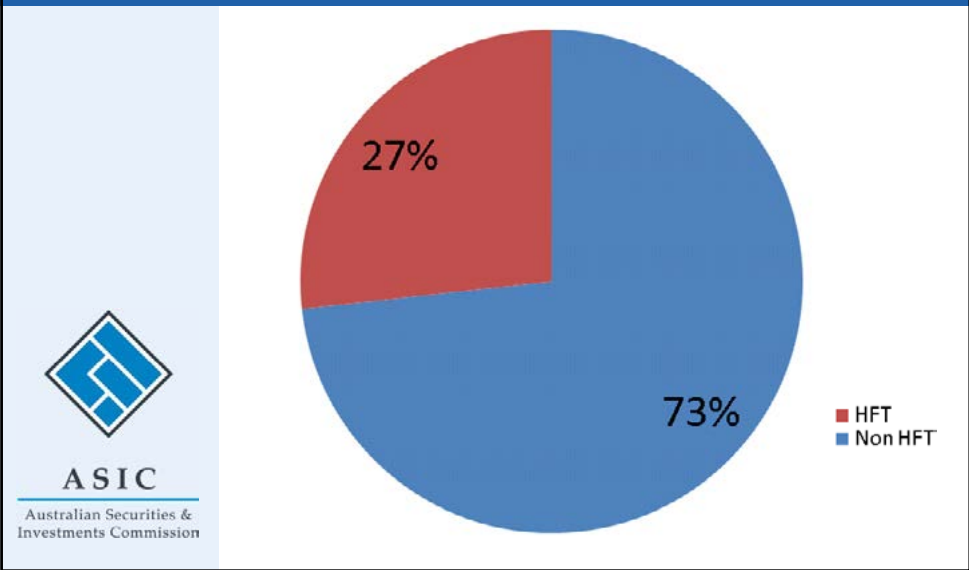
## Breakup of Order Book



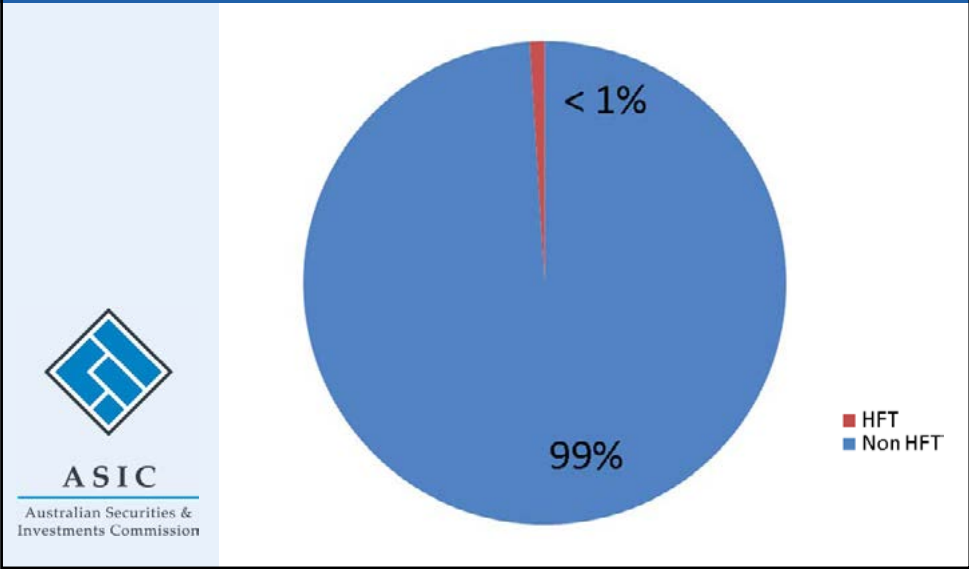
## Breakup of Number of Trades



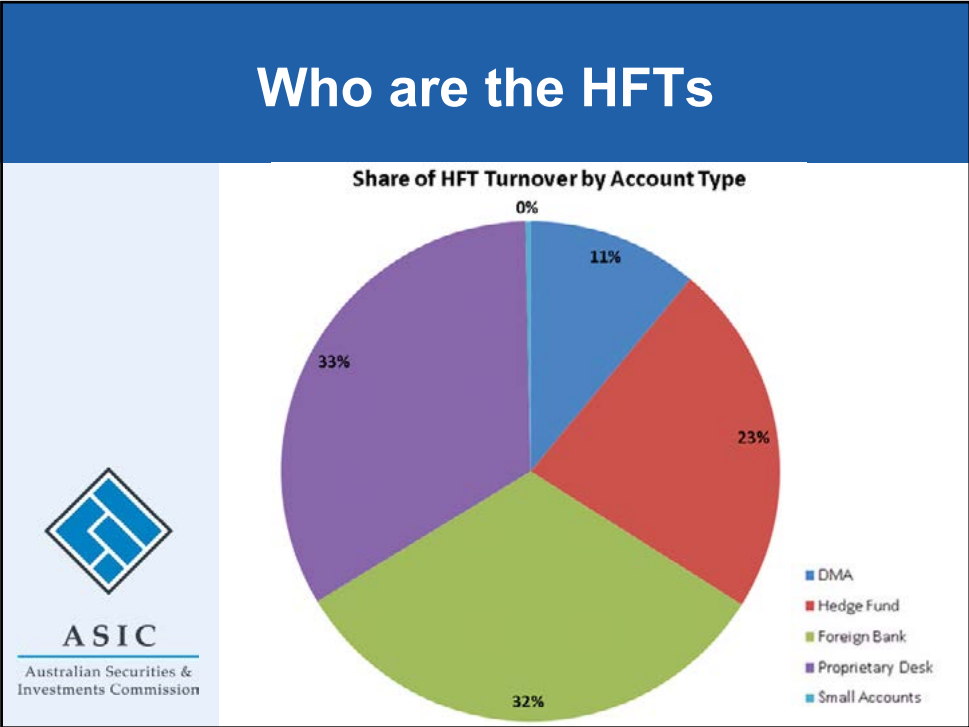
## Breakup of Turnover



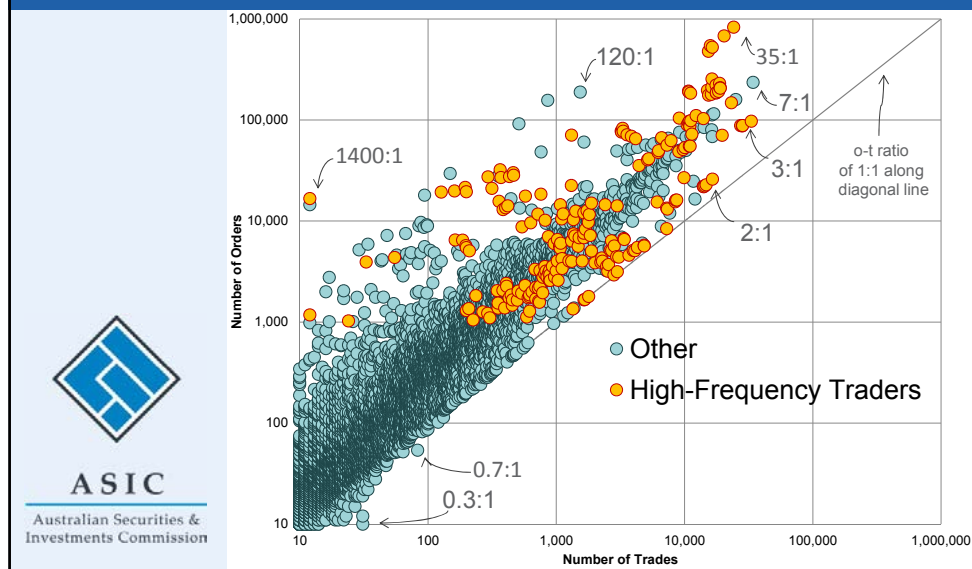
## Breakup of Traders



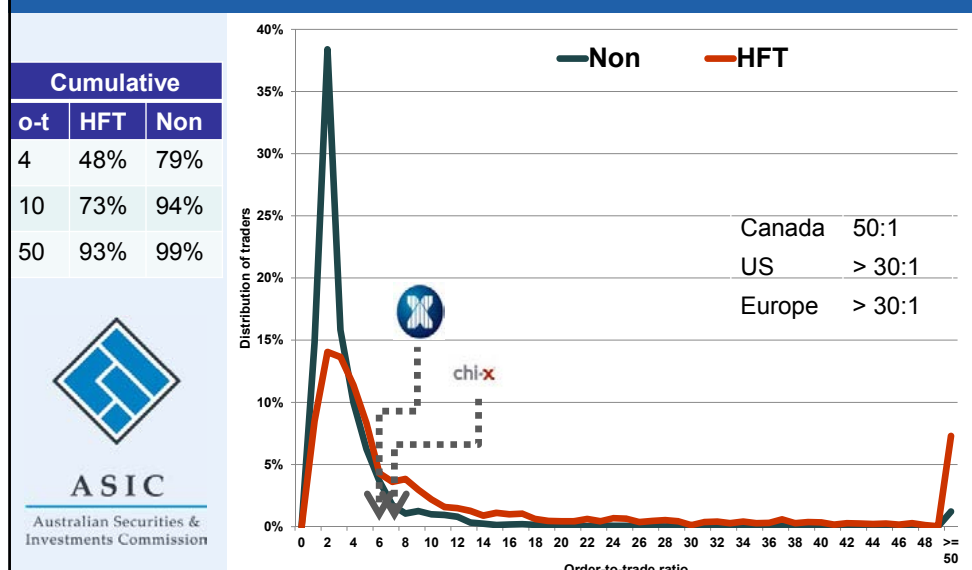
## Who are the HFTs



## Order to Trade Ratio – Scatter Plot



## Order to Trade Ratios





## CIFR FSI Workshop

7 May 2014

David Lynch  
Chief Executive

[www.afma.com.au](http://www.afma.com.au)

## About AFMA

- AFMA represents participants in the wholesale banking & financial markets.
- AFMA's key functions:
  - Promote **market development** and **integrity** by providing industry input to the government and regulators on public policy matters,
  - Promote **market efficiency** by coordinating the efficient operation of the OTC markets via market conventions, documentation and data
  - Promote **market professionalism** through training and accreditation of market professionals and promoting *Codes of Ethics & Conduct*



Slide 2

## AFMA's Member Firms

AFMA has a **'broad church'** membership

Over 120 financial market members covering wholesale and retail financial markets:

- Australian and international banks
- Brokers (equities, futures and OTC)
- Private wealth advisers
- Market infrastructure operators
- State Government treasury corporations
- Electricity and environmental product traders
- Partner members - leading law and advisory firms



Slide 3

## 1. FINANCIAL SYSTEM CONTEXT



Slide 4

## Financial System & Economic Growth

**Economic growth** is related:

- Positively to the **savings rate**  
*Savings facilitate investment*
- Positively to **capital productivity**  
*Price signalling & capital allocation functions of the financial system are very important*
- Negatively to **financial intermediation costs**  
*Investment =  $(1-\alpha)$ \*Savings*



Slide 5

## AFMA FSI Strategic Points

Before considering OTC markets in detail, some strategic points in AFMA's FSI submission are:

- A strong economy depends on well functioning banking and financial markets
- Well functioning markets depend in part on good regulation – but there's an opportunity to build on our current position
- The policy focus has mainly been on how to regulate financial markets rather than how to develop them
- Need a clear strategy for ongoing financial system development



Slide 6

## 2. OTC MARKETS



Slide 7

## OTC Markets in Australia

- OTC contracts are bilateral trades in financial instruments
- Key Australian OTC markets include:
  - Short term debt market (incl Repo)
  - Government bonds
  - Corporate bonds
  - Derivatives (swaps, forwards, options)



Slide 8

## Selected Financial Markets

**Table 2.1– Selected Financial Markets in 2012-13**

Market	Market turnover (\$ billion)	Market share held by each leading provider on average
Equities	1,151	10%
Government bonds	1,778	15%
Non-government bonds	777	20%
Repo	7,864	15%
Interest rate & cross currency swaps	10,495	15%
Overnight index swaps	8,894	15%
Forward rate agreements	5,937	17%



Slide 9

## OTC Markets Linkages

- OTC markets should only be thought of as being one part of a highly integrated financial system
- Exchange and OTC markets both compete and are complementary
- Banks are key participants in OTC markets
- Change one part of the system and it will often affect other parts



Slide 10

## Why Do OTC Markets Matter?

### Financing

- Debt capital raising for government, banks and business – market based financing
- Competition benefits, diversification
- Assist price signalling and capital allocation
- Reduce intermediation costs
- More market based financing



Slide 11

## Derivatives

### Risk management

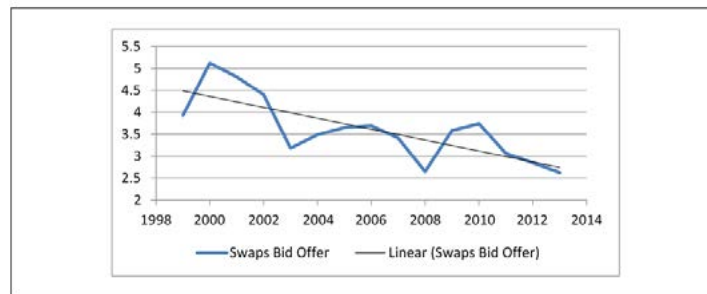
- Driven by needs of the economy – financial price flexibility assists economic development
- Entity level risk management maximises shareholder wealth and lowers capital costs
- Derivatives complement underlying markets, reducing risk management costs



Slide 12

## Swaps spreads

**FIGURE 2.8—AUD Swaps Bid-Offer Spread (basis points; average all tenors)**



Note: Derived from Bloomberg data.



Slide 13

## 3. LOOKING TO THE FUTURE



Slide 14

## Factors Shaping the Financial System

- Demographic change
- Asian century
- Infrastructure financing
- IT and technological development
- Regulation (eg G 20 derivatives reforms)
- More standardisation of products
- Innovation



Slide 15

## Example - ASX Equities Trading

**FIGURE 3.1 – ASX Equities Trading – Share of Lit Market**



Source – Derived from ITG data.



Slide 16

## Financial Policy Settings

- Need for an intellectually strong and well-resourced policy making capability in Treasury
- Capability to assess the cumulative effect of policy, not just a measure-by measure assessment
- Clear policy guidance for regulators
- Coherent and disciplined process to establish the need for cost recovery from industry for regulation



Slide 17

## Regulation

- Clear line between policy making and regulation
- Appropriate delegation of rule making authority to regulators
- Inspector General of Financial Regulation
- Industry involvement in the regulatory process



Slide 18

## International Regulatory Context

- Post-GFC enhanced role of international standard setters – checks and balances required
- Australia needs policies and processes to protect the national interest
- Active participation by Australian regulators in international bodies to set agendas and help shape standards
- Effective scrutiny of international rules and use of national discretion
- Industry needs globally consistent standards and must contribute to the international process



Slide 19

## Developing OTC Financial Markets

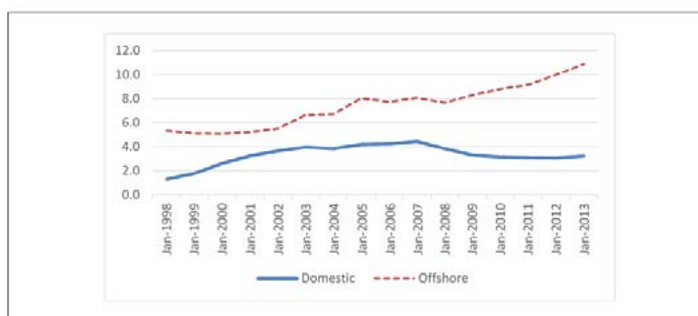
- Future will to a great degree depend on industry participants' responses to competitive pressures
- Effective policy formation and sound regulation are an essential input
- Need balance between innovation, competition, regulation, consumer protection and revenue raising



Slide 20

## Corporate Bond Financing

**FIGURE 8.1 - Australian Corporate Bond Issues (% of GDP)**



Note – Derived from RBA for non-financial corporations bonds on issue and ABS data.



Slide 21

## Corporate Bond Market

- Potentially significant benefits for funding and financial stability of the economy
- A number of constraints to market's development – some government related (eg tax) and some industry related (eg investor education)
- Clear government and industry strategy and priority to develop the market required:
  - Removing constraints for issuers
  - Improving investor access
  - Investor education
  - Industry collaboration



Slide 22

## Australia's International Competitiveness

- Income & employment benefits from retaining and growing financial services but Australia has not reached its potential
- Good policy ideas have not translated into consistent actions – policy, tax and regulation
- Government commitment and leadership is vital
- Need *Johnson+* policy agenda



Slide 23

END



Slide 24





## Bank provisioning

7 May 2014

James Cummings and Kassim Durrani

## Introduction

### **Role of loan-loss provisioning**

First line of defence against credit losses  
This study examines the practices of Australian banks

### **Impact of regulatory costs**

Provisions deducted directly from CET1 capital  
Test whether banks with lower capital ratios maintain lower provisions

### **Basel II: Different rules for IRB banks**

Expected losses calculated using internal credit risk models  
Test whether reduced the incentives to use provisions for capital management



## Loan-loss provisioning

### Capital management

Provisions used to reduce regulatory costs (Moyer, 1990)  
 Basel I changed the incentives (Kim and Kross, 1998; Ahmed et al, 1999)

### Earnings management

Less volatile earnings signal lower risk to investors  
 More pronounced for listed commercial banks (Anandarajan et al, 2007)

### Accounting provisions versus regulatory provisions

Expected loss approach advocated by BCBS  
 Perspective of the New York Fed

## Treatment of provisions

### Basel I banks and Basel II standardised banks

Impact on:	Impact of a one dollar increase in:		Impact of a one dollar increase in:	
	Specific provisions		GRCL	
<b>Tier 1 capital ratio</b>				
Numerator	↓ Retained earnings		↓ Retained earnings	
Denominator	↓ RWA		No impact on RWA	
Net impact	↓ Tier 1 capital ratio		↓ Tier 1 capital ratio	
<b>Total capital ratio</b>				
Numerator	↓ Retained earnings		↓ Retained earnings	
Denominator	↓ RWA		↑ GRCL (max 1.25% RWA)	
Net impact	↓ Total capital ratio		No impact on RWA	
			None	

### Basel II IRB banks

Impact on:	Impact of a one dollar increase in:		Impact of a one dollar increase in:	
	Step 1: EL defaulted	Step 2: EP defaulted	Step 1: EL non-defaulted	Step 2: EP non-defaulted
<b>Tier 1 capital ratio</b>				
Numerator	↑ Shortfall (50%)	↓ Retained earnings ↓ Shortfall (50%)	↑ Shortfall (50%)	↓ Retained earnings ↓ Shortfall (50%)
Denominator	No impact on RWA	No impact on RWA	No impact on RWA	No impact on RWA
Net impact	↓ Tier 1 capital ratio	↓ Tier 1 capital ratio	↓ Tier 1 capital ratio	↓ Tier 1 capital ratio
<b>Total capital ratio</b>				
Numerator	↑ Shortfall	↓ Retained earnings ↓ Shortfall	↑ Shortfall	↓ Retained earnings ↓ Shortfall
Denominator	No impact on RWA	No impact on RWA	No impact on RWA	↑ Surplus (max 0.6% RWAC)
Net impact	↓ Total capital ratio	None (when in shortfall)	↓ Total capital ratio	No impact on RWA
				None

## Data and sample

### 22 banks, March 2004 to December 2012

Total loans, non-performing loans, provisions and earnings from APRA  
Capital base and risk-weighted assets from APRA

### Domestic and foreign subsidiary banks

Excludes banks with tier 1 capital ratios greater than 30%  
Excludes building societies and credit unions

### Basel II implemented in Australia from 1 January 2008

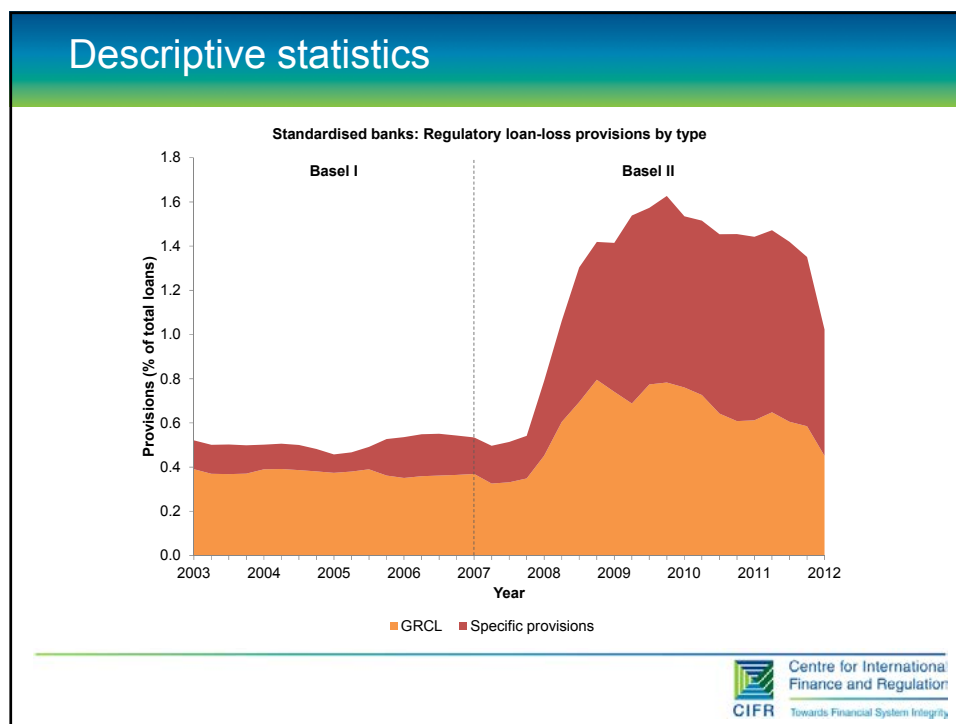
5 internal ratings-based banks  
AIRB: ANZ Bank, Commonwealth Bank, NAB, Westpac; FIRB: Macquarie Bank

## Descriptive statistics

### Standardised banks, N=564

Data item	Mean	Standard deviation	Lower quartile	Median	Upper quartile
Total loans \$mil	16,018	18,715	1,988	9,515	25,106
Loans to households %	56.0	32.9	37.7	61.0	85.6
Loans to corporates %	43.7	32.8	14.4	38.8	61.4
Non-performing loans %	2.06	2.77	0.58	1.00	2.44
RWA for credit risk %	85.5	23.8	69.7	81.2	99.3
Deposits %	17.5	14.9	3.4	15.9	27.1
Specific provisions %	0.41	0.59	0.04	0.14	0.57
GRCL %	0.51	0.35	0.28	0.42	0.65
Total provisions %	0.91	0.83	0.41	0.60	1.18
Tier 1 capital ratio	11.3	4.4	8.4	9.8	12.7
Total capital ratio	13.6	3.9	11.1	12.0	14.9
EBPT % pq	0.33	0.48	0.17	0.27	0.41

## Descriptive statistics

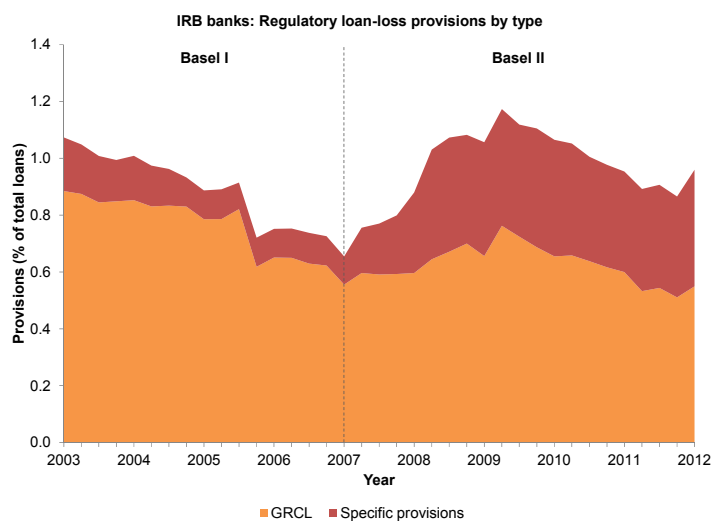


## Descriptive statistics

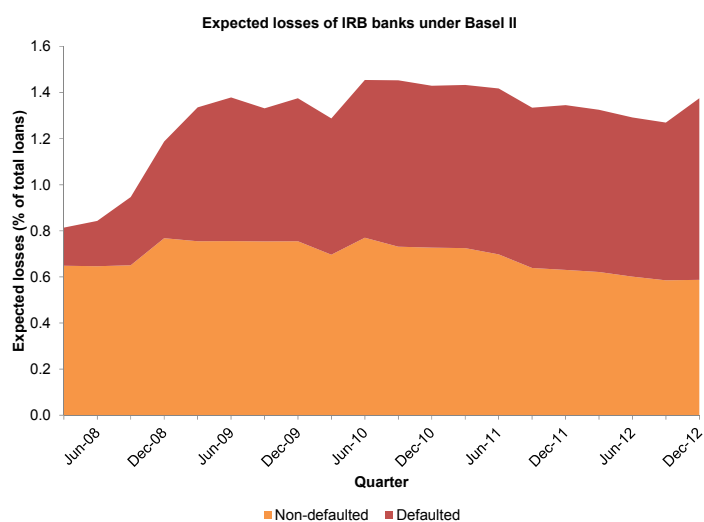
### IRB banks, N=180

Data item	Mean	Standard deviation	Lower quartile	Median	Upper quartile
Total loans \$mil	207,428	121,102	152,206	211,672	297,121
Loans to households %	62.6	10.2	58.3	63.3	70.2
Loans to corporates %	36.6	10.3	28.3	36.5	41.3
Non-performing loans %	1.82	2.17	0.69	1.22	1.91
RWA for credit risk %	125.7	77.8	73.8	101.4	124.9
Deposits %	26.8	11.4	18.1	24.8	32.4
Specific provisions %	0.30	0.23	0.12	0.26	0.41
GRCL %	0.77	0.25	0.58	0.72	0.87
Total provisions %	1.07	0.39	0.82	0.97	1.19
Tier 1 capital ratio	10.0	2.2	8.0	10.2	11.8
Total capital ratio	12.9	2.1	11.6	12.9	14.0
EBPT % pq	0.37	0.30	0.27	0.36	0.44

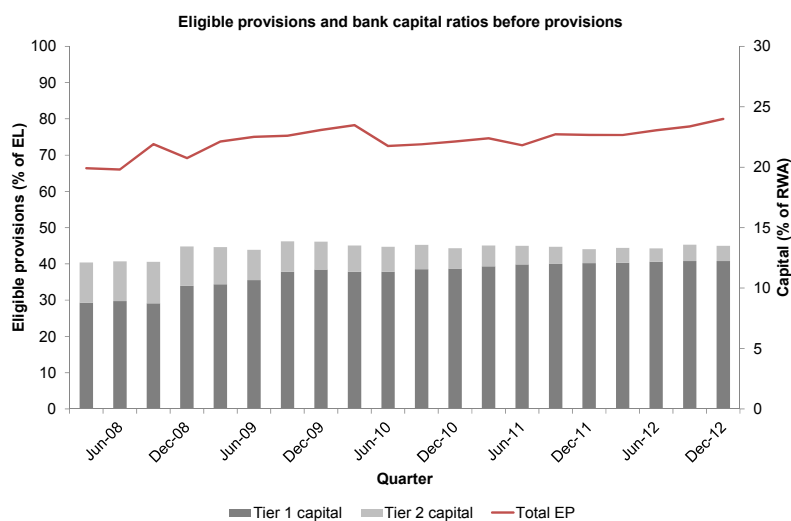
## Descriptive statistics



## Further analysis for IRB banks



## Further analysis for IRB banks



## Policy implications

### Forward-looking model for provisioning

Supports capital adequacy requirements  
More useful for prudential regulation than an incurred loss model

### Use of banks' internal risk assessments

IRB banks: Inputs to provisioning and capital requirements  
Reliability of the risk weightings

### Basel III reform package

Minimum requirement for CET1 capital of 4.5% from 1 January 2013  
Minimum requirement for tier 1 capital increased to 6% from 1 January 2013  
Conservation buffer for CET1 capital of 2.5% from 1 January 2016  
Countercyclical buffer for CET1 capital of 0-2.5% from 1 January 2016

Launch date: 17 July 2014  
CIFR Symposium on Market and Regulatory Performance

---



## Systematic Credit Portfolio Risk - Implications on Regulation for Bank Capital and Securitisation Ratings

Harald Scheule

*UTS Business School and CIFR*

## Centre for International Finance and Regulation (CIFR)

- Project number E001: Systematic credit portfolio risk and implications on regulations for bank capital and securitisation ratings
- Four stages, 2012 -2015:
  - Stage I: Analysis of credit portfolio risk with regard to level, cyclical, concentration and correlation risk
  - Stage II: Analysis of ADI and LMI capital and provisions/reserves
  - Stage III: Analysis of the risks in relation to securitisations
  - Stage IV: Analysis of implications on provisioning and capital regulation implemented by prudential regulator (Australian Prudential Regulation Authority)

## Team

- Harald Scheule, Associate Professor of Finance, University of Technology, Sydney
- Daniel Roesch, Professor of Finance and Director of Institute, Institute of Banking and Finance, Leibniz University Hannover
- Jonathan Crook, Professor of Economics, Edinburgh University
- Yongwong Lee, Postdoctorate Research Fellow, University of Technology, Sydney

## Collaboration

- APRA
- Deutsche Bundesbank
- Global Association of Risk Professionals
- Credit Research University of Edinburgh
- Industry:
  - Subject Matter Experts (SMEs)
  - Collection of default/loss data

CIFR Project  
○○●

Research Example  
○○○○○○○○○

Financial System Inquiry  
○○○○○

## Outcomes to date

- Collection of retail and corporate default/loss data
- Post-doctorate Research Fellow has joined
- Research engagement with the OCC
- Engagement with industry partners
- Submissions to RBNZ and FSI
- Publications and presentations (e.g., BIS/Worldbank, Deutsche Bundesbank, FDIC and OCC)

Harald Scheule

Systematic Credit Portfolio Risk



4 / 19

CIFR Project  
○○○○

Research Example  
●○○○○○○○

Financial System Inquiry  
○○○○○

## Prudential Regulation

Luetzenkirchen, K./ Roesch, D./ Scheule, H.: Capital adequacy and systematic risk of asset securitizations, Journal of Banking and Finance, 2013, 37(12), 5236-5247

Harald Scheule

Systematic Credit Portfolio Risk



5 / 19

## Prudential regulation in Australia

- APRA (Basel Committee on Banking Supervision): to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions are met within a stable, efficient and competitive financial system.
- Focus on economic downturns (e.g., 999 of 1,000 scenarios for credit risk)

## Ratings-Based Approach

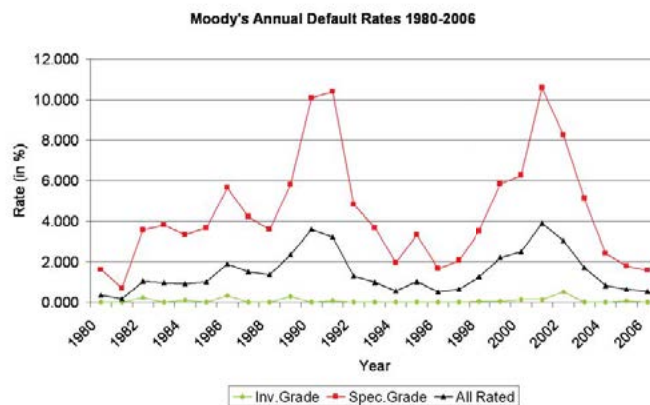
Risk weights for long-term rated securitization tranches in the Ratings Based Approach

This table shows that risk weights are higher for lower credit ratings, non-senior, non granular and resecuritization exposures.

Long-term Rating	Securitization Exposures			Resecuritization Exposures	
	Senior, Granular	Non-senior, Granular	Non-granular	Senior	Non-senior
AAA	7	12	20	20	30
AA	8	15	25	25	40
A+	10	18	35	35	50
A	12	20	35	40	65
A-	20	35	35	60	100
BBB+	35	50	50	100	150
BBB	60	75	75	150	225
BBB-	100	100	100	200	350
BB+	250	250	250	300	500
BB	425	425	425	500	650
BB-	650	650	650	750	850
Below	Deduction				

Basel II: Tier I and II capital  $\geq 8\% \times \text{RWA} \times \text{thickness}$

## Credit ratings and systematic risk



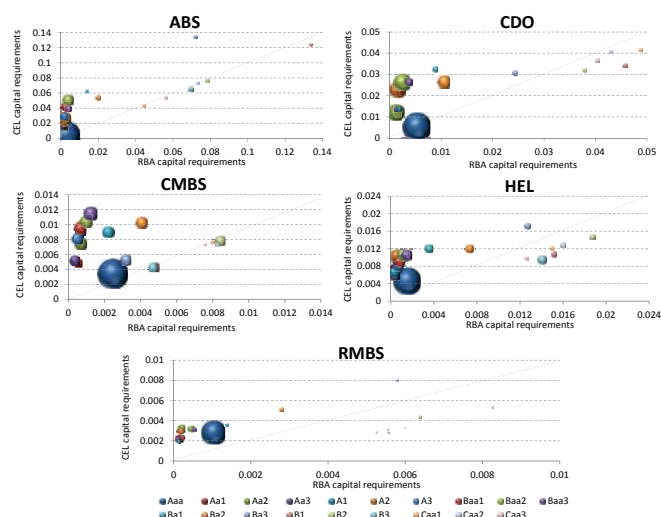
## Recent literature

- Ratings do not adequately address systematic risk
- Securitisations exhibit higher systematic risk/cyclicality than single-name debt
- Does RBA for securitizations provide a buffer for systematic risk?

## Contribution

- Development of framework to empirically measure the exposure to systematic risk of the underlying asset portfolio
- Calculation of conditional expected tranche loss (CEL)
- Comparison of RBA capital to CEL
- Empirical calibration of RBA risk weights

## Capital 2008

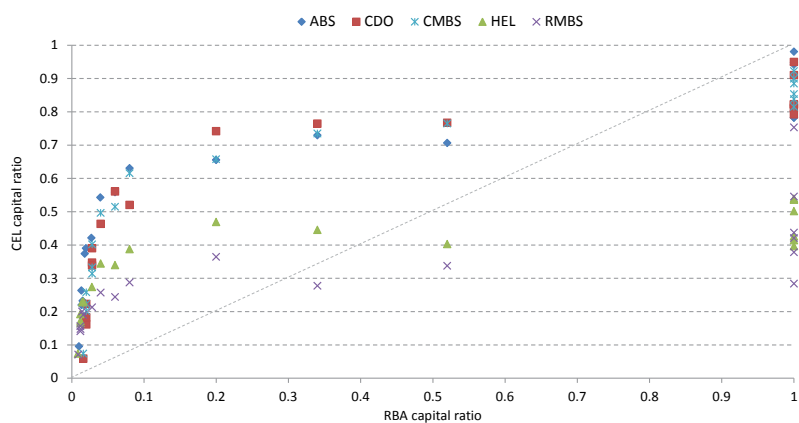


CIFR Project  
 ○○○○

 Research Example  
 ○○○○○○○●○○

 Financial System Inquiry  
 ○○○○○

### Capital 2000-2008



Harald Scheule

Systematic Credit Portfolio Risk

12 / 19

 CIFR Project  
 ○○○○

 Research Example  
 ○○○○○○○○○●○○

 Financial System Inquiry  
 ○○○○○

### Capital re-calibration

Rating grade	mean RW	implied new RW	implied new RG
Aaa	0.15	0.88	Baa3
Aa1	0.19	2.70	Ba2
Aa2	0.20	2.69	Ba2
Aa3	0.19	3.18	Ba2
A1	0.26	4.01	Ba2
A2	0.27	4.16	Ba2
A3	0.35	4.65	Ba3
Baa1	0.50	5.80	Ba3
Baa2	0.75	5.97	Ba3
Baa3	1.00	6.64	B1 and worse
Ba1	2.50	7.86	B1 and worse
Ba2	4.25	7.79	B1 and worse
Ba3	6.50	8.12	B1 and worse
B1	12.50	8.95	B1 and worse
B2	12.50	8.58	B1 and worse
B3	12.50	9.40	B1 and worse
Caa1	12.50	9.86	B1 and worse
Caa2	12.50	10.13	B1 and worse
Caa3	12.50	10.34	B1 and worse

Harald Scheule

Systematic Credit Portfolio Risk

13 / 19

## Discussion

- Contribution: increase in transparency of regulatory policy
- Global Financial Crisis leads to a material revision of IRB parameters and potentially risk weights
  - One-off event due to non-economic reasons vs. economic downturn?
  - Should the US be used to calibrate parameters in other geographic regions?
- Coordination with bank-internal models and credit rating agencies: development of rating standards
- Findings in line with recent proposal for revision by Basel Committee on Banking Supervision

## General

- Welcome of Financial System Inquiry (FSI) and opportunity to comment on ways in which the Australian financial system may become more stable and efficient
- Focus on the area of credit risk and the links to home lending, bank capital, deposit-taking, and covered bonds
- Comment in particular on Australian Authorised Deposit-taking Institutions (ADIs), their regulator, the Australian Prudential Regulation Authority (APRA), as well as experience from the Global Financial Crisis (GFC)

## General credit risk measurement

- Large ADI internal credit risk models: independently confirm the magnitude of risk weights differences in relation to permissible approaches for comparable risk exposures. Seek ways to base Australian risk estimates in internal ratings-based approaches on economic downturn scenarios consistent with the experience of other developed economies with the respective downturn experiences.
- Downturn modelling risk: apply experience values from other geographic regions to Australia for bank-internal credit risk modelling and stress-testing.

## General credit risk measurement (cont.)

- Credit ratings: define minimum rating standards for credit ratings and other forms of credit risk assessment. Such minimum standards may be based on metric risk measures (e.g., default probabilities, or expected losses), as well as metric risk measures which reflect economic downturns.
- Credit risk data: increase transparency of risk in relation to credit-linked securities by allowing informed users (e.g., academic researchers) free data access.

## Home lending

- Concentration risk: implement incentives to limit asset exposures of Australian lenders to Australian mortgages: increase internationalisation of bank assets or support a larger degree of home lending risk transfers to other industries and geographic regions. This may be supported by further development of financial market instruments such as covered bonds, derivatives, insurance policies, and asset securitisation.
- Negative equity risk: implement incentives for households to reduce leverage with a focus on home loans.

## ADI Capital Regulation - Basel III

- Analyse the cost efficiency of current (Basel II) and future proposed (Basel III) ADI capital regulation. Derive a cost-optimal minimum capital requirement for ADIs.

## The Dark Side of Relative Performance Evaluation in Financial Firms

Richard Holden (UNSW)  
(joint w/ Florian Ederer (Yale))

## Wall Street Trading & The Crisis

- Trading of certain (risky) securities a key part of the crisis
  - e.g. Lehman
- Common view:
  - Moral hazard across: TBTF/bailouts
  - MH within: "bad" incentive contracts for traders
- If true then:
  - Fix TBTF (credible commitments, breakups, Glass-Steagal,...)
  - Fix incentive contracts (regulation of stock options and grants already in place,...)

## But What if the Contracts Were Optimal?

- A basic premise of principal-agent theory is the Sufficient Statistic Theorem (Holmstrom, 1982)
  - Don't want to pay people for Luck/things they can't control
- In general want Relative Performance Evaluation—strip out common shocks (positive or negative)
- Contracts should reward traders for performance relative to traders on similar desks in other firms
  - e.g. non-G8 bonds, mortgage-backed securities,...
- This is, in fact, what a lot of these contracts look like—pay “relative to market”

3

## Principal-Agent Theory

- A Principal hires an Agent to take a(n) action(s) for her
- P observes some noisy measure of action (e.g.  $y=a+x$ ), where  $x$  is a random variable
- P is risk-neutral (well diversified), A is risk-averse
- P offers A a contract based on  $y$  (which is contractible)
- Contract must induce A to take the action P expects her to take (Incentive Compatibility) and give A at least her outside option in expected utility (Individual Rationality)

4

## The Model: Setup

- Multiple Principal-Agent dyads
- Principals compete against each other for a fixed prize based on output of their respective agents
  - can extend to multiple prizes
- Each agent takes 2 unobservable actions that stochastically affect output to P
  - Think of actions as finding trading opportunities in 2 assets classes—one "risky", one "safe"
- P receives a noisy signal of her agent's action and observes the performance of all other agents
- Each P designs a contract of the form:  $I = s + b_1 y_1 + b_2 y_2 + c z$
- Question: what does c vector look like in market equilibrium?

## The Model: One Dyad

- When one P (firm) utilizes RPE it is good for her
- Removes (compensation) risk from the agent by insuring against common shocks (e.g. whole market is down)
- Allows same effective compensation at lower cost (better risk-sharing contract)
- More subtly: changes  $b_1$  and  $b_2$  (incentive slopes on 2 asset classes)
  - In fact, makes it optimal to raise  $b_1$  (incentive on risky asset class performance)
  - Why? Because it helps P increase her chance of beating of P's
  - Analytically similar to a portfolio allocation problem: what more exposure to the risky "asset"

## The Model: Market Equilibrium

- Privately optimal contracting within one dyad imposes a negative externality on other dyads/firms
- Lowers their chance of winning, inducing a change in contract skewed toward more incentive on the risky asset class
- In equilibrium only thing that changes is ALL firms offer larger incentives on trading risky asset class
- Like a prisoners dilemma

7

## Implications

- An "optimal contracting externality"
- Firms and governments do the same thing—both internalize externalities
- How can the OCE be internalized?

8

## Internalizing the Optimal Contracting Externality

- "Ban" relative performance evaluation?
  - Tricky—abrogate private contracts? How to check?
  - RPE generally good when no OCE, so mixed messages?
    - e.g. puzzling/worrying that CEO stock options don't have strike prices linked to peers/index
- Tournament aspect of Principal competition key
  - If  $P=CEO$  then perhaps easier to regulate
  - "Make banking boring again"—from the top down

9



# Should retirement savings be diversified across funds?

**Jacquelyn E. Humphrey, Karen L. Benson**  
UQ Business School, University of Queensland

**Wei-Lun Lee**  
Standard Chartered Bank

**CIFR workshop: Financial System Inquiry**

## Introduction

- Diversification (spreading your money across multiple investments) is one of the fundamental principles of finance
- Diversification reduces the (total) risk of investments
- One easy way for an investor to diversify is to invest in a managed fund

## Introduction



- However, recent research suggests even holding a managed fund may not sufficiently diversify investment risk, particularly for retirement savings (Elton, Gruber and Green, 2007; Moorman 2009)
- Implication: investors who do *not* diversify their retirement savings across multiple funds will suffer increased portfolio risk and reduced overall utility
- In stark contrast, the Australian Government has been strongly encouraging investors to consolidate their retirement savings into *just one fund*

3

## Research Question



- Given these two conflicting views, our research question in this paper is:

Are investors better off diversifying their holdings across multiple funds, or should they concentrate their holdings into one fund?

4

## Reasons for diversifying



- Reasons why investors might be better off diversifying across funds include:
  - Evidence on whether Australian fund managers in general can outperform broad market indexes after fees is at best mixed and
  - any outperformance does not appear to be persistent – might be a good idea to diversify manager skill (Gallagher, 2001; Faff, Gallagher and Wu, 2005; Sawicki and Ong, 2000; Humphrey and O'Brien, 2010; Kim, In, Ji and Park, 2014)
  - Portfolios of a number of funds seem to have better Sharpe ratios than portfolios of just one fund (Elton et al., 2007; Moorman 2009)

5

## Reasons for consolidating



- Reasons why investors should consolidate include:
  - Minimising fees
  - Reducing paperwork/ record keeping
  - Being “in control” of investments
  - It is costly – in terms of money and also time – for investors to identify, investigate and invest in a new funds (Sirri and Tufano, 1998; Huang, Wei and Yan, 2007)

6

## Some statistics on superannuation funds



- After the introduction of choice, only 3-6% of investors changed superannuation fund
  - Approximately half of this was due to the investor changing employer, rather than an active choice (Fear and Pace, 2009).
- 42.9% of funds are held in the default investment strategy
- There are five million accounts on the “Lost Member Register”
- A huge outflow of cash from superannuation funds with the introduction of SMSFs
- These facts suggest that investors in superannuation funds may not take an active interest in their retirement savings.
- May also suggest low financial literacy

7

## Data and sample



- Start off with equity superannuation funds from Morningstar
  - Delete index funds, fund of funds and sector funds
  - Delete multiple classes of the same fund, retaining the class with the highest return
- Final sample - 624 funds
- Sample period January 1992 to December 2012
- Also look at all fund types (not only equity) and apply the same criteria – 3727 funds
- Risk-free rate and market return data from AGSM-CRIF

8

## Method



- Our study is in two parts
1. We replicate Elton et al., (2007) and Moorman (2009)
    - We find that there is indeed a benefit (increased Sharpe ratio) from diversifying i.e. their results hold in the Australian context
    - Best outcome is obtained by choosing funds from different families and of different styles
    - However, their analysis relies on extremely strong and unrealistic assumptions

9

## Method



2. We relax their assumptions and look at actual fund returns and risk:
  - We take each fund in our sample and combine it sequentially with every other fund to form two-fund portfolios.
  - For each portfolio, we calculate the weight that must be invested in each of the two funds to obtain the maximum Sharpe ratio
  - We then count the number of fund pairs for which the Sharpe ratio is maximised using just one fund
  - We group funds across two criteria:
    - Same family or different family
    - Same style or different style
    - So in total we have four groups
  - This will help us to determine the best way to diversify if diversification is the best outcome

10

## Method



- We perform the analysis for our full sample period and also just post Choice (July 2005- December 2012)
- Also look at
  - Forming three-fund portfolios
  - Not only equity fund portfolios
  - What happens if we allow short selling

11

## Results



Tables 3 and 4

12

## Robustness



- We also look at forming three-fund portfolios
- Approximately 30% of the Sharpe ratios are optimised by forming portfolios of more than one fund
- However, the number of potential combinations becomes extremely large
  - For SFSS, there are 48,795 three-asset portfolios to choose from and 5,074,295 for DFDS
  - This amount of options may be overwhelming for the average investor

13

## Conclusion



- In only 18% of cases would investors be better off holding two rather than one superannuation fund
- This proportion is lower in the post-choice era (after July 2005).
- Should investors decide to hold more than one fund, the optimal fund to add to the portfolio would seem to be a fund that is completely different in terms of family, style and asset class
- Note that our analysis has not taken into account the cost of altering the portfolio

14

## Conclusion



- For engaged, financially literate investors, a less than one-in-five chance of the resulting portfolio having a higher Sharpe ratio may be sufficient incentive to justify the required research and cost involved in diversifying across funds.
- However, for the majority of superannuation investors this may not be the case
- For these investors, consolidation would seem to be the logical investment strategy

15





Centre for International  
Finance and Regulation  
Towards Financial System Integrity

## The size, cost, asset allocation and audit attributes of Australian self-managed superannuation funds

Bruce Arnold (UNSW), Hazel Bateman (UNSW), Andrew Ferguson  
(UTS) & Adrian Raftery (Deakin)

Financial Systems Enquiry – 7<sup>th</sup> May, 2014

## Acknowledgments

- The Superannuation business line of the Australian Taxation Office (ATO) for the provision of the fund data set
- The Institute of Chartered Accountants in Australia (ICAA) through its Academic Research Grant Scheme
- The Centre for International Finance and Regulation (CIFR) - project number E104 ([www.cifr.edu.au](http://www.cifr.edu.au)).

The views expressed herein are those of the authors and are not necessarily those of the ATO, ICAA and CIFR nor any CIFR Consortium Member



**Institute of  
Chartered Accountants  
Australia**

## Objectives

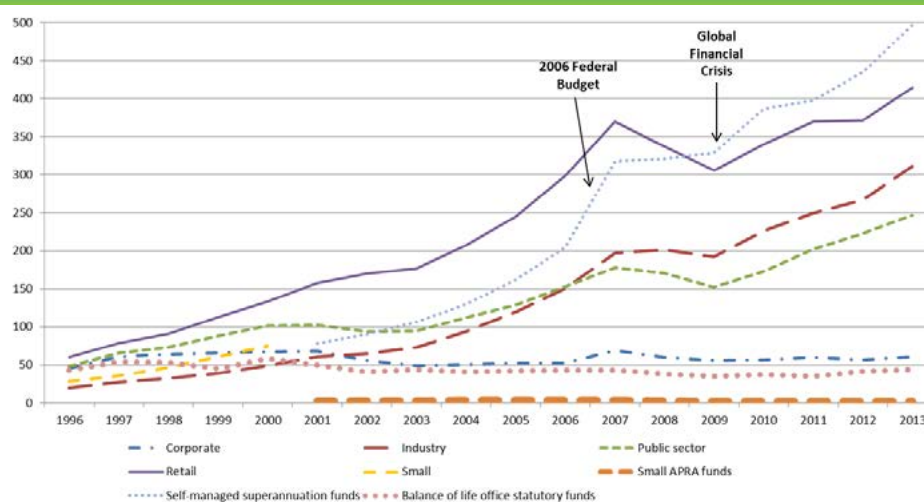
1. Document the size, asset allocation and cost of the self-managed superannuation fund (SMSF) sector
2. Do industry specialist auditors pass on scale benefits in this small client market?
3. Do industry specialist auditors strategically price the 'service bundle'?
4. Does the provision of other services impair the independence of auditors?

## Motivation

- Australia has the world's fourth biggest pension fund sector in the world at \$1.803 trillion, greater than the market capitalisation of the ASX (\$1.527T), the combined deposits of all Australian banks (\$1.669T) and the national GDP (\$1.556T)
- Government-commissioned Cooper Review (2010) highlighted lack of empirical research on the SMSF segment and its auditors
- Research void on audit in the retirement savings industry (Cullinan 1998b)

**Table 1 - Superannuation industry estimates as at 30 June 2013**

Fund type	Corporate	Industry	Public sector	Retail	Small APRA	SMSFs	Other	Total
Number of funds	108	52	38	127	2,950	509,362	124	512,761
Total assets (billion)	61.7	323.2	256.8	422.4	1.7	505.5	45.2	1,616.5

**Figure 1: Superannuation industry in Australia 1996-2013 by total assets (\$ billion)**


## Self-managed superannuation funds


- DIY
- Up to 4 members
- Can invest in direct property, shares & collectibles
- Can borrow (via instalment warrants)
- Audit, tax return & financials each year (AAS 25)
- Approved auditors can come from 8 professional bodies
- Auditors can provide other services
- Auditors can be easily removed
- No trustee remuneration allowed

## Sample

- Proprietary data obtained from the ATO (anonymised)
- 209,420 SMSF-year observations (reduced to 99,668 observations for audit study)
- Funds in the accumulation phase (i.e., none in pension phase)
- Sample years 30 June 2008 - 2010


**Table 2 - Breakdown of Self-Managed Superannuation Funds sample by year, 2008-2010**

	2008	2009	2010	Total	
<b>Panel A - SMSF-year observations in sample</b>					
SMSF-year observations received from ATO	73,002	73,000	73,000	219,002	
Less: Observations removed due to incomplete financial information	- 3,408	- 1,393	- 1,138	- 5,939	
Less: Extreme observations removed	- 1,156	- 1,223	- 1,264	- 3,643	
Remaining SMSF-year observations with audit fee disclosed	<b>68,438</b>	<b>70,384</b>	<b>70,598</b>	<b>209,420</b>	
<b>Panel B - % of SMSF-year observations in sample by state</b>					
	2008	2009	2010	Total	Australian Population
Australian Capital Territory (ACT)	1.49%	1.43%	1.41%	1.44%	1.65%
New South Wales (NSW)	31.42%	31.56%	31.55%	31.51%	32.10%
Northern Territory (NT)	0.23%	0.22%	0.21%	0.22%	1.04%
Queensland (QLD)	16.79%	16.43%	16.19%	16.47%	20.12%
South Australia (SA)	7.13%	7.22%	7.36%	7.24%	7.28%
Tasmania (TAS)	1.45%	1.35%	1.43%	1.41%	2.25%
Victoria (VIC)	29.96%	29.94%	30.06%	29.99%	24.80%
Western Australia (WA)	11.53%	11.84%	11.78%	11.72%	10.76%
	100.00%	100.00%	100.00%	100.00%	100.00%


 Centre for International Finance and Regulation  
 Towards Financial System Integrity

**Table 3 - Descriptive Statistics of SMSFs sample in accumulation phase, 2008-2010 (all years)**

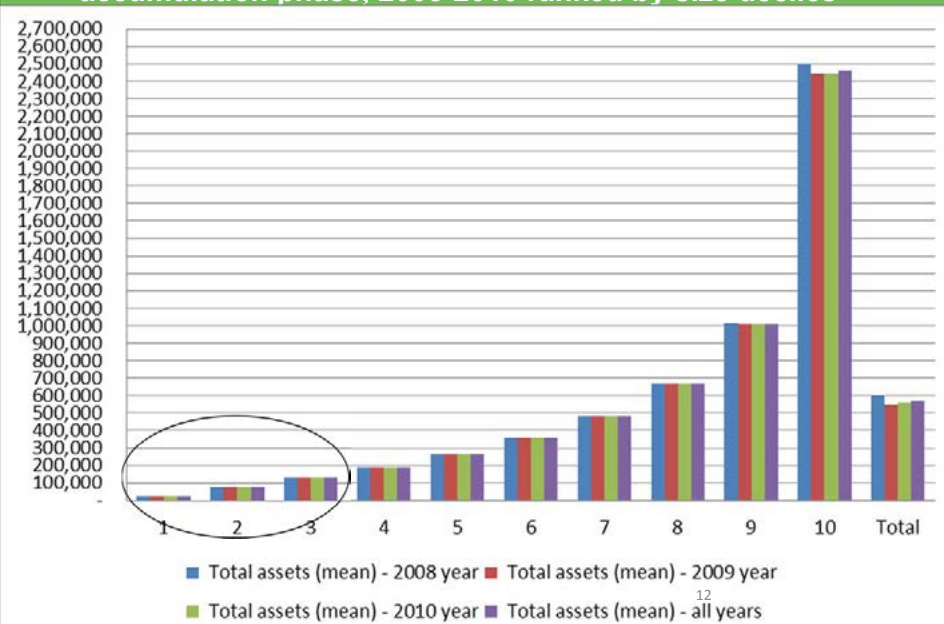
	Mean	Median	Std. Dev.
Listed trusts	24,614.50	-	118,475.60
Unlisted trusts	42,374.77	-	232,271.80
Insurance policy	230.71	-	12,035.96
Other managed investments	15,334.25	-	105,048.90
<b>Cash and term deposits</b>	<b>155,886.70</b>	<b>52,483.00</b>	<b>310,277.80</b>
Debt securities	1,237.91	-	66,940.86
Loans	3,276.10	-	56,846.12
<b>Listed shares</b>	<b>179,363.10</b>	<b>44,024.00</b>	<b>938,950.80</b>
Unlisted shares	11,318.65	-	80,857.57
Derivatives and instalment warrants	1,492.69	-	23,705.33
Non-residential real property	70,277.46	-	265,042.60
Residential real property	29,975.09	-	182,652.20
<b>Artwork, collectibles, metal or jewels</b>	<b>2,087.19</b>	-	<b>26,614.37</b>
Other assets	17,712.44	1,275.00	95,990.01

10 
 Centre for International Finance and Regulation  
 Towards Financial System Integrity

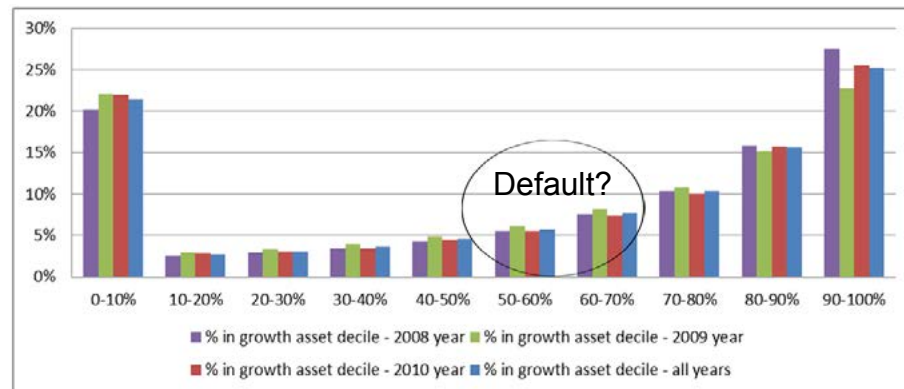
**Table 3 (cont'd) - Descriptive Statistics of SMSFs sample in accumulation phase, 2008-2010 (all years)**

	Mean	Median	Std. Dev.
Overseas shares	1,666.37	-	44,274.16
Overseas non-residential real property	211.02	-	8,976.14
Overseas residential real property	156.26	-	6,359.89
Overseas managed investments	517.20	-	40,796.55
Other overseas assets	2,714.96	-	59,851.21
<b>Total assets</b>	<b>560,447.40</b>	<b>307,444.00</b>	<b>1,168,019.00</b>
Borrowings	2,701.71	-	31,863.96
Total member account balances	545,866.30	295,791.00	1,100,395.00
Reserve accounts	409.33	-	14,158.15
Other liabilities	10,384.82	2,033.00	90,381.87
Total liabilities	559,362.20	306,356.00	1,167,709.00
Member Count	1.91	2.00	0.66
<b>Total assessable income</b>	<b>65,936.82</b>	<b>33,878.00</b>	<b>95,727.81</b>
<b>Total deductions</b>	<b>5,392.26</b>	<b>2,994.00</b>	<b>7,141.75</b>
Taxable income	60,536.69	28,386.00	93,901.16

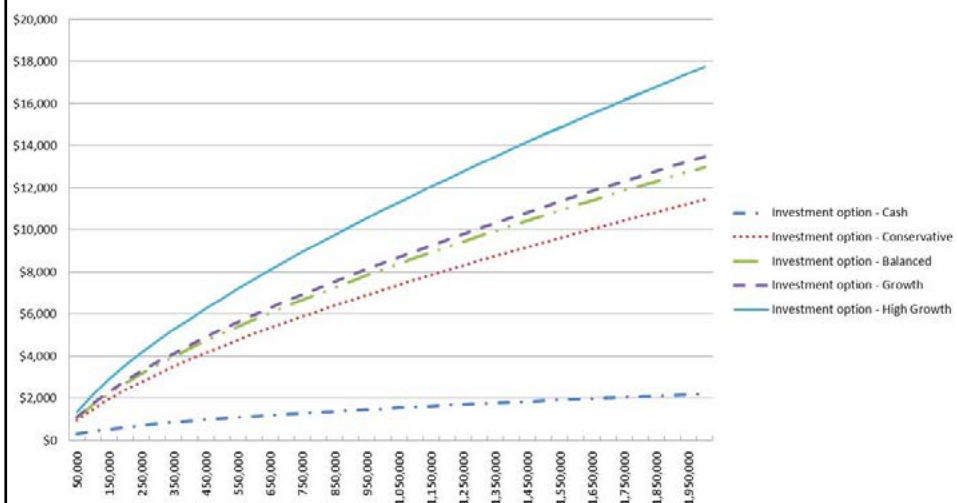
**Figure 2: Total assets for sample of 209,420 SMSFs in accumulation phase, 2008-2010 ranked by size deciles**



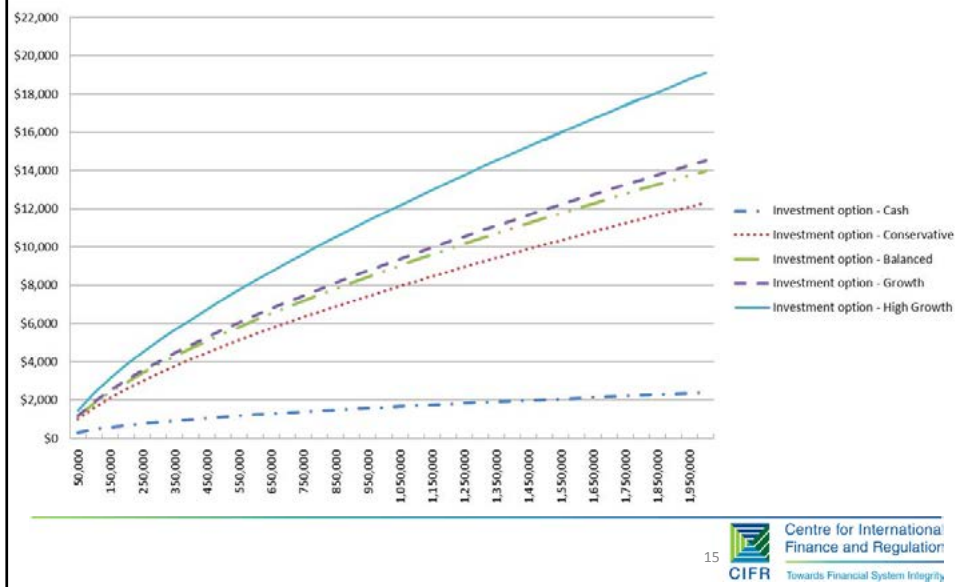
**Figure 3: Percentage of sample of 209,420 SMSFs, 2008-2010 ranked by deciles in growth assets**



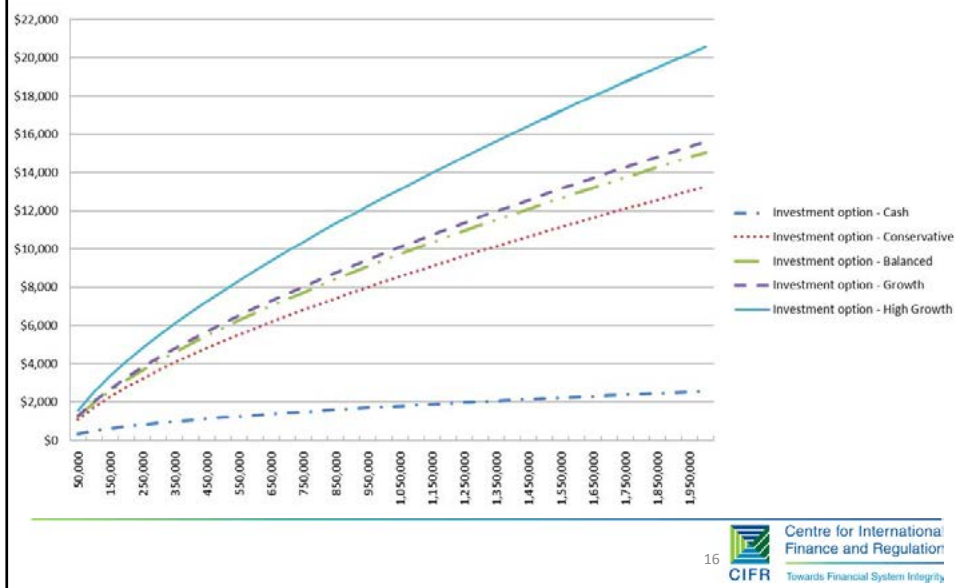
**Figure 4a: Estimated annual running costs (by investment option) for an SMSF with one member**



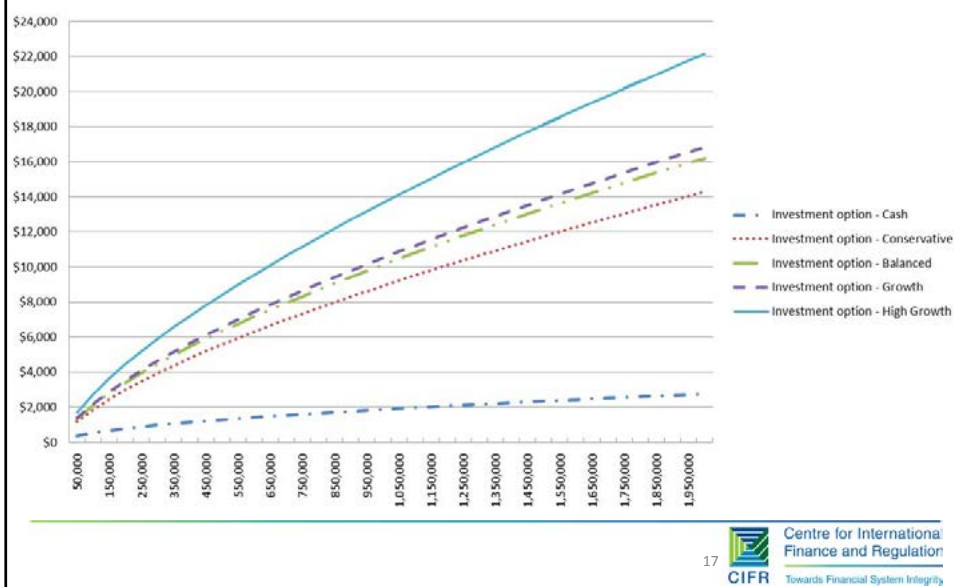
**Figure 4b: Estimated annual running costs (by investment option) for an SMSF with **two** members**



**Figure 4c: Estimated annual running costs (by investment option) for an SMSF with **three** members**




**Figure 4d: Estimated annual running costs (by investment option) for an SMSF with four members**



**Table 4 Audit fee estimation of Industry Leader premiums for SMSFs sample, 2008-10**

	Panel A (2008 year n=27,075)			Panel B (2009 year n=33,765)			Panel C (2010 year n=38,828)			Panel D (All years n=99,668)		
	Co-efficient	t-stat	Probability	Co-efficient	t-stat	Probability	Co-efficient	t-stat	Probability	Co-efficient	t-stat	Probability
Intercept	4.482	85.426	.000	4.411	95.476	.000	4.337	99.528	.000	4.413	163.58	.000
LASSETS	.131	28.661	.000	.139	34.176	.000	.149	38.273	.000	.140	58.786	.000
PARTICIPANTS	.008	1.301	.193	.023	4.398	.000	.013	2.629	.009	.015	4.970	.000
ROA	-.079	-1.229	.219	-.613	-7.786	.000	-.597	-9.261	.000	-.456	-11.907	.000
LCASH	-.000	-.140	.889	.002	1.114	.265	-.001	-.721	.471	.000	.318	.751
LPROPERTY	.001	1.414	.157	.002	2.161	.031	.001	2.253	.024	.001	3.008	.003
LSHARES	.004	4.773	.000	.006	9.155	.000	.005	8.743	.000	.005	13.649	.000
FOREIGN	-.015	-.0975	.330	-.006	-.473	.636	-.020	-1.722	.085	-.013	-1.783	.075
LCONT	.001	1.111	.267	.001	1.012	.311	.001	1.054	.292	.001	1.501	.133
ARTWORK	.138	4.974	.000	.137	5.551	.000	.102	4.558	.000	.125	8.741	.000
BORROWING	.022	.623	.533	-.058	-2.239	.025	-.108	-6.083	.000	-.065	-4.813	.000
RESERVEACCTS	.154	2.569	.010	.152	2.893	.004	.004	.123	.902	.085	3.2997	.001
INHOUSE	.117	4.169	.000	.123	5.519	.000	.102	4.586	.000	.113	8.221	.000
DISPOSAL	.094	9.835	.000	.071	9.787	.000	.058	8.681	.000	.067	15.477	.000
LOSSES	.194	12.572	.000	.124	10.503	.000	.142	14.822	.000	.147	22.268	.000
OPINION	.086	4.255	.000	.112	6.390	.000	.084	5.123	.000	.093	9.012	.000
LAG	.057	7.370	.000	.065	9.174	.000	.070	10.459	.000	.060	14.669	.000
LEADER_1	-.423	-22.819	.000	-.417	-19.967	.000	-.264	-15.811	.000	-.355	-31.956	.000
LEADER_OTHER	-.187	-11.010	.000	-.335	-21.852	.000	-.356	-26.495	.000	-.305	-34.932	.000
F-statistic		124.32	.000		210.44	.000		249.64	.000		562.39	.000
Adjusted R <sup>2</sup>		.076			.100			.103			.092	

18  Centre for International Finance and Regulation  
Towards Financial System Integrity

**Table 5 Total fee estimation of Industry Leader premiums for SMSFs sample, 2008-10**

	Panel A (2008 year n=33,578)			Panel B (2009 year n=38,238)			Panel C (2010 year n=42,228)			Panel D (All years n=114,044)		
	Co-efficient	t-stat	Probability	Co-efficient	t-stat	Probability	Co-efficient	t-stat	Probability	Co-efficient	t-stat	Probability
Intercept	3.459	44.244	.000	3.724	54.910	.000	3.747	60.213	.000	3.672	92.477	.000
LASSETS	.225	33.037	.000	.209	34.771	.000	.203	37.233	.000	.211	60.330	.000
PARTICIPANTS	.015	1.635	.102	.028	3.722	.000	.005	.747	.455	.016	3.577	.000
ROA	-.343	-3.602	.000	-1.184	-10.468	.000	-.926	-10.634	.000	-.717	-13.091	.000
LCASH	-.007	-2.554	.011	-.004	-1.445	.149	-.001	-.386	.700	-.004	-2.700	.007
LPROPERTY	.005	4.000	.000	.001	1.423	.155	.003	3.110	.002	.003	4.518	.000
LSHARES	.003	2.695	.007	.008	7.710	.000	.007	8.005	.000	.006	10.704	.000
FOREIGN	-.046	-2.137	.033	-.041	-2.217	.027	-.038	-2.348	.019	-.041	-3.785	.000
LCONT	-.004	-2.746	.006	-.001	-1.263	.207	-.001	-.637	.524	-.002	-2.584	.010
ARTWORK	.249	6.116	.000	.197	5.844	.000	.113	3.641	.000	.185	9.114	.000
BORROWING	-.000	-.005	.996	-.078	-2.062	.039	-.108	-4.022	.000	-.085	-4.132	.000
RESERVEACCTS	.121	1.655	.098	.103	1.667	.096	-.037	-.842	.400	.038	1.171	.242
INHOUSE	.037	.898	.369	.076	2.322	.020	.084	2.798	.005	.067	3.335	.001
DISPOSAL	.248	16.925	.000	.133	12.315	.000	.109	11.543	.000	.153	23.707	.000
LOSSES	.284	12.138	.000	.164	9.233	.000	.213	15.896	.000	.218	22.092	.000
OPINION	.048	1.639	.101	.132	5.036	.000	.105	4.455	.000	.095	6.180	.000
LAG	.038	3.243	.001	.022	2.010	.044	.055	5.861	.000	.039	6.404	.000
LEADER_1	<b>-.659</b>	<b>-30.129</b>	<b>.000</b>	<b>-.592</b>	<b>-26.708</b>	<b>.000</b>	<b>-.414</b>	<b>-23.393</b>	<b>.000</b>	<b>-.538</b>	<b>-44.847</b>	<b>.000</b>
LEADER_OTHER	.265	6.489	.000	.112	3.159	.002	.064	2.045	.041	.132	6.486	.000
F-statistic		159.205	.000		171.00	.000		199.145	.000		512.13	.000
Adjusted R <sup>2</sup>		.078			.074			.078			.075	

**Table 6 Audit quality estimation by Industry Leaders for SMSFs sample, 2008-10 (dependent - breaches detected)**

	Panel A (2008 year n=27,075)			Panel B (2009 year n=33,765)			Panel C (2010 year n=38,828)			Panel D (All years n=99,668)		
	Co-efficient	z-stat	Probability	Co-efficient	z-stat	Probability	Co-efficient	z-stat	Probability	Co-efficient	z-stat	Probability
Intercept	-4.604	-15.24	0.000	-6.044	-18.54	0.000	-6.657	-19.29	0.000	-5.742	-30.54	0.000
LASSETS	0.223	8.826	0.000	0.343	12.592	0.000	0.360	12.765	0.000	0.303	19.445	0.000
PARTICIPANTS	0.064	1.979	0.048	0.104	3.175	0.002	0.127	3.685	0.000	0.095	4.945	0.000
ROA	0.761	1.951	0.051	1.138	2.068	0.039	1.780	3.790	0.000	1.758	6.947	0.000
LCASH	-0.056	-6.228	0.000	-0.107	-12.53	0.000	-0.094	-10.39	0.000	-0.087	-17.12	0.000
LPROPERTY	-0.009	-1.936	0.053	-0.020	-4.062	0.000	-0.015	-3.093	0.002	-0.014	-5.005	0.000
LSHARES	-0.020	-4.526	0.000	-0.040	-8.877	0.000	-0.036	-8.155	0.000	-0.033	12.994	0.000
FOREIGN	-0.363	-3.606	0.000	-0.298	-2.715	0.007	-0.410	-3.537	0.000	-0.348	-5.568	0.000
ARTWORK	0.311	2.441	0.015	0.160	1.171	0.242	0.254	1.844	0.065	0.243	3.160	0.002
BORROWING	0.267	1.507	0.132	0.325	2.204	0.028	-0.113	-0.863	0.388	0.054	0.643	0.520
INHOUSE	2.144	25.296	0.000	2.448	28.627	0.000	2.621	32.709	0.000	2.401	50.184	0.000
DISPOSAL	-0.474	-8.560	0.000	-0.487	-9.191	0.000	-0.510	-9.392	0.000	-0.452	-14.73	0.000
LOSSES	0.226	2.799	0.005	0.235	3.080	0.002	0.253	3.533	0.000	0.224	5.243	0.000
OPINION	1.802	26.436	0.000	2.104	31.175	0.000	2.164	32.092	0.000	2.028	52.186	0.000
LAG	-0.008	-0.172	0.864	0.265	5.443	0.000	0.237	4.779	0.000	0.210	7.671	0.000
FEERESID	0.188	5.378	0.000	0.291	7.610	0.000	0.242	6.173	0.000	0.225	10.340	0.000
OTHERSERVICES	<b>0.338</b>	<b>5.892</b>	<b>0.000</b>	<b>0.337</b>	<b>5.359</b>	<b>0.000</b>	<b>0.243</b>	<b>3.532</b>	<b>0.000</b>	<b>0.349</b>	<b>9.710</b>	<b>0.000</b>
LR-statistic		1821.9	0.000		2863.5	0.000		2938.4	0.000		7531.3	0.000
McFadden R <sup>2</sup>		0.109			0.166			0.169			0.146	
Total correctly predicted		80.1%			88.1%			91.3%			88.3%	

## Limitations

- Limitations with data set (due to Privacy Act constraints)
  - Big-4 firms
  - Age & gender of SMSF members
  - Age of SMSF
  - Not panel data
- Funds are in accumulation phase (none in retirement phase)
- Audit fee data only available from 2008 year

## Conclusion

- SMSFs have a relatively low cost structure due to scale economies
- Evidence of large audit suppliers taking advantage of scale economies and employing a service bundling pricing strategy
- Lower priced audits as a conduit to supplying higher margin non-audit services
- The supply of NAS poses no auditor independence threat in the SMSF setting

andrew.ferguson@uts.edu.au  
adrian.raftery@deakin.edu.au



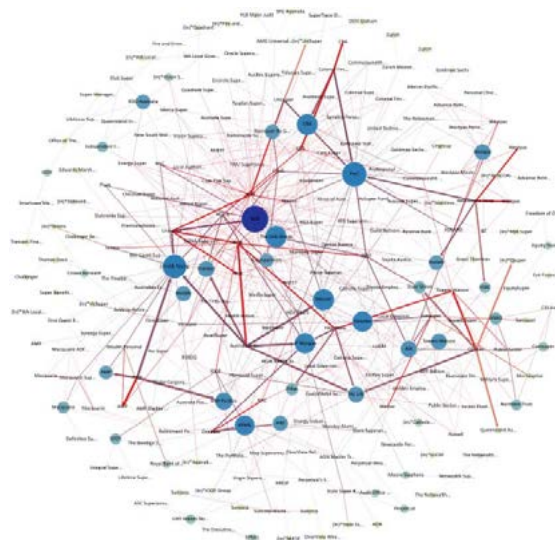


## So what?

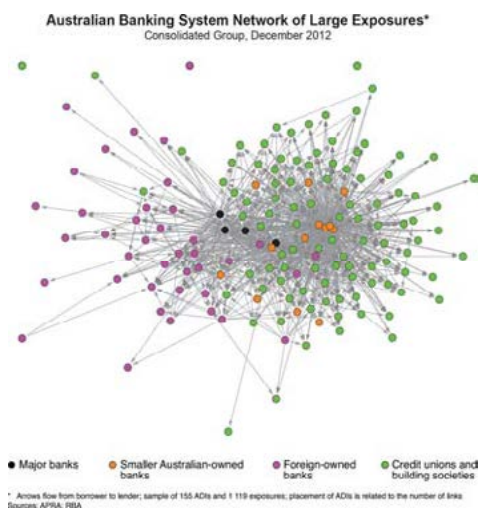
1. Cognitive diversity + local knowledge promises 'synaptic' wisdom
  - Other people are doing research on this
2. A diverse system is potentially a resilient one
  - CIFR has funded research into this
  - Resilience  $\neq$  Stability, Equilibrium, Safety, Efficiency ...



## Behold the superannuation system



## The GFC spawned a frenzy of network analyses in banking



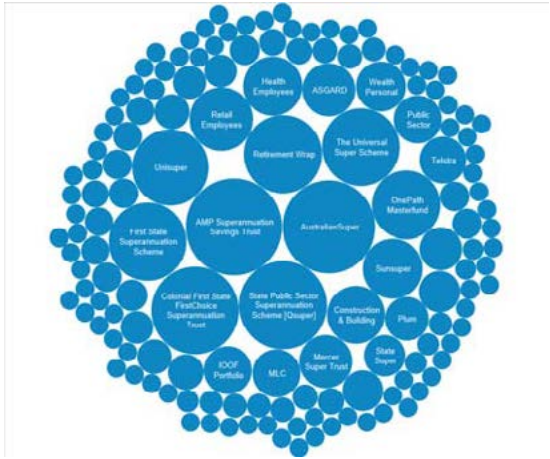
## But super is different from other financial institutions...



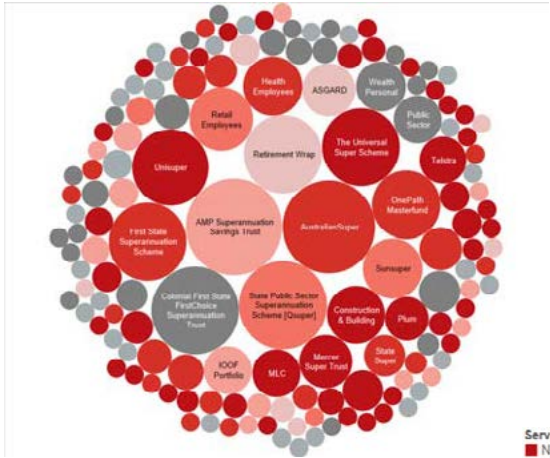
Funds have no separate legal existence - they are 'virtual' institutions

- Trustees can (and do) fail without bringing down the fund
- Funds are not typically linked as counterparties
- Funds outsource most of their activities

# Super Industry

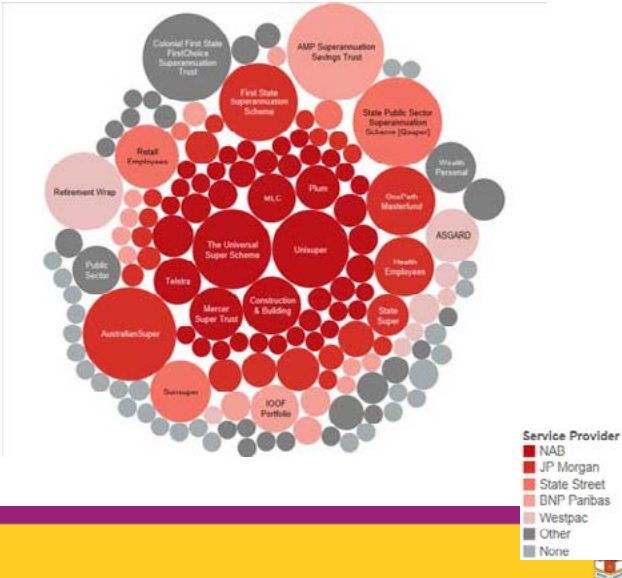


# Custody

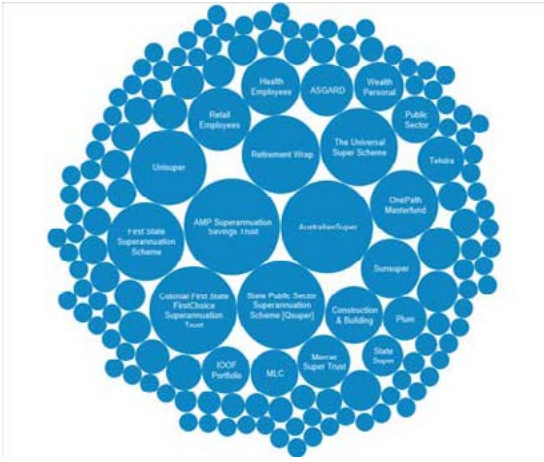


- Service Provider
- NAB
  - JP Morgan
  - State Street
  - BNP Paribas
  - Westpac
  - Other
  - None

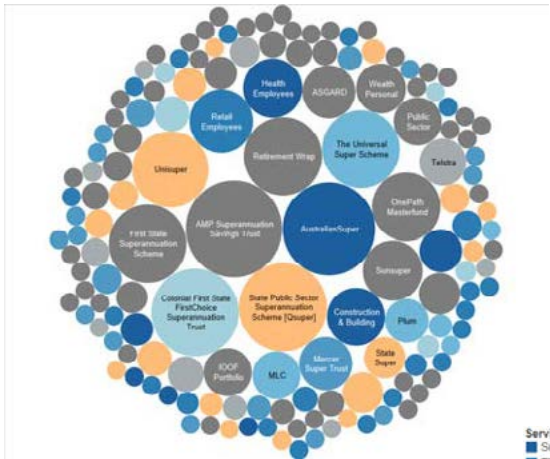
### Custody



### Super Industry



# Administration



- Service Provider**
- Superpartners
  - The Link Group
  - Mercer
  - NAB
  - CBA
  - Inhouse
  - Other
  - None



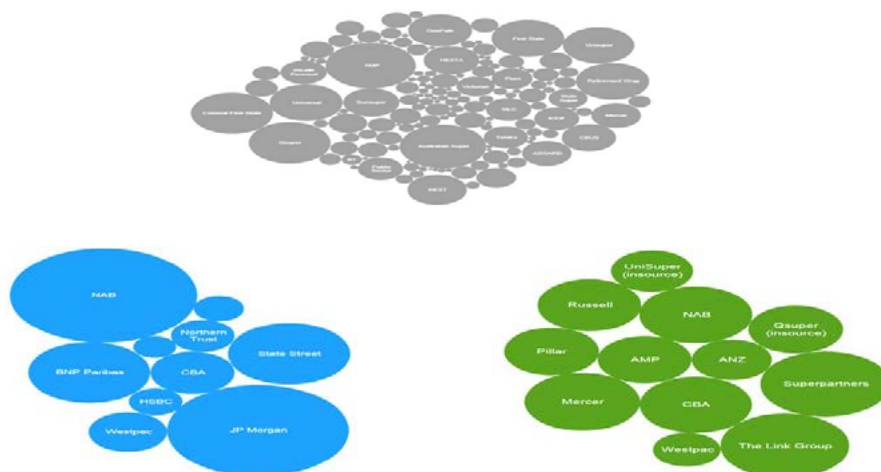
# Administration



- Service Provider**
- Superpartners
  - The Link Group
  - Mercer
  - NAB
  - CBA
  - Inhouse
  - Other
  - None



So in fact superannuation is a network with nodal differentiation...



## No fund is an island ...



- Funds routinely rely on outsource providers
- Funds 'share' directors - though less recently
- Funds co-invest with other funds in bespoke structures

*But also ...*

- Directors share conceptual frames (thanks ASFA, AIST, Russell, Mercer ...)
- Funds aim to fit into peer groups (thanks ChantWest, SuperRatings, Morningstar ...)
- Fund valuations rely on common data (eg security price feeds - remember LIBOR?)
- Reporting relies on standardised principles (thanks AASB, APRA ...)

**So what?**

- Together these cause **interdependence** and/or **synchrony** across the system
- Moreover, these links each have a different **aetiology** (causation)
- The regulatory scheme currently fails to engage adequately with these risks

## So What?

- Many key nodes are outside APRA jurisdiction
  - Member benefit administrators
  - Investment managers
  - Offshore custodians
  - Hedge funds and other offshore vehicles
- A number of key nodes actually play multiple roles - esp. banks
- Data collection on linkages is not always reported:
  - sub-custody
  - co-investment
- Regulatory action must have regard for systemic criticality
- Competition issues increasingly important



Rob Nicholls  
Research Associate  
*Centre for Law, Markets & Regulation*

Never Stand Still

Faculty of Law

## The implications of complexity for systemic risk in the superannuation system

CIFR Workshop  
7 May 2014

## Governance and Performance of Superannuation in Australia – Results of the First Generation

Chris Angus, Nigel Douglas and Mike Rafferty

\*Based on research funded by the McKell Institute

### 10 things we already knew about Super

- Superannuation funds have different characteristics
- Many of these differences are aesthetic or insignificant. But superannuation is an industry rather than a market.
- Therefore some of these internal fund differences turn out to be very important. The important differences can be thought of in 3 dimensions:
  1. Governance and business models
  2. Distribution
  3. Performance

Differences in these areas have meant that people in different funds will have very different retirement outcomes.

# 1. Fund Governance & Business Models\*

\*Source for governance data: APRA 2008

## Two basic superannuation fund types

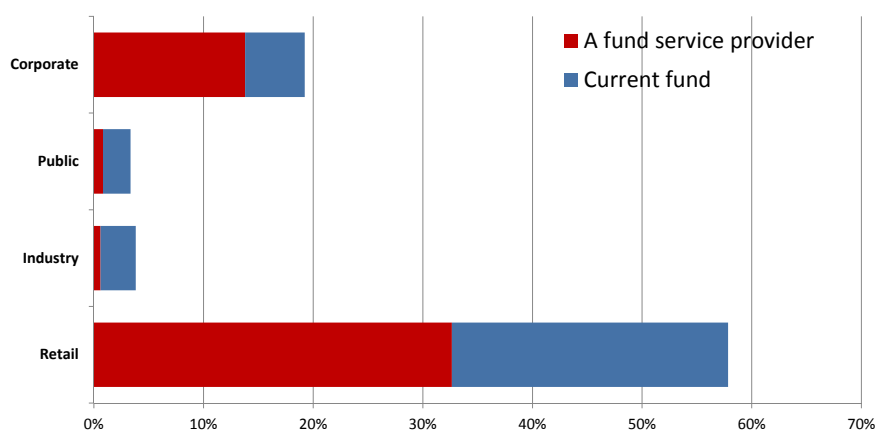
1. Derived from the old insurance industry business model
  - Vertically integrated financial firms
  - For Profit
  - Sales/Advice product distribution driven distribution
  - Appointed Trustees
  
2. Derived from industrial agreements
  - Free standing fund, contract out most services
  - Co-operative/Not for profit
  - Industrial Agreement and award-based
  - Representative Trustees

These two fund types behave differently in important ways

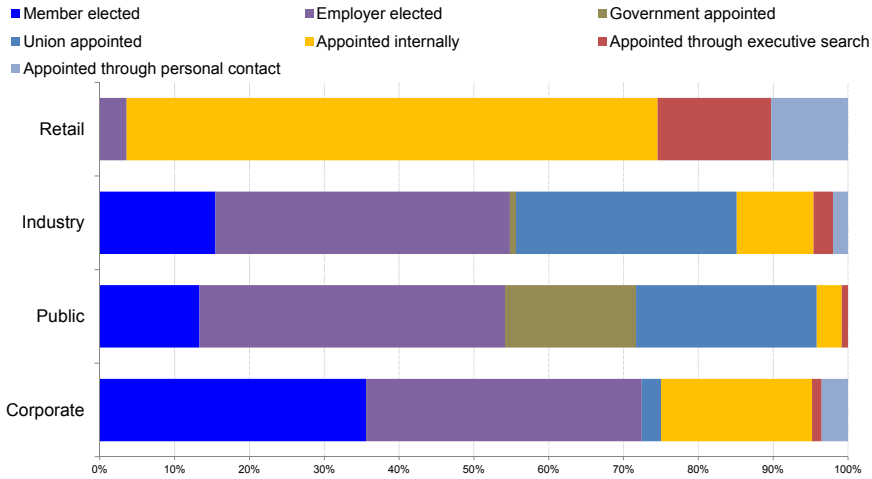
## Key Governance differences - Representative NFP Trustees have:

1. more diverse backgrounds
2. much less likely to be employed by the fund or a service provider
3. hold fewer additional directorships
4. spend more time on individual board matters
5. have fewer direct relationships to the fund or related service providers
6. direct fewer service contracts with parent or closely related providers
7. invest more of their retirement savings in the fund they are a board member

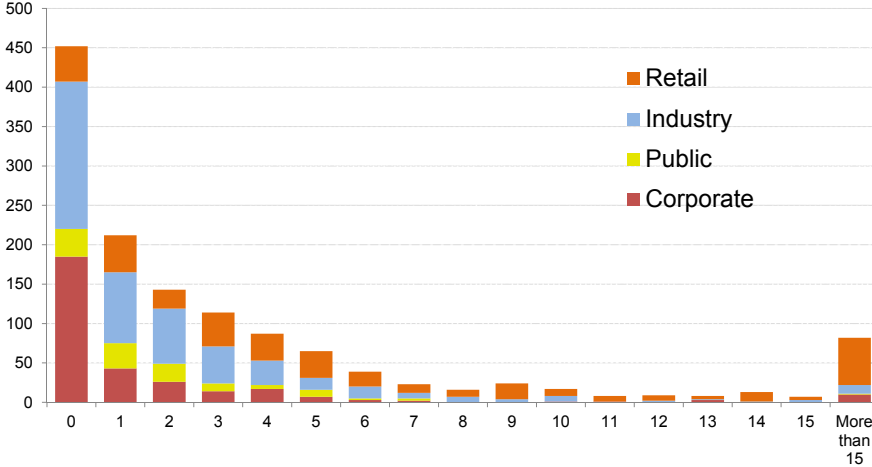
## Primary Employer of Trustee/Director



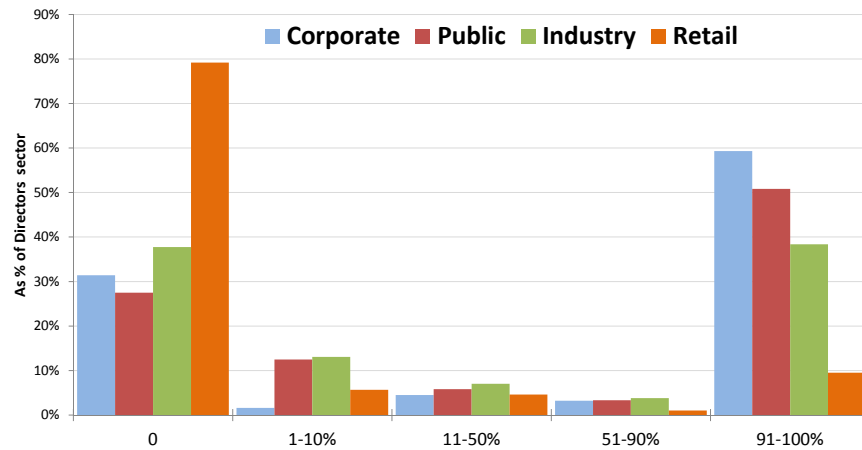
## Method of board appointment



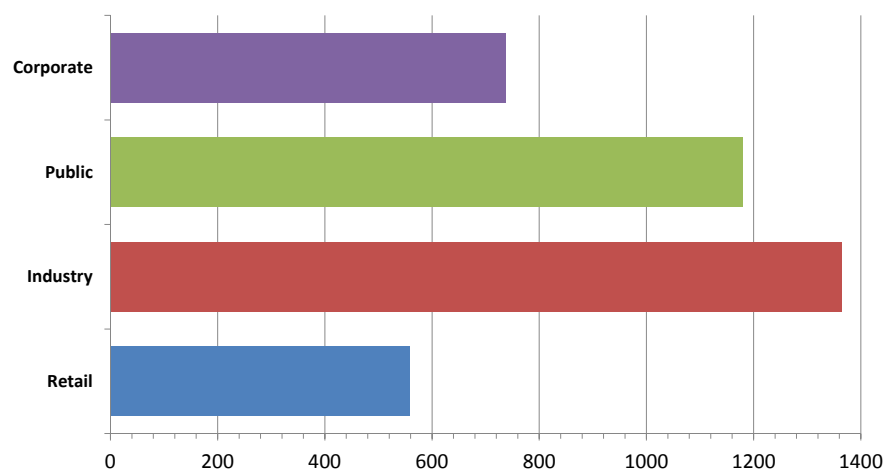
## Number of other Trustee/Directorships currently held



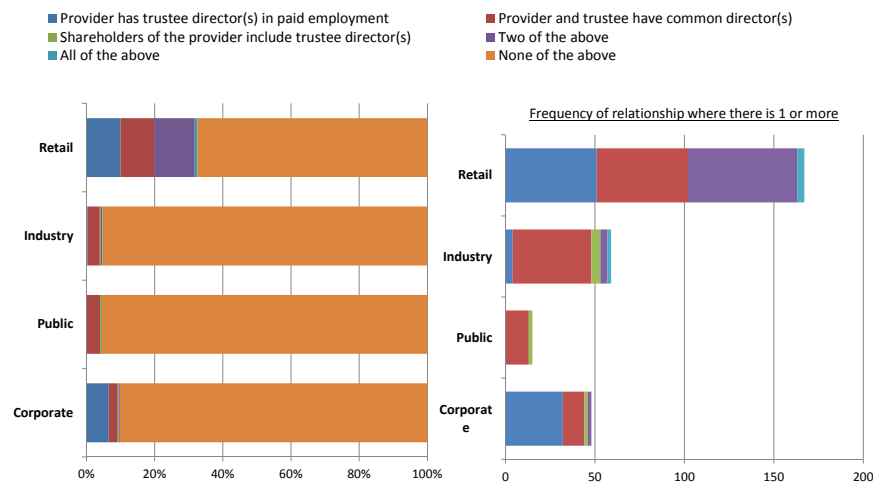
### Skin in the Game ? Per cent of trustee/director super invested in this fund



### Average number of trustee director hours spent per fund per year



## Service Provider relationship with trustee directors



## Fund Performance\*

- A couple more things you already knew

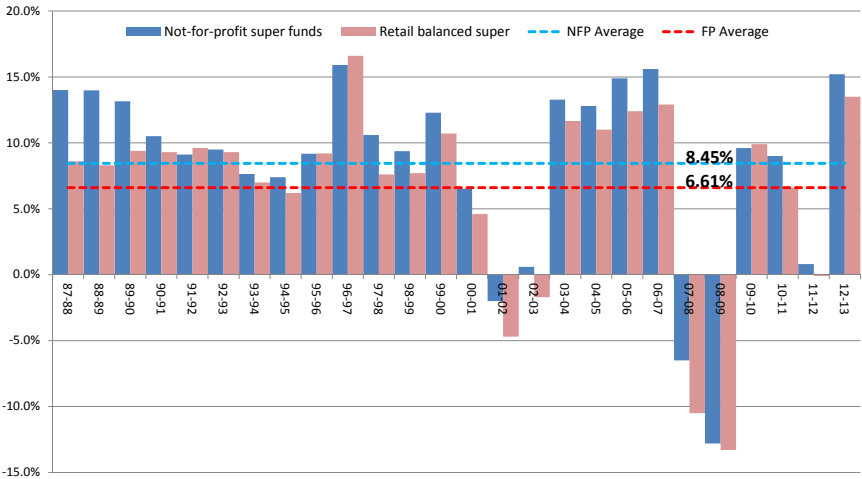
8. NFP Representative funds have been lower cost than FP (Retail) funds

9. NFP Representative funds have consistently outperformed FP funds

\*Source for fund performance data: Rainmaker Information 2013

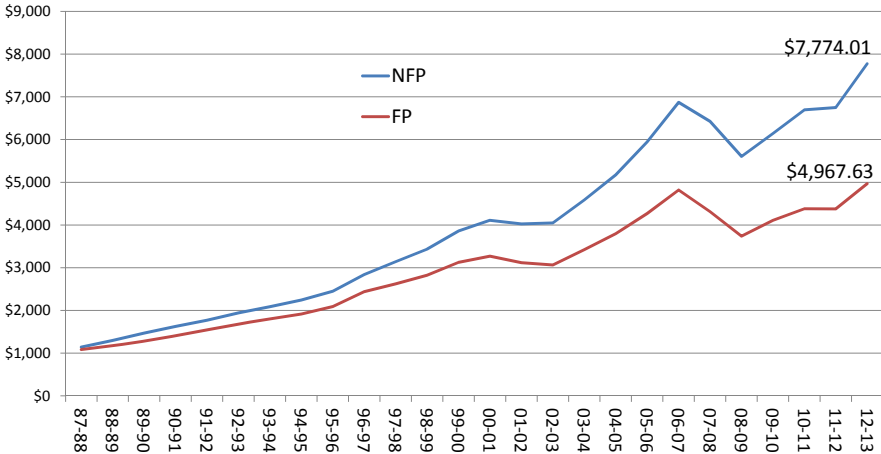
### Superannuation Fund Performance by Governane Model –

Crediting rates by market segment 1988 to 2013 & average over total period

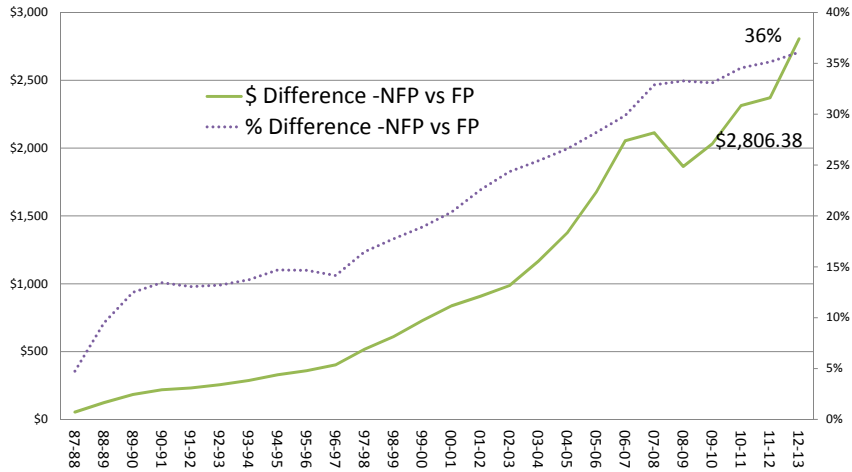


### Scenario 1: Initial investment of \$1000 in 1987,

Annual crediting rates compounded, balanced & default funds - 1988 to 2013

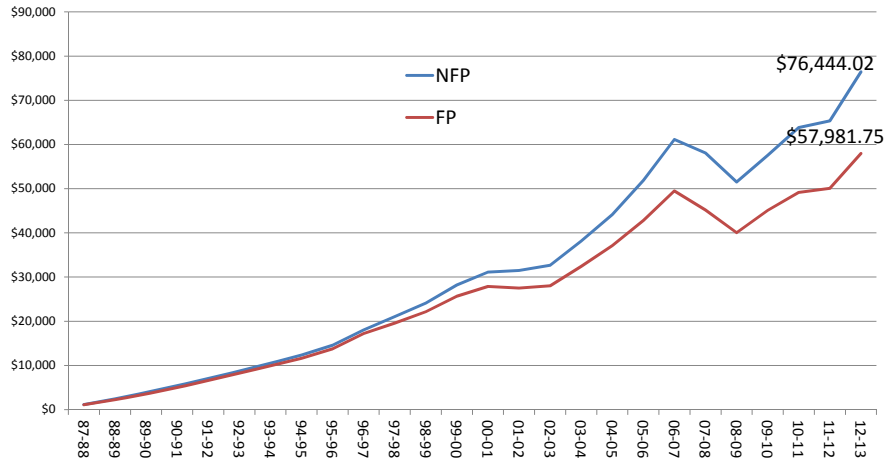


### Scenario 1: Differences in Outcomes

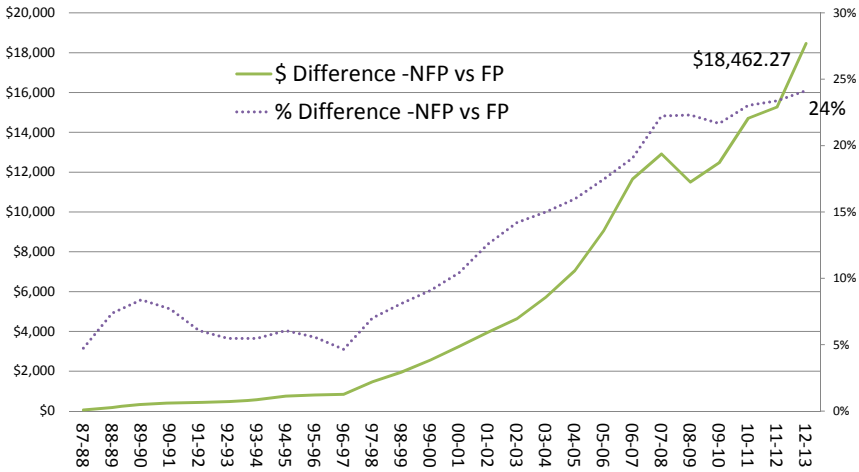


### Scenario 2: Initial investment of \$1000 in 1987 +\$1000 added each year,

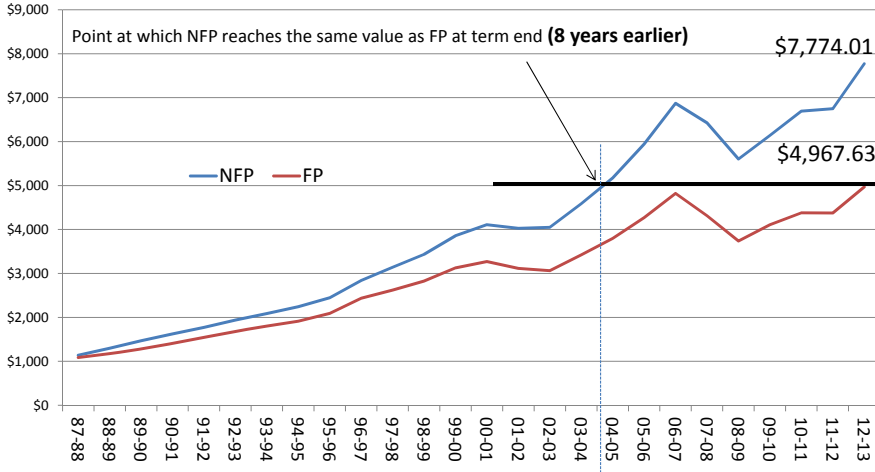
Annual crediting rates compounded, balanced & default funds - 1988 to 2013



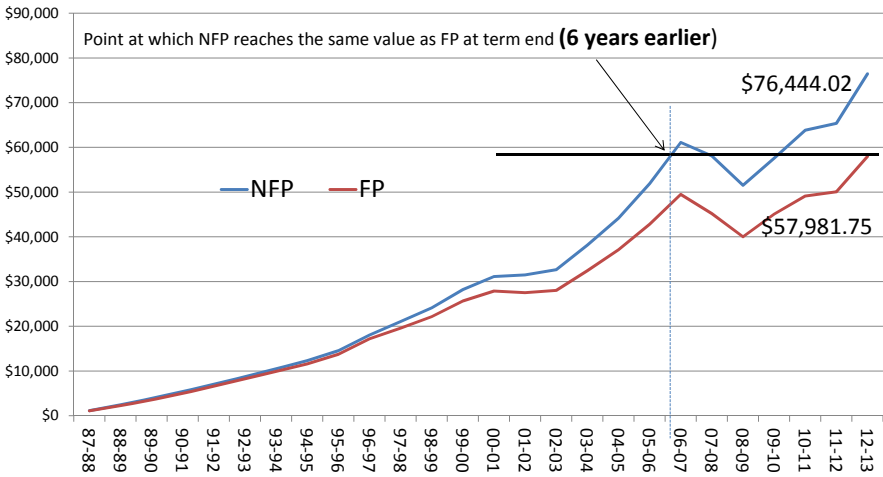
### Scenario 2: Outcome differences



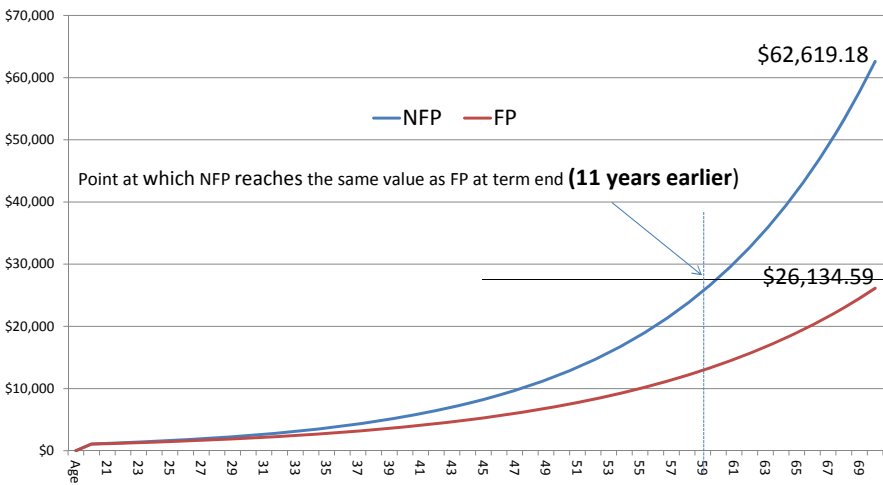
### Scenario 1 - Initial \$1000 lump sum plus crediting rates compounded, 1987-2013

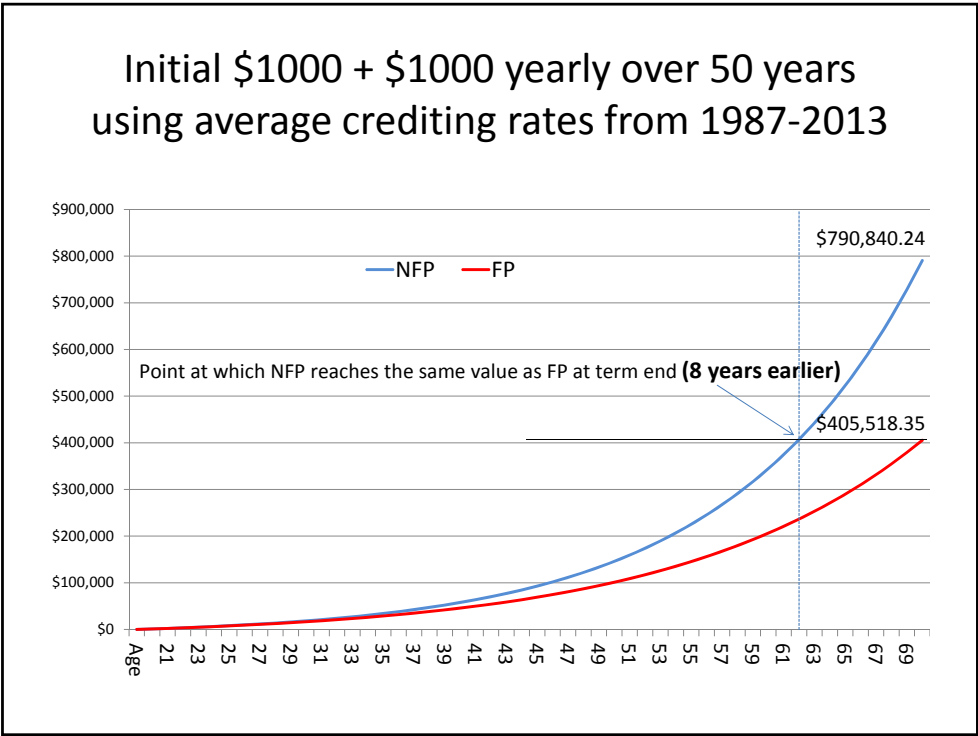


### Scenario 2 - Initial \$1000 + \$1000 yearly plus crediting rates from 1987-2013



### Initial \$1000 lump sum over 50 years using average crediting rates from 1987-2013







## **Superannuation fees:**

**Why they are high, why it matters  
and how to get them down**

**Jim Minifie  
Program Director, Productivity Growth**

**May 2014**

### **Agenda**

---



**Australia's high superannuation fees are hurting retirement**

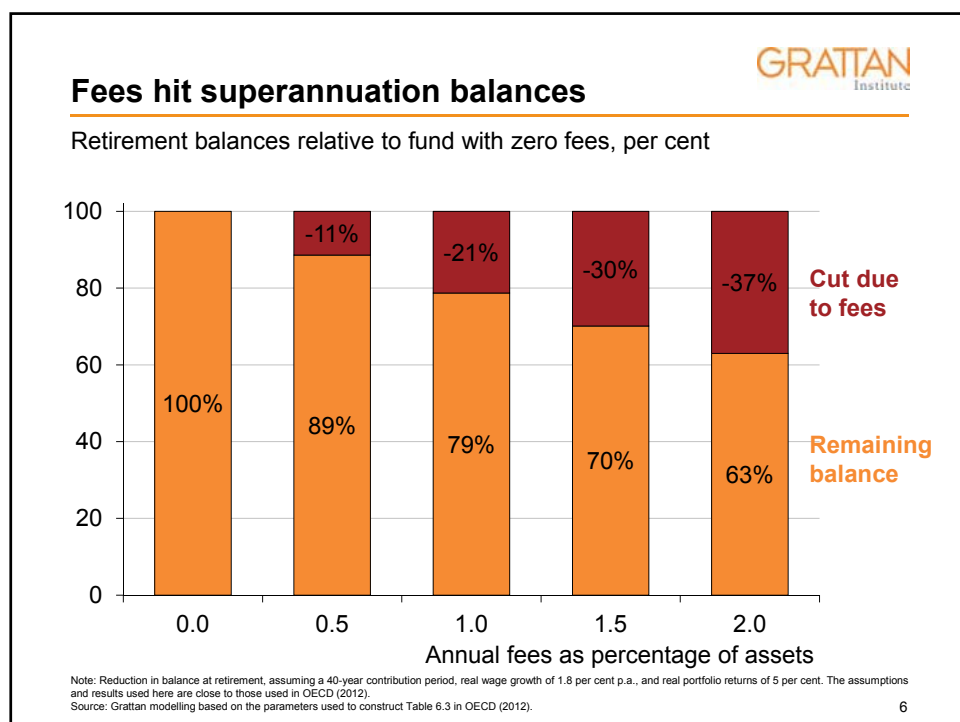
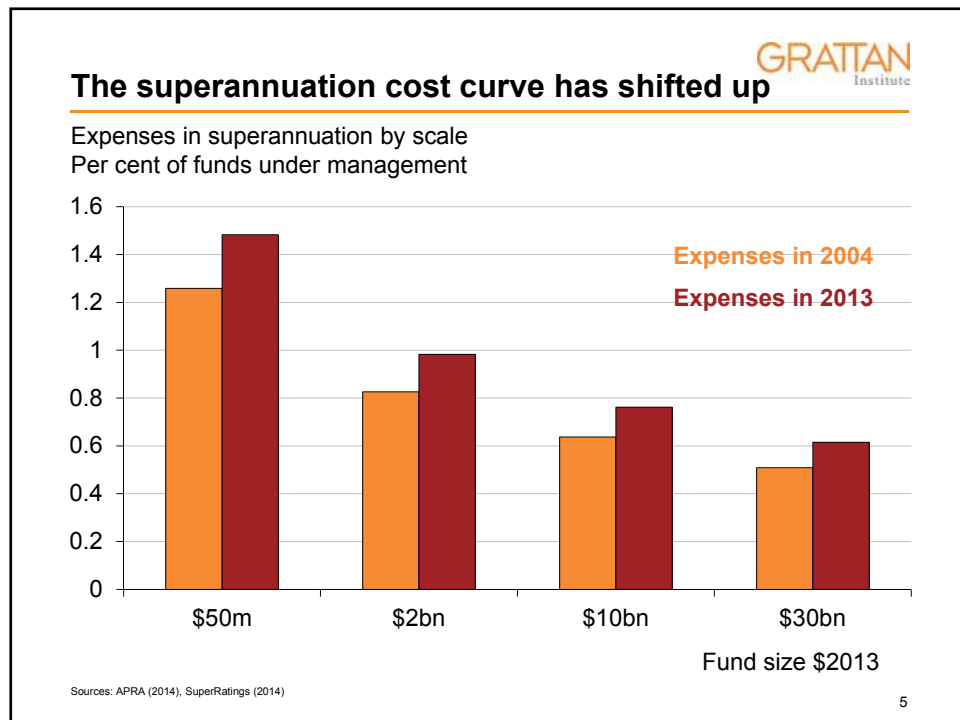
Why superannuation fees are high

'Stronger super' will not lower fees much

Lessons from other pension systems

How to get superannuation fees down

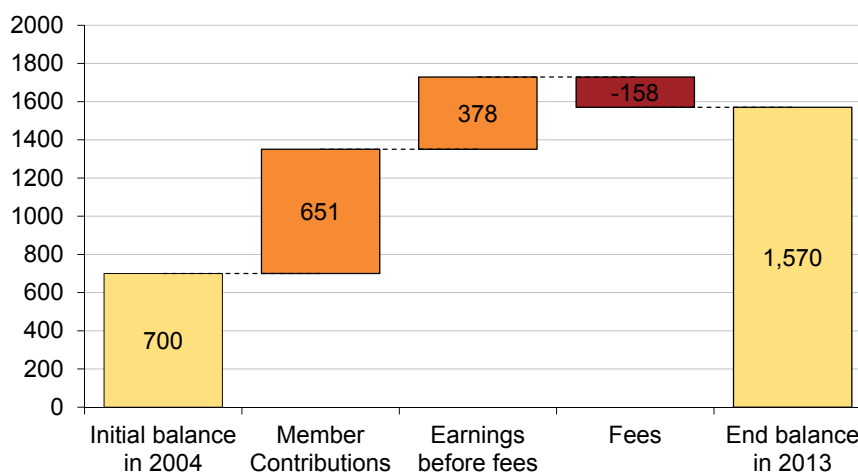




## Fees absorbed over a third of gross accumulation in the system

GRATTAN  
Institute

Composition of changes in superannuation balances, 2004-2013  
Billions of 2013 dollars

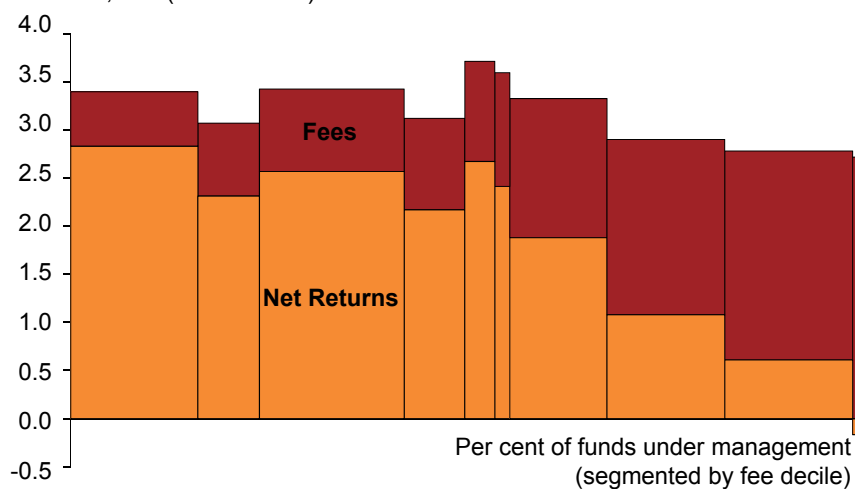


Note: Initial and terminal balances are from the aggregate APRA fund-level dataset (including self-managed funds) and scaled to 2013 dollars using the CPI (ABS, 2014). Fees are fund-weighted averages Rice Warner (2012) for 2004 – 2005, and SuperRatings (2014) for 2006-2013, applied to real funds under management at the midpoint of each year. Impact of fees includes foregone accumulation. Gross earnings are estimated by adding fees to the net FUM-weighted average rates of return from the APRA dataset. Source: APRA (2014a) (initial and end balances, contributions, net earnings), Rice Warner (2012) & SuperRatings (2014) (fees). 7

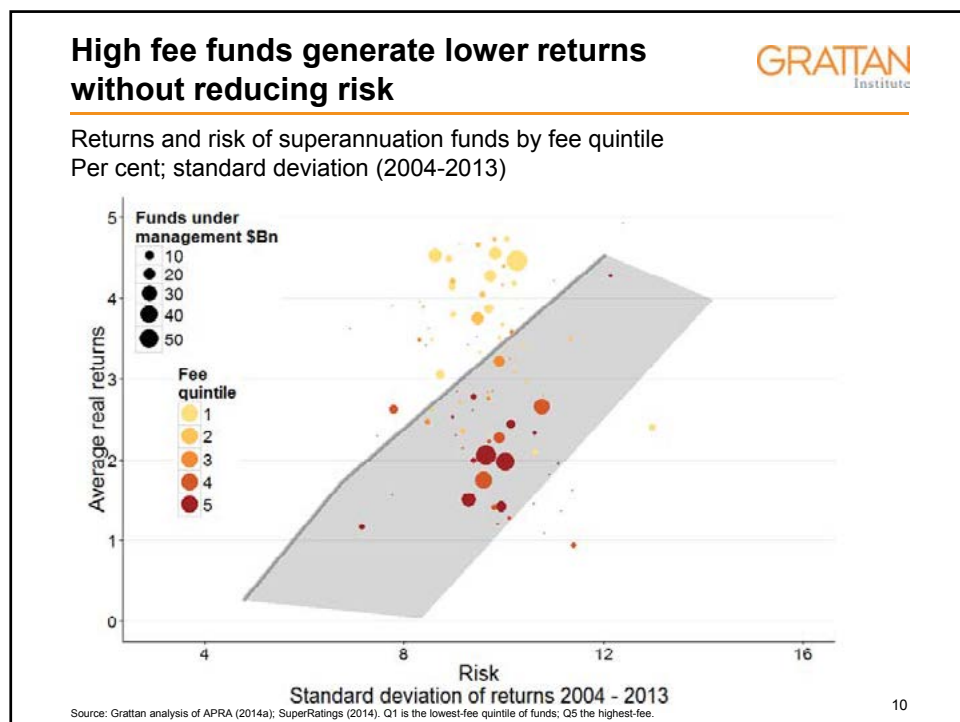
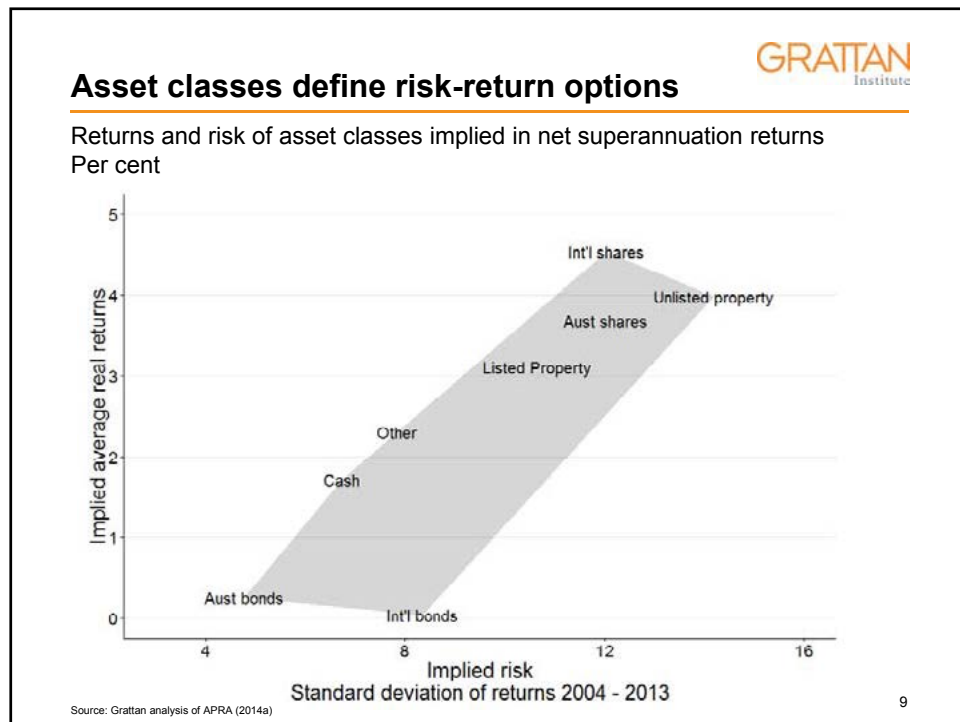
## Fees reduce net returns

GRATTAN  
Institute

Fees and net returns, ordered by fund decile  
Per cent, real (2006 – 2013)



Note: Returns are deflated by consumer price index. Fees are asset-weighted product fees at the fund level. Excludes self-managed funds. Source: Grattan analysis of APRA (2014a), SuperRatings (2014). 8



## Agenda

GRATTAN  
Institute

Australia's high superannuation fees are hurting retirement

**Why superannuation fees are high**

'Stronger super' will not lower fees much

Lessons from other pension systems

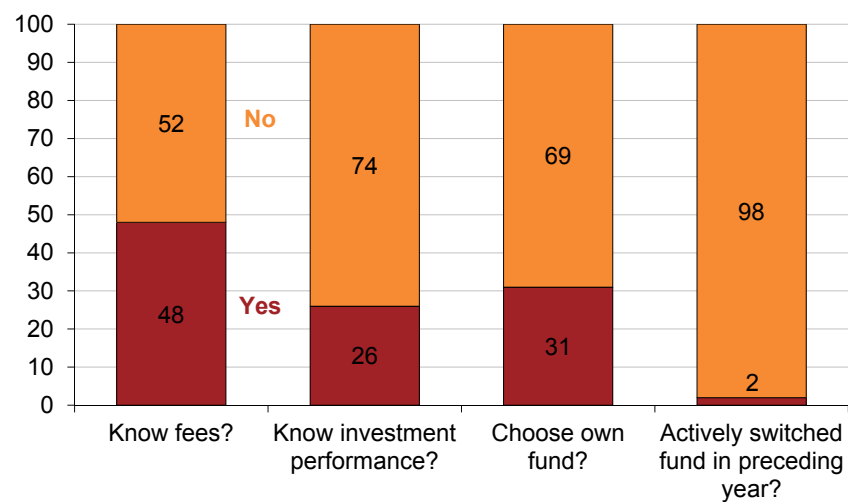
How to get superannuation fees down

11

## Many account holders are not engaged with superannuation

GRATTAN  
Institute

Survey responses from individuals with superannuation accounts  
Per cent



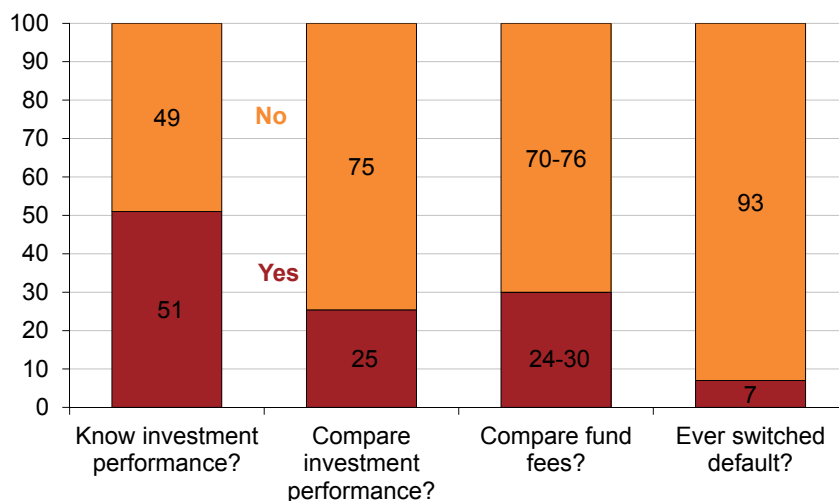
Source: Q1: Financial Services Council and ING Direct (2013), Q2-3: Colmar Brunton (2010b), Q4: Colmar Brunton (2010b), Commonwealth of Australia (2010a).

12

## Many employers are not engaged with superannuation

GRATTAN  
Institute

Survey responses from employers who nominate default funds  
Per cent



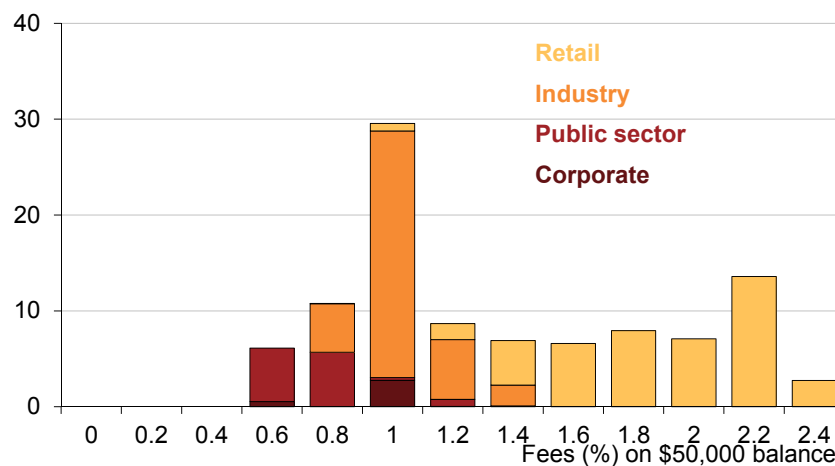
Notes: Question sample sizes range from 399-517.  
For Q1 - Large employers slightly more likely to know - 59%. Don't know assigned to 'No' - Q1 (3%), Q2 (1%), Q3 (1%), Q4 (2%).  
Sources: Colmar Brunton (2010b).

13

## Segmented market suggests that the 'law of one price' does not hold

GRATTAN  
Institute

Distribution of funds by list fees  
Percentage of total funds under management



Note: Fees recorded for public sector and some corporate funds may not include all relevant costs as some are paid by the employer. Excludes some smaller products offering a broad range of investment options. Excludes self-managed superannuation funds.  
Source: Grattan analysis of SuperRatings (2014) (fee) and APRA (2014a) (FUM) data. For the past decade fees have remained highly differentiated. Industry fund fees have risen slightly; fees on simpler retail products have fallen slightly, and risen on other retail products.

14

## Agenda

GRATTAN  
Institute

Australia's high superannuation fees are hurting retirement

Why superannuation fees are high

'Stronger super' will not lower fees much

Lessons from other pension systems

How to get superannuation fees down

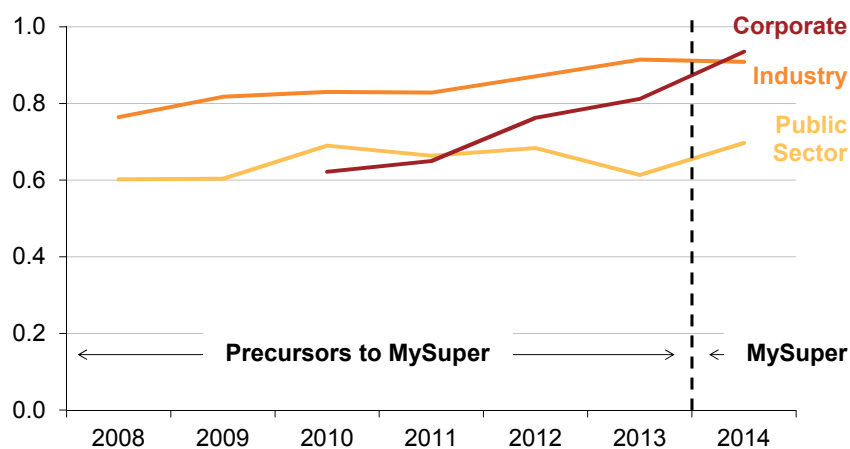
15

## Funds do not seem to be cutting fees as they switch to MySuper

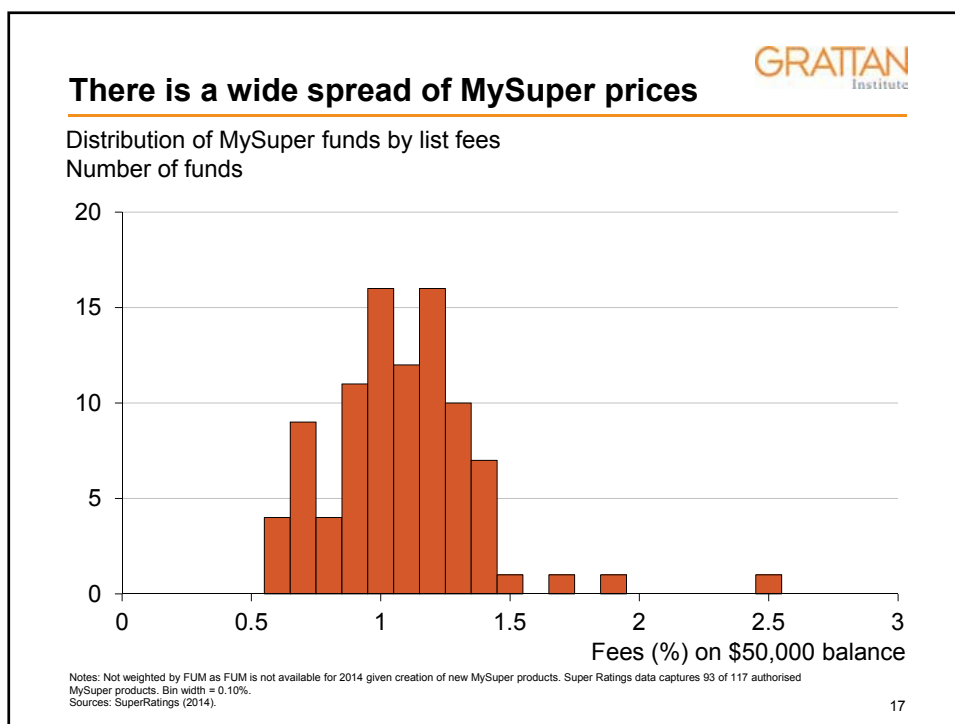
GRATTAN  
Institute

Fees for MySuper products and their precursors

Annual fee, per cent of funds under management for \$50k account



Note: Estimated FUM-weighted fees. All funds where data was available were included. The industry fund series (14 products; 2014 product FUM = \$116b) and public sector series (3 MySuper products; 2014 product FUM = \$43bn) are weighted by the FUM of products subsequently qualified as MySuper. The corporate series (12 MySuper products; 2012 fund-level FUM = \$38b) are weighted by fund FUM. For retail products, the estimated 2014 MySuper fee is 1.19%, assuming MySuper FUM is proportional to fund FUM. It is not possible to construct a time series for retail default products because the 2014 data lacks retail product level MySuper FUM, possibly because retail funds have not yet rolled default accounts into MySuper products. Source: Grattan analysis of SuperRatings (2014)



**GRATTAN**  
Institute

## Agenda

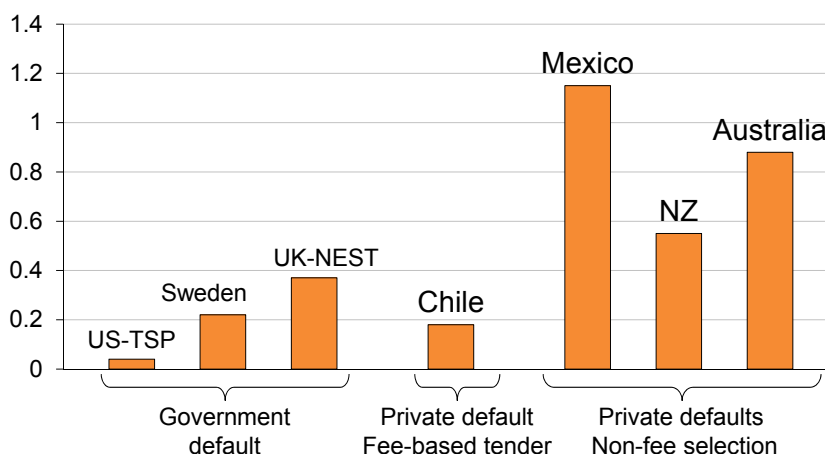
- Australia's high superannuation fees are hurting retirement
- Why superannuation fees are high
- 'Stronger super' will not lower fees much
- Lessons from other pension systems**
- How to get superannuation fees down

18

## Pension systems with government default or fee-based tender have low fees

GRATTAN  
Institute

Fees for default pension products in selected countries  
Annual fee, per cent



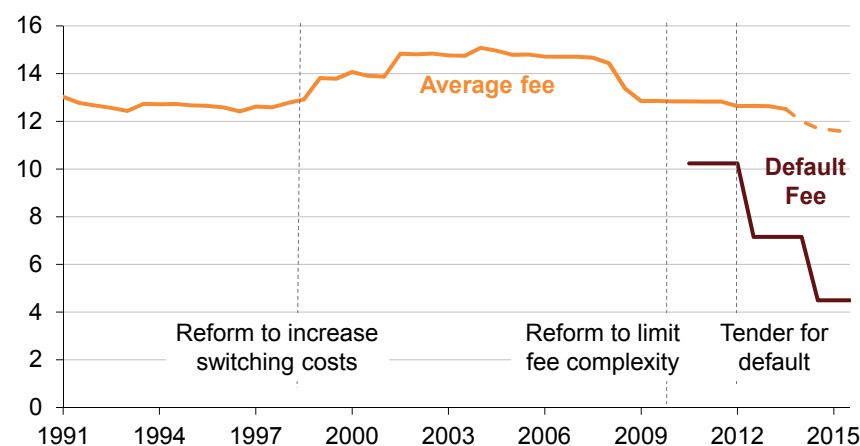
Note: 2014 or latest available. Conversion from percentage of contribution fees (for Chile and UK NEST) to funds under management fees done with following assumptions: 40-year contribution period, real wage growth of 1.9 per cent p.a., and real portfolio returns of 5 per cent as used in OECD (2012). NZ: Unweighted mean fees of nine default funds; Aus: weighted mean fees of MySuper products detailed in Figure 13.  
Source: Thrift Savings Plan (2014); Superintendencia de Pensiones (2014); Swedish Pensions Agency (2013); (2014c); Government of New Zealand (2014a), UK Nest (2014); APRA (2014a); SuperRatings (2014); CONSAR (2013).

19

## Chile's auction brought default fees down but did little for the back book

GRATTAN  
Institute

Fees for default and non-default products in Chile  
Contribution fee, per cent



Note: Fees are per cent of contributions. Not directly comparable with fees on preceding chart. Latest default fees is equivalent to 0.2 per cent funds under management (FUM) fee. Conversion to per cent of FUM assumes 40-year contribution period, real wage growth of 1.8 per cent, and real portfolio returns of 5 per cent as used in OECD (2012).

Source: Grattan analysis of Superintendencia de Pensiones (2014).

20

## Agenda

Australia's high superannuation fees are hurting retirement

Why superannuation fees are high

'Stronger super' will not lower fees much

Lessons from other pension systems

**How to get superannuation fees down**

21

## Reform 1: Select default funds in a fee-based tender

Main parts of the reform

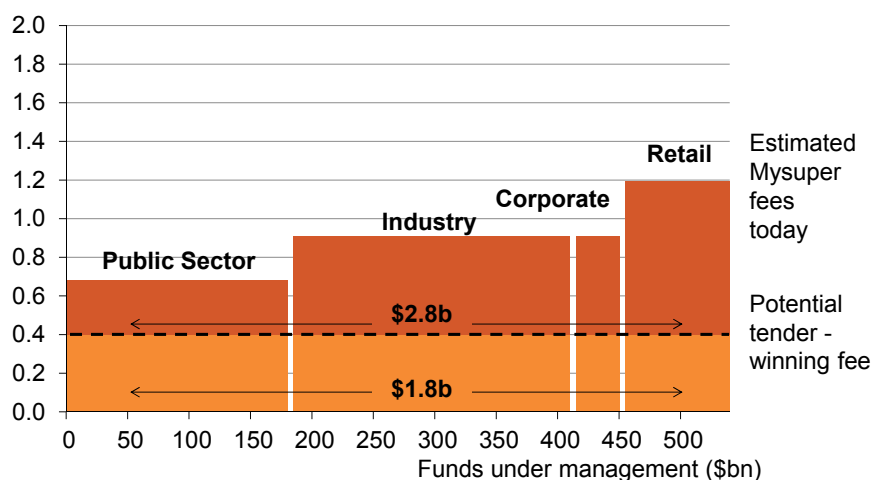
- |  |   |
|--|---|
| <div style="background-color: #c85130; color: white; padding: 5px; display: inline-block; transform: rotate(-90deg); transform-origin: left top;">Default product</div>    | <ul style="list-style-type: none"> <li>• Asset allocation range or ranges; diversification in asset class</li> <li>• Limits on trading volumes (churn, tax)</li> <li>• Define insurance offer separately; Fixed administration fee?</li> </ul>  |
| <div style="background-color: #c85130; color: white; padding: 5px; display: inline-block; transform: rotate(-90deg); transform-origin: left top;">Applicable flows</div>   | <ul style="list-style-type: none"> <li>• Period: e.g. two years</li> <li>• Applicable accounts: e.g. all new default accounts opened</li> </ul>   |
| <div style="background-color: #c85130; color: white; padding: 5px; display: inline-block; transform: rotate(-90deg); transform-origin: left top;">Auction design</div>     | <ul style="list-style-type: none"> <li>• Open or closed bids; if open, number of rounds</li> <li>• If multiple asset ranges, single / simultaneous / sequential</li> <li>• Period over which winning fee remains as a cap</li> <li>• Separate competitive tender for insurance</li> </ul> |
| <div style="background-color: #c85130; color: white; padding: 5px; display: inline-block; transform: rotate(-90deg); transform-origin: left top;">Roles</div>              | <ul style="list-style-type: none"> <li>• Pre-qualification by APRA, as today</li> <li>• Another government body to run the tender</li> <li>• If more than one winning fund, role for employers, FWA</li> </ul>  |
| <div style="background-color: #c85130; color: white; padding: 5px; display: inline-block; transform: rotate(-90deg); transform-origin: left top;">Supporting changes</div> | <ul style="list-style-type: none"> <li>• Protections for legacy MySuper account holders</li> <li>• Limitations on 'upsell' of default account holders</li> <li>• Dashboards on legacy and choice products</li> </ul>  |

22

## A tender for default funds could save over \$2b on today's volumes

GRATTAN  
Institute

Indicative current and potential tender fee level on default funds  
Per cent



Note: Estimated default FUM only. FUM is mid-2013. Assumes default products are 70 per cent of public sector, industry, and corporate funds under management, and 20 per cent of retail funds under management.

Source: Grattan analysis; industry analyst judgement (default shares); APRA (2014a); SuperRatings (2014).

23

## Reform 2: Make tax time super choice time

GRATTAN  
Institute

Main parts of the reform

### Additional tax return step

- Add a step to annual tax filing permitting taxpayers to compare current fund with the winner of the default tender
- And, if desired, to switch to funds on the spot

### Comparison information

- Summary information on the taxpayer's current fund
- Directly comparable information on the winner of the tender
- Background information to support decision

### IT requirements

- Further work is required to scope the IT task
- Needs to link and extend existing ATO functionality behind e-Tax, SuperSeeker and the Small Business Clearing House

### Dashboards

- Common across choice products and the default
- Objective (eg add asset allocation, drop target returns)
- More relevant (eg add information on costs of turnover)

24

## Summary

---

### **Australia's high superannuation fees are hurting retirement**

- Australian super fees are high by international standards, especially considering our scale
- High fees are associated with lower net returns and lower retirement incomes

### **Superannuation fees are high because there is little pressure in an opaque market**

- Many account holders and employers are disengaged and do not focus on fees
- Pressure from price-sensitive customers has not cut fees much for others
- Inattention to fees has allowed costs to grow unchecked

### **'Stronger super' will not lower fees much**

- Stronger super will result in real but modest cost savings
- Stronger super does not strongly increase fee-based competition
- Early signs suggest the reforms are not making a step change

### **Lessons from other pension systems**

- Centralising default fund administration can reduce costs
- Government tenders for default funds can reduce costs
- Disclosure and comparison are not enough by themselves
- Trigger events can engage account holders but are not widely used

### **How to get superannuation fees down**

- Select default funds in a fee-based tender
- Make tax time super choice time

25

## Supporting slides

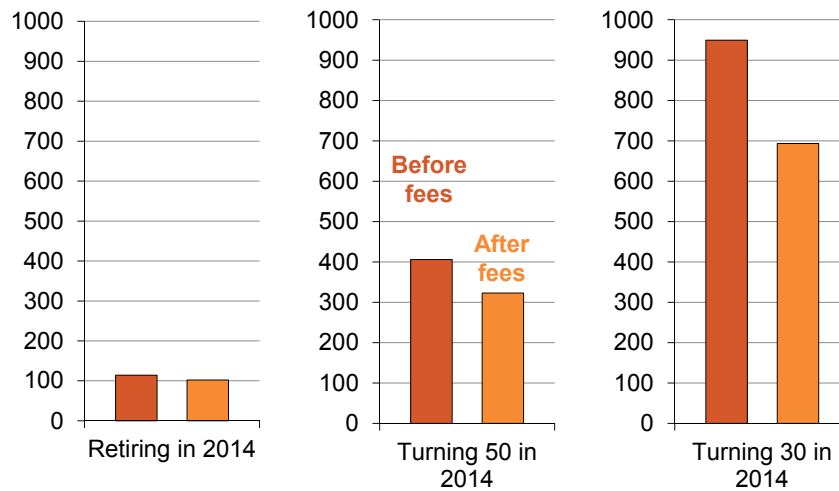
---

26

## Cumulative impact of fees will be high for those starting work now

GRATTAN  
Institute

Balances at retirement before and after fees, thousands of 2013 dollars

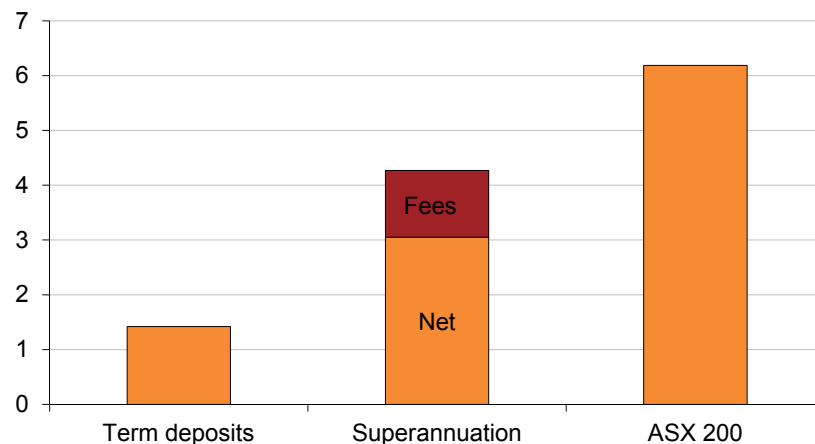


Note: Fees of 1.2 per cent per annum paid over a working life. Superannuation balances accumulated at the Superannuation Guarantee rate applying in each year. Assumes actual real mean weekly earnings growth before 2010, and real wage growth of 1.4 per cent thereafter, age-specific earnings from the ABS Household Expenditure Survey, Real gross portfolio returns assumed at 5 per cent.  
Source: Grattan modelling; ABS (2011). 27

## Fees absorbed over a quarter of returns on funds in the system for the entire decade

GRATTAN  
Institute

Superannuation and asset class returns  
Annual real returns, per cent (2004-2013)

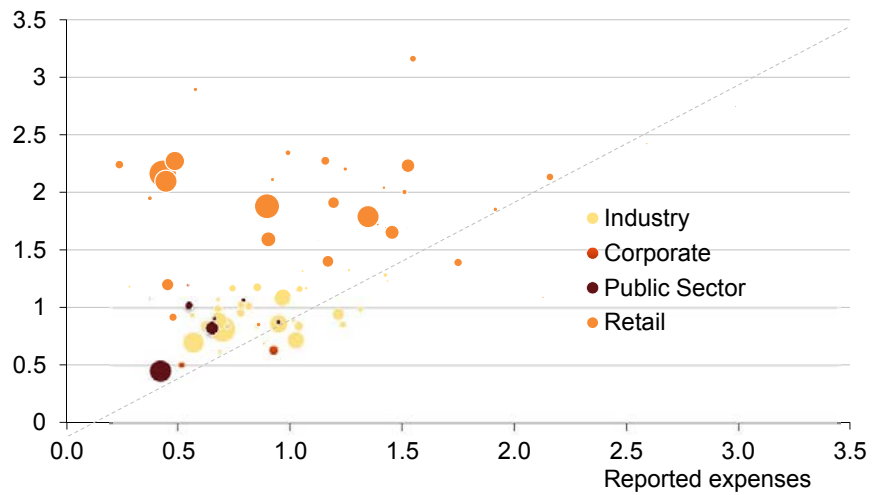


Note: Term deposits are the compounded returns of 3-year term deposits from July 2003 to July 2013, after 15 per cent annual tax as for superannuation. Superannuation is the compounded net return of APRA-monitored funds over the same period. Net superannuation returns are post-tax. Tax rates applicable to superannuation funds are lower than the corporate rate (10 per cent for capital gains, and 15 per cent for income). ASX 200 returns are the annualised returns of the S&P ASX 200 Net Total Returns Index over the same period. The index is post-tax (at rates applicable as withholding tax from the perspective of a non-tax-treaty country; unfranked dividends 30%; interest 10%; royalties 30%). 28  
Source: APRA (2014a); S&P (2014); RBA (2014).

## Retail funds' list fees bear little relationship to costs

GRATTAN  
Institute

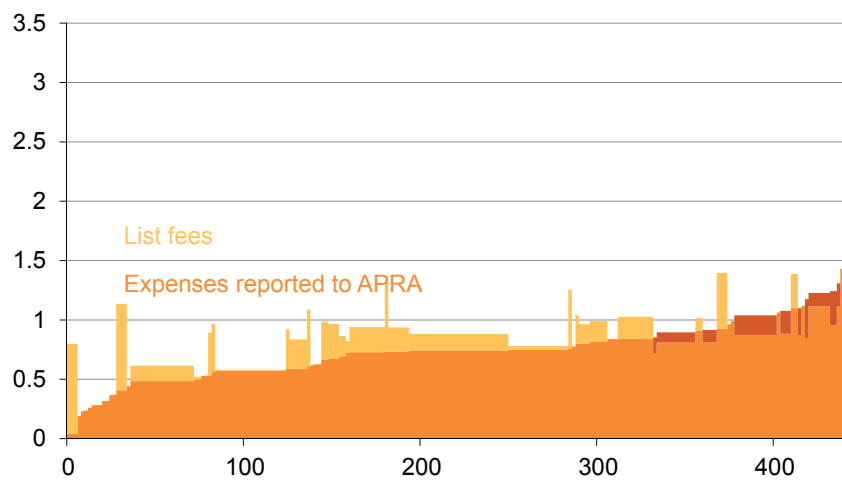
Fees vs. operating expenses for Australian superannuation fund  
Per cent



## Not-for-profit costs are typically close to reported expenses

GRATTAN  
Institute

Not-for-profit fund cost curve; list fees superimposed where known  
Per cent



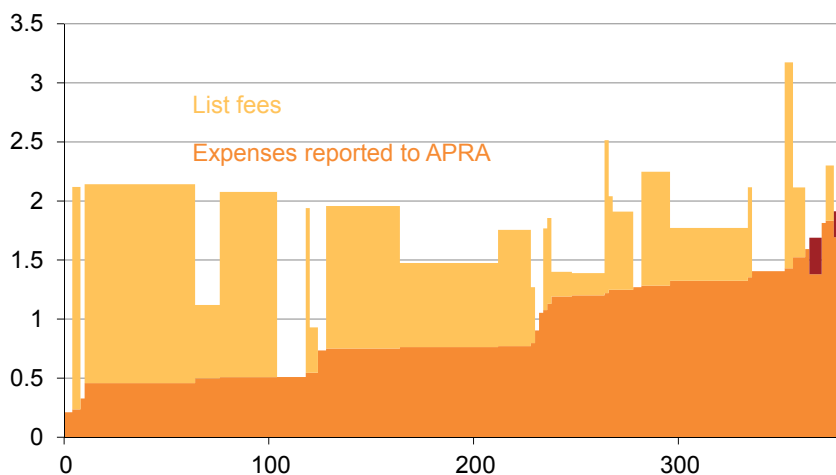
Note: Where list fees are lower than expenses reported to APRA the cost curve is the top of the dark range and fees are the bottom.  
Source: APRA (2014), SuperRatings (2014)

30

## For-profit list fees exceed reported expenses

GRATTAN  
Institute

For-profit fund cost curve; list fees superimposed where known  
Per cent



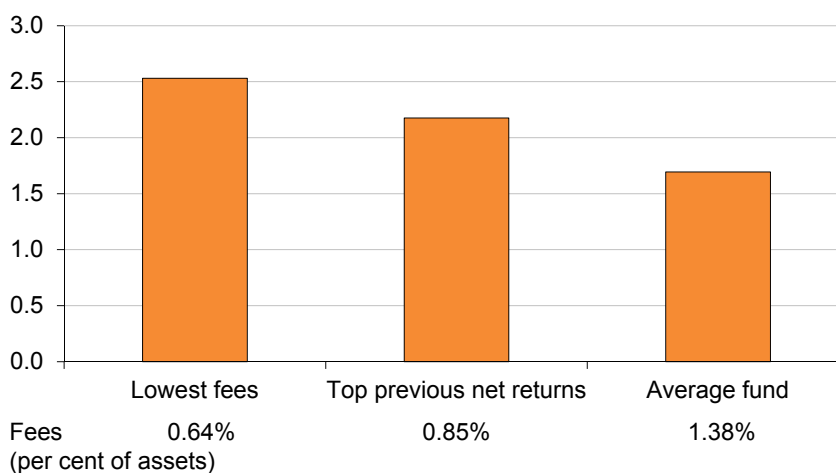
Note: Where list fees are lower than expenses reported to APRA the cost curve is the top of the dark range and fees are the bottom  
Source: APRA (2014), SuperRatings (2014)

31

## Fees have been better predictors of returns than previous returns

GRATTAN  
Institute

Subsequent returns of superannuation funds selected using three rules  
Per cent, real



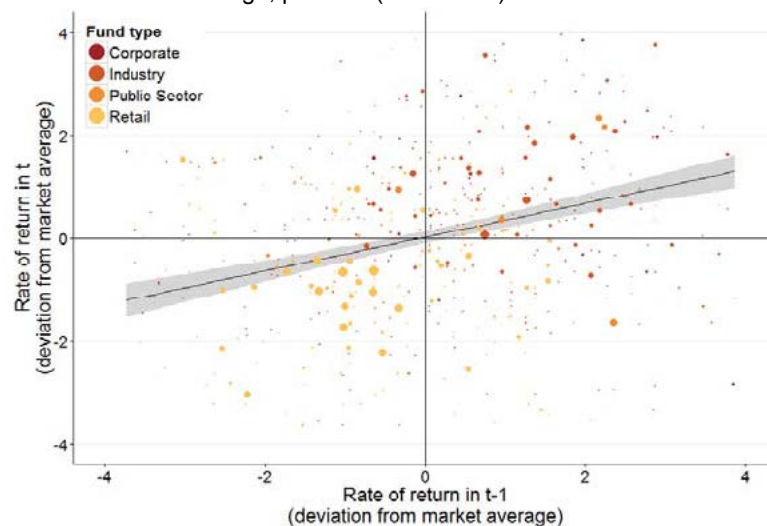
Note: In each year in the sample from 2006 to 2011, three sets of funds are compiled. The first are the 10 per cent of funds with the lowest fees. The second are the 10 per cent whose historical returns (for history back to 2004) are highest. The third is all funds. The orange bars indicate the average of the subsequent returns for all decision years.  
Source: Grattan analysis of APRA (2014a) & SuperRatings (2014).

32

## Net returns are weakly predicted by previous returns

GRATTAN  
Institute

Year-to-year persistence of net returns  
Deviation from average, per cent (2006-2013)



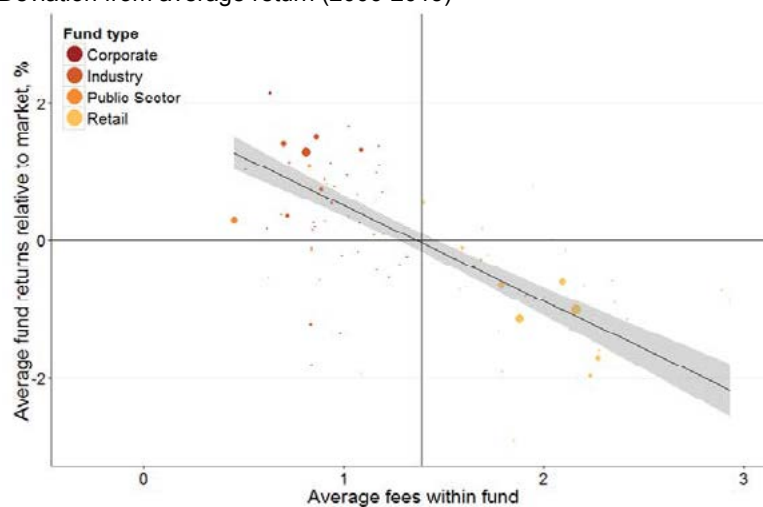
Source: Grattan analysis of APRA (2014a), SuperRatings (2014)

33

## Net returns are strongly predicted by fees

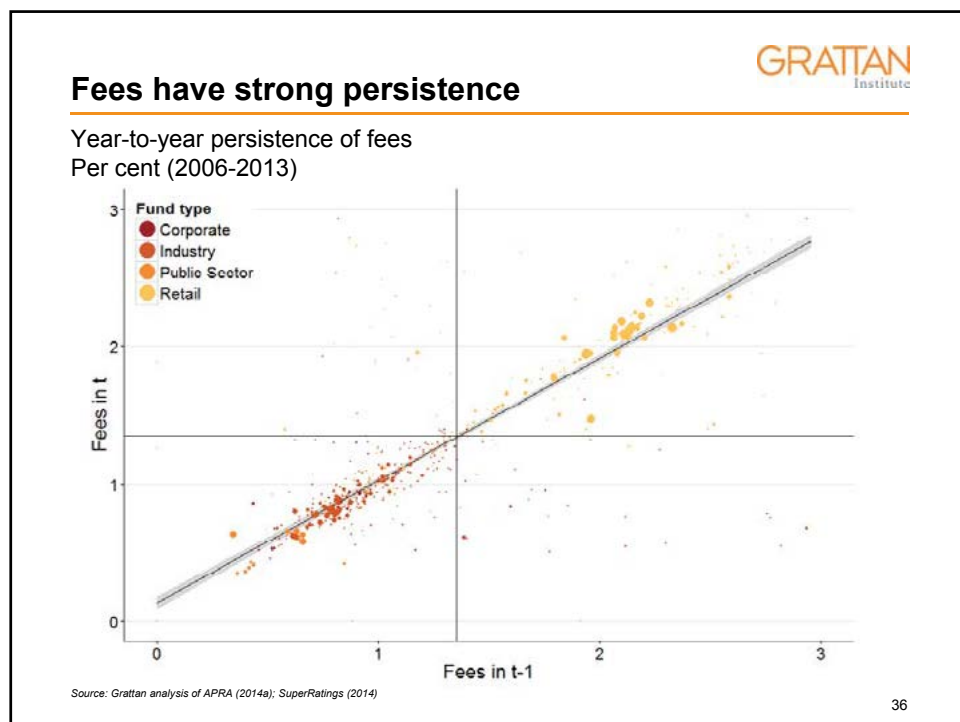
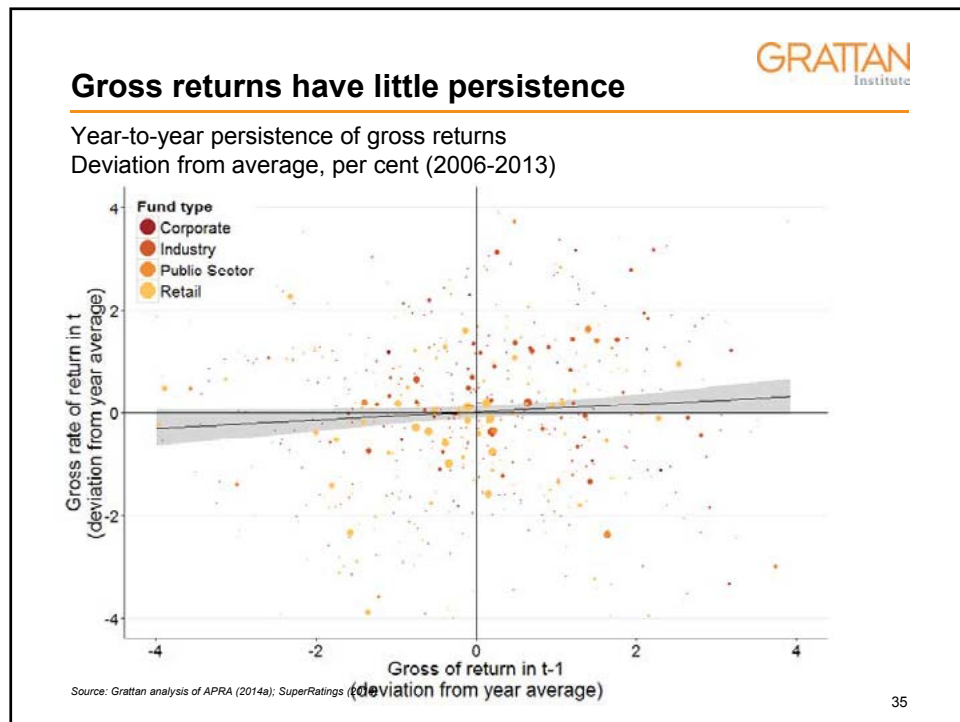
GRATTAN  
Institute

Average net returns: correlation with average fees  
Deviation from average return (2006-2013)



Source: Grattan analysis of APRA (2014a), SuperRatings (2014)

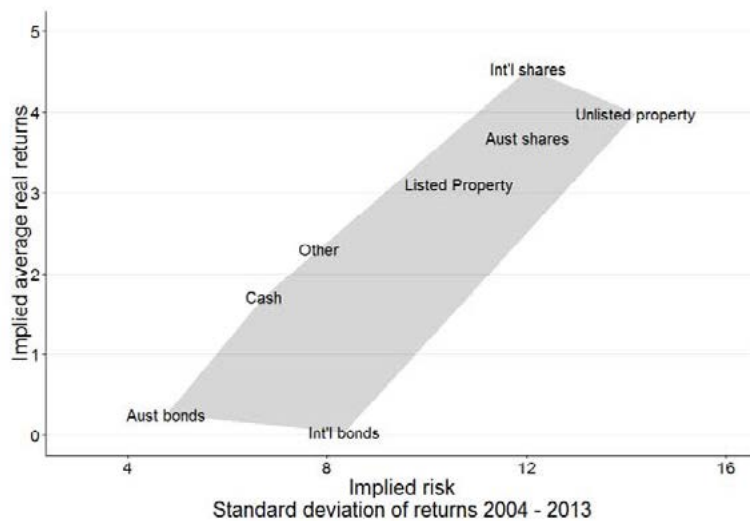
34



## Asset classes define risk-return options

GRATTAN  
Institute

Returns and risk of asset classes implied in net superannuation returns  
Per cent



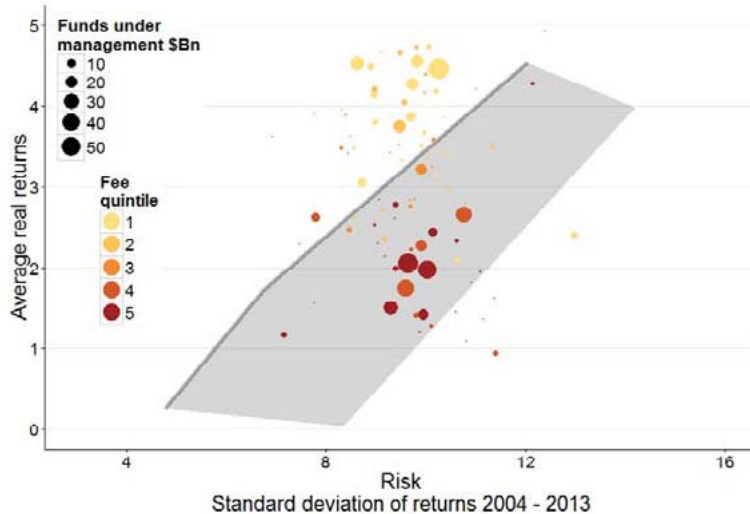
Source: Grattan analysis of APRA (2014a)

37

## High fee funds generate lower returns without reducing risk

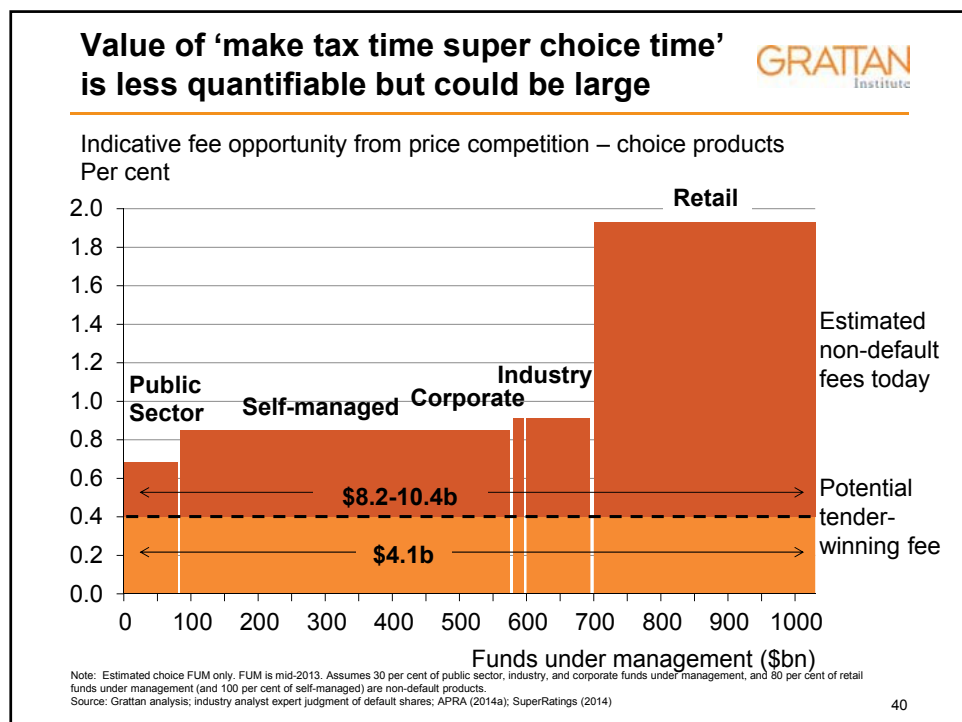
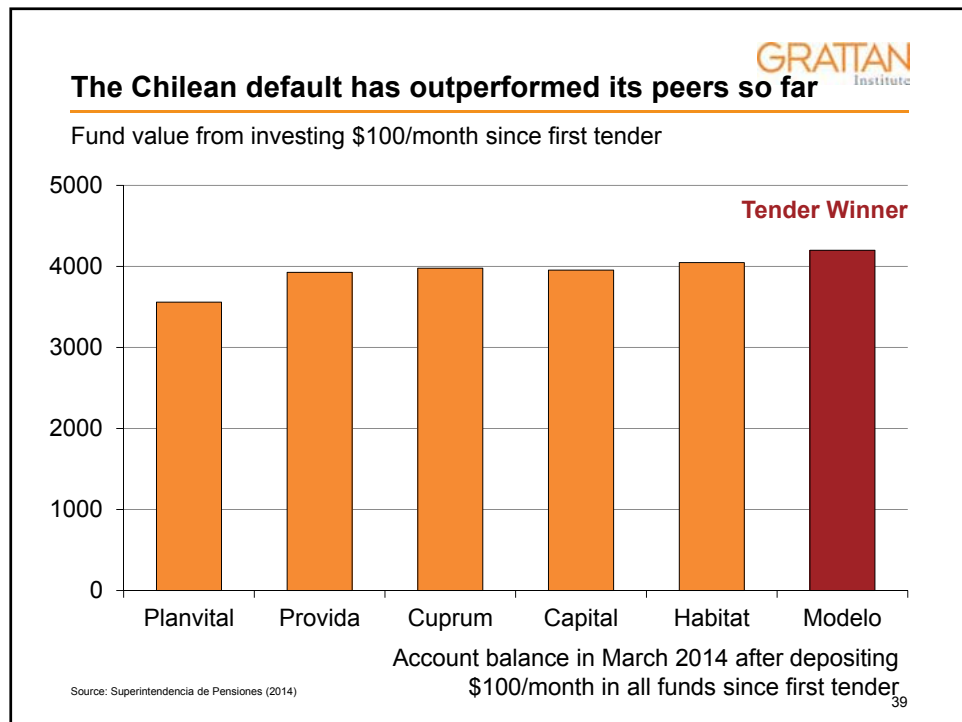
GRATTAN  
Institute

Returns and risk of superannuation funds by fee quintile  
Per cent; standard deviation (2004-2013)



Source: Grattan analysis of APRA (2014a); SuperRatings (2014). Q1 is the lowest-fee quintile of funds; Q5 the highest-fee.

38



## Portfolio Holdings Disclosure

*An empirical analysis of potential costs and benefits*

Dr. Zhe Chen (CIFR)  
Prof. David Gallagher (CIFR)  
Dr. Adrian Lee (UTS)

## Context

- **Treasury Consultation:** “Better Regulation and Governance, Enhanced Transparency and Improved Competition in Superannuation”
- Specifically - “Which model of portfolio holdings disclosure would best achieve an appropriate balance between improved transparency and compliance costs?”
- All submissions to Treasury were made publically available on Monday
- <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2013/Better-regulation-and-governance/Submissions>

## Potential Benefits and Costs

- **Costs**
  - Cost of compliance
  - Information leakage
  
- **Benefits**
  - Regulation
  - Transparency
  - Competition

## Our Study

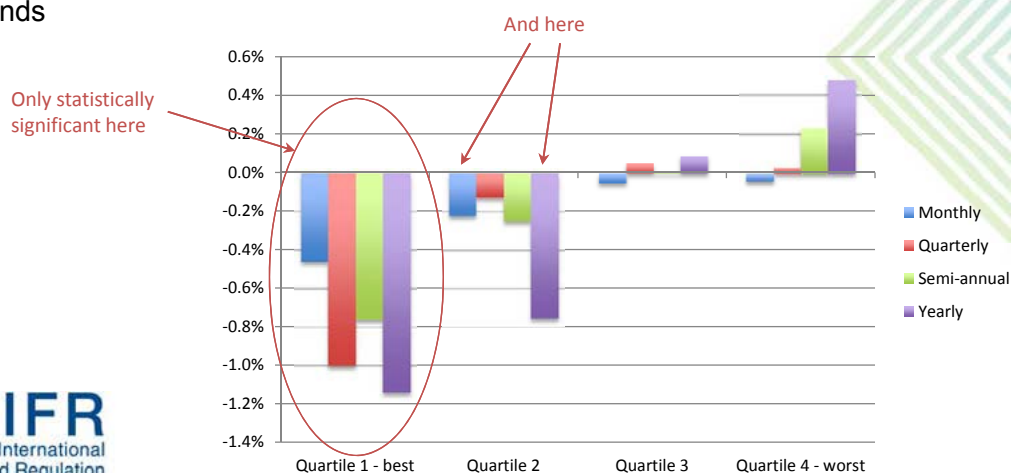
- *“Testing the Effect of Portfolio Holdings Disclosure in an Environment Absent of Mandatory Disclosure”*
  
- **Research Questions:**
  - How accurately does the performance (returns and volatilities) of disclosed portfolios reflect that of underlying portfolios?
  - How susceptible are funds to copycat behaviour if they are required to disclose holdings periodically?
    - Vary disclosure frequency
    - Vary lag between reporting date and disclosure date (the grace period)

## The Data

- Hand-collected trades and holdings data for 58 Australian Equities fund managers between 1996 and 2010
- Provides “true” representation of excess returns, inter-day volatility and idiosyncratic risk
- Without data like this, it is impossible to inform policy-making with evidence-based research

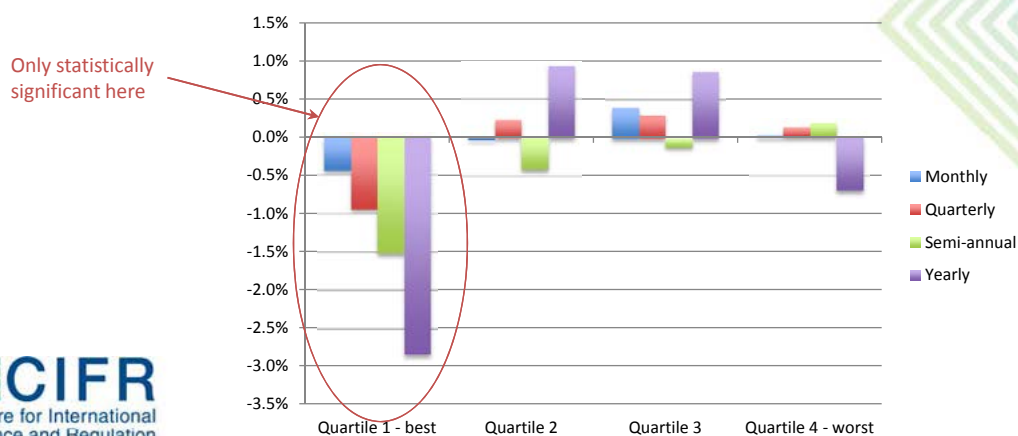
## Accuracy of Periodic Disclosure

- Periodic reporting understates the excess performance (alpha) of top quartile funds



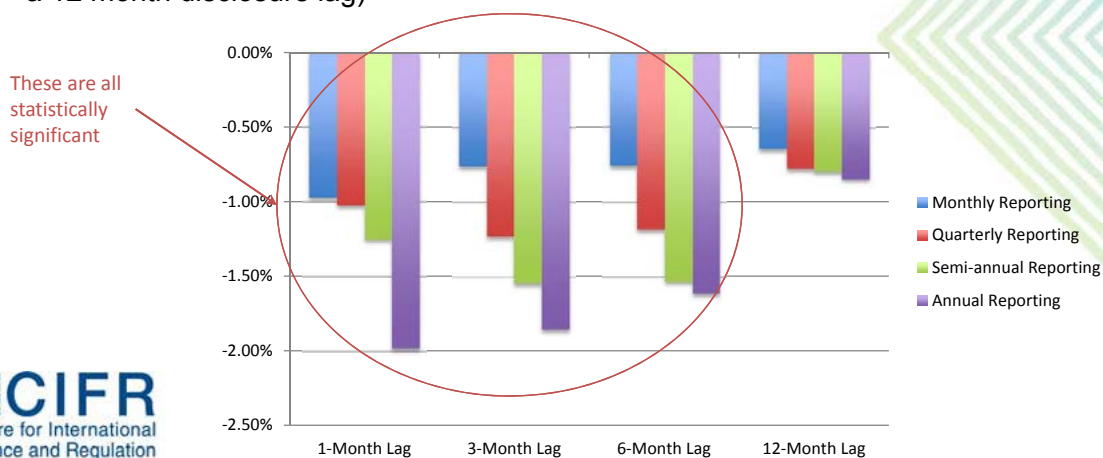
## Accuracy of Periodic Disclosure

- Periodic reporting also understates the idiosyncratic volatility of top quartile funds



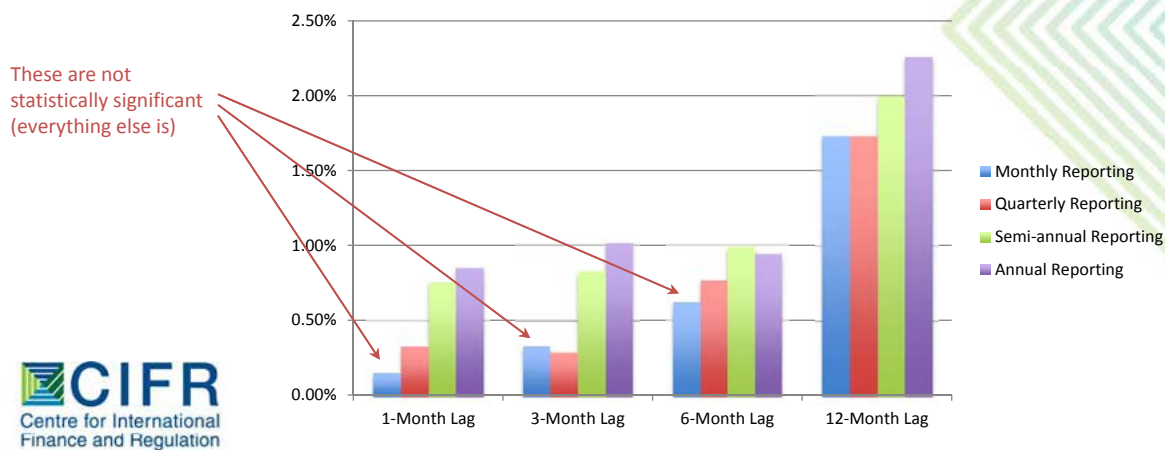
## Susceptibility to Copycat Funds

- Copycats of top-quartile funds underperform the underlying managers (except with a 12 month disclosure lag)



## Susceptibility to Copycat Funds

- Copycats following bottom-quartile funds outperform them (except when following very closely)



## Susceptibility to Copycat Funds

- To be fair, skilled fund managers are difficult to select for *ex-ante* (we've selected them *ex-post*)
- On average, the performance of copy-cat funds is not significantly different from underlying funds
  - This is consistent with previous studies (e.g. see Frank, Poterba, Shackleford and Shoven (2004), Verbeek and Wang (2013))

## Conclusions

- Periodic reporting may actually favour highly skilled fund managers because they generate alpha in the intra-reporting period – e.g. through signalling
- Information leakage may lead to greater competition at the lower performance end
- There's a difference between reporting and disclosure
  - Data need to be reported to drive academic research and evidence-based policy making
  - Disclosure treads a fine line between providing accurate representation and limiting information leakage

REGULATORY FRAMEWORKS FINANCIAL MARKETS  
 INTERNATIONAL INTEGRATION  
 CAPITAL MARKETS  
**SYSTEMIC RISK** RISKS GLOBAL  
 MANAGING SYSTEMIC FINANCIAL  
 RISK TRANSMISSION SYSTEM  
**FINANCIAL** MARKET QUALITY  
**MARKET** MEASUREMENTS  
 PAYMENT SYSTEMS  
 INFORMED REGULATION  
 LEGISLATION, SELF-REGULATION CODES  
**REGULATORY SYSTEM**  
 ARCHITECTURE REFORM  
**MARKET AND**  
**REGULATORY** PROTECTION  
**PERFORMANCE** CORPORATE  
 EFFECTIVE FINANCIAL CONSUMER BONDS  
 ENFORCEMENT EXPERIENCE, PRUDENTIAL  
 AND ACCOUNTING STANDARDS  
**SUPERANNUATION**

**DEVELOPMENTS**  
 AUSTRALIA  
 FINANCIAL  
 SERVICES HUB  
 MANAGED FUNDS  
 NEW MARKETS  
 INVESTOR PROTECTION  
 MARKET AND REGULATORY PERFORMANCE  
 INNOVATION  
 INTEGRITY

PRODUCTS  
 SERVICES  
 COUNTERPARTY  
 RISK  
 MARKETS  
 TECHNOLOGIES  
 COMPLEXITY  
 OUTSOURCING  
 LEGISLATION, SELF-REGULATION CODES



Centre for International  
 Finance and Regulation

**CIFR**

Towards Financial System Integrity