SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

ANZ
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EXECUTIVE SUMMARY

The Inquiry has been asked to examine how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.

The Australian financial system has, in the past, delivered lower costs, innovative services and wide access to products for customers. It has proved resilient, competitive and adaptable despite the Global Financial Crisis (GFC) and failures of a small number of financial institutions. Markets for banking and financial services operate efficiently with minimal barriers to entry and many different providers offering products at competitive prices.

The regional growth opportunity

The massive growth of Asian economies and their financial systems will be a transformational change affecting the next generation of Australians. Asia will account for 50 per cent of global GDP by 2050. Financial markets will change as Asian financial institutions play a much stronger role actively managing large stocks of savings and investments.

We believe the Inquiry can support the development of a more internationally competitive and oriented financial sector, allowing Australia to realise the full benefits of the regional opportunity.

Australia can increase national economic and employment growth if our businesses and financial institutions can operate within Asian markets on a competitive basis. We can benefit by providing services and accessing larger pools of capital. Taking full advantage of the regional opportunity can boost national income while helping to meet the growth, economic diversification and demographic challenges facing Australia.

To realise the Asian opportunity, policymakers and regulators should take greater account of the economic and competitiveness implications of decisions, in addition to considering system stability and consumer protection.

The impact of regulation and policy changes on the international competitiveness of Australian financial institutions and their customers should be reviewed. Hurdles to offshore competitiveness, such as adverse capital treatment of trade finance and equity investments, should be changed.

Offshore investments and financial flows should receive competitive taxation treatment to make Australia an attractive base for developing international financial services. Dividends from offshore profits should not be subject to full Australian tax as well as being taxed in the location in which the profits were derived.

Understanding of the role and importance of offshore business and Australia's outbound investment should be improved and regular statistics produced.

Australia can be a constructive partner for the further development of Asia's financial system. We can assist Asian economies by supporting the deepening of Asian financial markets, offering skills where appropriate, and continuing efforts to reform markets.

Efficient funding and strong credit management

ANZ considers that markets for bank funding operate efficiently and there is no intervention required to facilitate the ongoing funding of Australia's economic growth.

The structure of banks' balance sheets and fund profiles are largely a function of management choice, driven by a combination of strategy, market positioning and financial considerations. ANZ's funding is well spread by type of deposit, customer, geographic market and tenor. It is flexible and cost effective while retaining safety and liquidity.

ANZ's Board of Directors and Management team are responsible for the prudent operation of the bank and balancing risk with shareholder returns. ANZ has strong capital and liquidity management and undertakes extensive contingency and risk planning under Australian Prudential Regulation Authority (APRA) supervision.

ANZ funding is well spread by type of deposit, customer, geographic market and tenor, and we believe that markets for bank funding generally operate efficiently. Offshore borrowing by banks improves liability tenor and diversification. This funding is under contract and hedged, and arguably more stable than deposits.

Since the GFC, demand for offshore funds from Australian financial institutions has reduced significantly. As resource industry investment moves to production and superannuation savings increase, Australia may not require the same level of offshore funding as before the GFC.

Superannuation funds are substantial equity and debt investors in Authorised Deposit-taking Institutions (ADIs). While increased investment in fixed interest securities by superannuation funds will be welcomed, an efficient market-based approach is needed.

Stability and strength of the financial system

ANZ considers that the stability framework that has been put in place is appropriate and does not require material change.

Australia had a strong financial structure and system prior to the GFC, supported by prudent bank management and a comprehensive regulatory framework. During the crisis, the Government provided assurance that deposits were safe and supported access to wholesale and securitisation markets.

Depositors' interests and the overall stability of the system have been protected, while avoiding incentives for imprudent risk-taking and minimising taxpayers' exposure.

Banks' actions and regulatory changes since the GFC have further strengthened an already strong Australian financial system. Regulatory changes include the Basel III capital and liquidity increases, the Reserve Bank of Australia (RBA) Committed Liquidity Facility (CLF), the Financial Claims Scheme (FCS), derivative reforms, new resolution powers and new consumer protection laws. Further regulatory change should be put on hold until a full assessment of the impact of recent regulatory imposts is undertaken.

One specific proposal which has emerged post the GFC that needs to be rejected is the argument that banks would be made 'much safer' at essentially little or no economic cost by having them hold far more capital and, as a result, rely less on debt funding to finance economic activity. In practice, the effect of further increases in ADI capital would likely lead to increases in the costs of, or reductions in, bank lending.

Any decision to further 'buttress' the financial system should not just view regulations in isolation but take into account other structures, policies and practices operating to protect our system from undue risk.

The FCS creates a level playing field for deposits, benefiting smaller banks. Large banks are not afforded protection from failure. Large banks' lower costs of funds and higher market ratings reflect their strength, diversification and management.

Wide access to services

Customers have access to a wide range of services. ANZ is a strong lender for housing and to small business. We have developed new low-cost superannuation products, play a strong institutional finance role, and have innovative approaches to financial literacy.

Rates and prices for our products and services are set taking into account customer needs, funding costs (including deposits, wholesale funding and shareholder capital), credit risk and competition. Since the GFC, risk premiums have generally risen, in response to a more cautious stance of savers and investors, leading to increases in bank funding costs and pricing. Depositors have benefited from higher returns.

ANZ is a major lender to small and medium businesses, including providing unsecured loans, and we are growing our share in these markets. The small business sector could be supported by improving its financial management capabilities and more disaggregated statistics on finance to business. Availability of non-bank funding of entrepreneurial activity and equity for small business is an area for further review. Importantly, there is no rationing of finance to the small and medium business sector and banks have significant capacity to meet increased need.

We are positive about the outlook for farming and agricultural businesses. Demand for agricultural commodities in the growing Asian middle class could see Australian agricultural exports increase to at least AUD73 billion per annum by 2050. Banks will continue to underpin lending in the agricultural sector, but other forms of investment may be needed as well to support these sectors.

Private funding of public infrastructure is affected by issues such as the impact of regulation on long-duration lending and investments, and management of demand, refinancing and project risk. An improved long-term debt market would support development of infrastructure and products for an ageing population, such as annuities.

Competition benefits returned to customers

ANZ competes strongly in the markets in which it operates. Our aim in consumer and business banking is to grow more quickly than the financial system as a whole in a prudent manner, balancing risk and return and maintaining our asset quality.

Analysis of the banking sector over the last 10 years shows bank customers have been the principal economic beneficiaries of competition in banking.

A key economic indicator is net interest margin (NIM), reflecting the difference between costs to borrow and interest paid to deposit holders. NIM has trended down over the long term, even though it increased slightly during the GFC as risk was repriced. Bank fees paid by households have declined despite increasing numbers of customer transactions.

Bank equity levels have increased, meeting regulatory requirements. Bank profits have increased in line with balance sheet growth. The rate of return on shareholders' equity has declined since the GFC reflecting competitive activity and the requirement for banks to hold more capital.

Productivity is an important indicator of market efficiency. Australia's financial and insurance services sector has the second highest productivity growth of the economic sectors identified by the ABS over the last 10 years.

An open market should continue to be the primary mechanism for maintaining an efficient, competitive financial system. Increasing the international competitiveness of the financial system and promoting funding diversity will be the most effective means of continuing to deliver benefits to customers.

Innovation

ANZ welcomes digital enablement and competition to drive innovation and improve the range, quality and cost of financial services. ANZ accords high priority to remaining at the forefront of technological innovation to better service customer needs.

Regulatory obstacles to digital uptake should be reviewed and the framework will need to adapt to innovative services. Governments should be encouraged to address inconsistencies between national laws restricting cross-border provision of services. Improved and more practical disclosure regulation is needed for digital services. The growth of alternative services should be monitored to ensure that prudential safeguards, system stability and security are not compromised.

Financial institutions and governments should continue work on cyber-security. Improving secure verification and authentication solutions and reforms to encourage sharing of information about criminal behaviour are priority areas.

More effective regulation

The Australian regulatory model establishes each agency as an independent body focused on its particular objectives. The Council of Financial Regulators (Council), comprising the RBA, APRA, the Australian Securities and Investments Commission (ASIC) and Treasury, has proved an effective peak coordination body for the Australian financial system. The present arrangements could be enhanced:

- Mechanisms are needed to provide guidance from government to regulators on the appropriate balance between broad economic outcomes, system stability and consumer protection.
- A more formal approach should be considered for coordinating macroeconomic and monetary policy with bank prudential regulation as macroeconomic and monetary policy plays an important role in financial system stability.
- Access to high quality commercial and economic advice and expertise to assist regulators in carrying out their functions should be encouraged.

Since the GFC, banks and other financial institutions have implemented a massive program of regulatory change including Basel III and other G20 changes, Competitive and Sustainable Banking System Package, *National Consumer Credit Protection Act 2009* (NCCP), Future of Financial Advice (FOFA), MySuper and the US *Foreign Account Taxation Compliance Act 2009* (FATCA). These changes should be completed, bedded down and their impacts assessed.

There are opportunities to learn from this period of extensive change. Improving regulation in the future requires:

- Ensuring that subordinate regulation is consistent with case law, the *Corporations Act 2001 or* other laws, particularly in relation to the responsibilities of Boards and managements.
- Better assessment of the benefits, costs, time frames and complexity of changes, including the interaction between prudential regulation and existing taxation, securities, corporate and solvency laws.
- Increased planning of, and reporting on, regulatory changes, and clarity about the role of different agencies. An annual assessment by the regulators or an independent body should be undertaken to test the regulation's efficacy and impact on the market.
- A continued focus by the Australian Government on managing the implementation of cross-jurisdiction regulation.

RECOMMENDATIONS

Regional opportunity

1. Greater priority should be given to the financial system's potential to generate economic and employment growth by supporting the development of Australian businesses offshore.

2. Prudential regulation should be reviewed with the goal of improving the international competitiveness of financial services and more accurately reflecting risk in regulatory requirements. Hurdles to competitiveness, such as excessively conservative treatment of equity investments and trade finance, should be addressed.

3. New regulatory imposts should be halted while a more considered cost benefit analysis of the impact of current regulatory changes is undertaken. Importantly, this analysis should take into account the protections that are already embedded in the existing policy and economic frameworks operating in Australia.

4. The Inquiry should review the impact of taxation on the international competitiveness of Australian financial services. This should be considered from the perspectives of developing strong offshore businesses and provision of services from within Australia.

5. A regular report should be developed on Australia's relative performance in developing offshore businesses.

6. Priority should be placed on reciprocal market access in offshore jurisdictions via bilateral and multilateral agreements in the Asia Pacific.

Funding and risk management

7. Superannuation funds should be managed in the best interests of members and fund managers held accountable through market mechanisms. Any proposals to direct Australian superannuation investment into specific sectors or for particular purposes should be rejected.

8. Markets for bank funding operate efficiently and there is no intervention required to facilitate the ongoing funding of Australia's economic growth. The Inquiry should review with industry practitioners the operation of offshore funding with a view to improving understanding of its benefits and risks.

System stability and strength

9. Decisions about proposals to increase prudential or similar regulation should be preceded by assessment of existing structures, policies and practices.

10. The present ex post funding of the FCS by ADIs should be retained as the most efficient mechanism.

11. ANZ considers that the stability framework that has been put in place is appropriate and does not require material change. Implementation of appropriate macro-prudential policies at a national level, combined with close risk supervision and effective resolution regimes, is the appropriate policy.

12. The Inquiry should recognise that it is not efficient for individual ADIs to hold buffers against extreme system risk. The framework for managing such extreme risk should be reviewed.

13. The benefits of Advanced Internal Ratings-based (AIRB) accreditation should reflect the benefits of better risk management enabled by AIRB models. Changes to this framework should not be made to achieve policy objectives such as support for a particular sector.

Access to financial services

14. The Inquiry should endorse the importance of improving financial literacy as a means to equip people to make better choices themselves, and as a complementary and worthwhile approach to consumer protection regulation.

15. The Inquiry should consider how the full range of financial services including bank lending, equity and non-bank funding can support entrepreneurial activity and business development.

16. A deeper long-term debt market should be encouraged to assist financing of infrastructure and development of long duration products such as annuities.

17. All APRA-approved, MySuper-compliant products should be able to compete equally in the default superannuation market.

18. The Inquiry, with the assistance of industry and regulators, should assess the operation of life insurance markets with a view to improving the affordable provision of services.

Competition

19. An open market should continue to be the primary mechanism for maintaining an efficient, competitive financial system. Improvements to retail bond markets and removal of interest withholding taxes would promote efficient competition.

Innovation

20. The policy framework should support the growth of innovative services subject to appropriate regulatory safeguards.

21. The growth of alternative electronic payment systems and virtual currencies should be monitored to ensure that the stability and security of the financial system is not compromised.

22. Where innovative service providers undertake prudentially regulated activities, appropriate safeguards should be put in place. For example, if new digital payment providers in effect accept deposits, they should be subject to the same requirements as existing deposit-taking institutions.

23. The Inquiry should seek out examples of specific regulatory barriers and policy gaps affecting the development of online financial services. It should consider best practice approaches to dealing with complex issues in migration to digital services.

24. Improving mutual recognition or harmonising regulation of cross-border information flows, in a manner consistent with protection and security of customers, should be a policy priority.

25. The Inquiry should seek examples of, and consider the role of, taxation, in impeding development of more efficient models of service delivery.

26. Banks and government need to continue to work together to improve secure verification and authentication solutions.

27. The Inquiry should review current arrangements for sharing intelligence between government and business with a view to reducing fraud.

28. Education of the community about fraud risks and preventive measures should continue to be a priority.

Policy and regulatory processes

29. Mechanisms should be considered to provide guidance from government to regulators on the appropriate balance between broad economic outcomes, system stability and consumer protection.

30. A more formal approach could be established for coordinating macroeconomic and monetary policy with bank prudential regulation.

31. Formal arrangements should be put in place to ensure all regulators have access to high quality commercial and economic advice and expertise.

32. Prudential regulation should be consistent with case law, the Corporations Act 2001 or other laws, particularly in relation to the responsibilities of Boards and managements.

33. Raising awareness of the level of protection for different types of financial products through regulator statements and continuing public education is important.

34. Assessments of the benefits, costs, implementation time frames and complexity need to be addressed before proceeding with regulatory change. Practical business issues and interaction between prudential, taxation, securities and corporations regulation need to be taken into account.

35. Treasury or one of the existing agencies should be appointed as the lead for coordinating cross-agency regulatory changes. A lead agency should develop and report on timetables for, and outcomes from, regulatory changes.

36. The important role of Government in managing implementation of international regulation should be supported and strengthened

1. REGIONAL OPPORTUNITY

KEY POINTS

- Strong and sustained growth of Asian economies will be the most important transformation affecting the next generation of Australian businesses and communities. ANZ expects Asia's share of global economic activity to rise to 35 per cent in 2030 and be over half by 2050.

- Asian financial markets will take on financial intermediation roles now largely carried out in Western developed economies. Asian markets will move to a central place in global flows of finance, with Asian countries competing to promote their cities as financial centres.

- ANZ's 'super regional' strategy uses the strength of our Australian and New Zealand businesses and connectivity across the Asia Pacific region to better meet the needs of our customers and to capture the banking opportunities linked to fast-growing regional capital, trade and wealth flows.

- The Inquiry can position Australia to take advantage of this opportunity emerging on the nation's doorstep. Australia's financial system, businesses and consumers can benefit from access to a larger pool of capital and businesses' ability to operate within the wider market on a globally competitive basis. Our economy and employment can be stronger and more diverse.

- To realise the Asian opportunity, policymakers and regulators should take greater account of the economic and competitiveness outcomes of decisions, in addition to considering system stability and consumer protection.

    - Regulators must evaluate the impact of regulation on the international competitiveness of Australian financial institutions and their customers.

    - Hurdles to offshore competitiveness, such as excessive capital requirements for trade finance and non-recognition of offshore equity positions, should be changed.

    - Offshore investments and financial flows should receive competitive taxation treatment to make Australia an attractive base for developing international financial services. Dividends from offshore profits should not be subject to full Australian tax as well as being taxed in the location in which the profits were derived.

    - Understanding of the role and importance of offshore business should be improved and regular statistics produced.

- Australia can be a constructive partner for the further development of Asia's financial system. We can assist Asian economies by supporting the deepening of Asian financial markets, offering skills where appropriate, and continuing efforts to reform markets.

ANZ'S STRATEGY

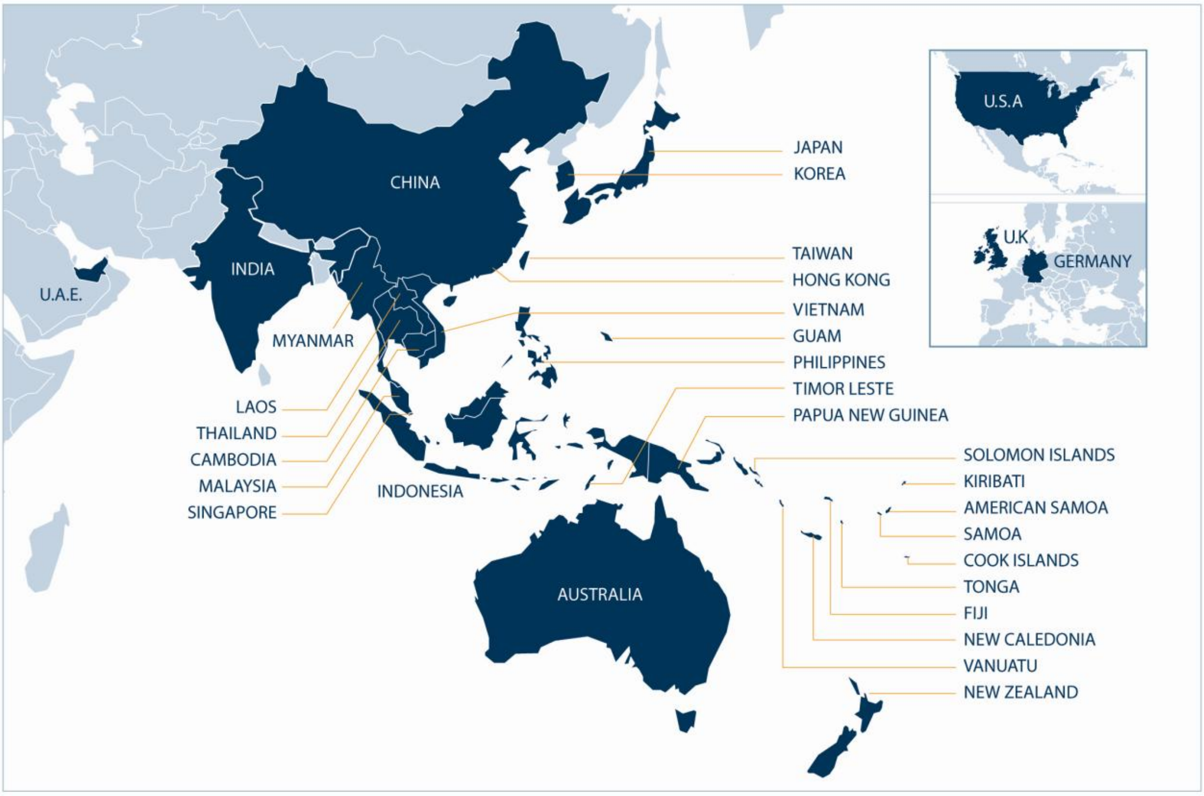
ANZ aims to build on our position in core Australian and New Zealand markets and to grow our business in Asia through our super regional strategy. We use the strength of our Australian and New Zealand businesses and connectivity across the Asia Pacific to meet the needs of our customers and to capture the banking opportunities linked to regional capital, trade and wealth flows.

In Asia, we focus on corporate and financial institutions in countries connected to our core markets through trade and capital flows, supported by our Asian retail branch network. Across the ANZ network, we share common processes, products and services designed with our customers in mind and to reduce costs, complexity and risk.

ANZ provides a broad range of banking and financial services to retail and business customers. We employ over 47,000 people worldwide, 21,000 of whom are employed in Australia. Within Asia, ANZ is represented in Cambodia, China, Hong Kong, India, Indonesia, Japan, Laos, Malaysia, Myanmar, the Philippines, Singapore, Taiwan, Thailand, Vietnam, and South Korea. ANZ is also represented across the Pacific in American Samoa, the Cook Islands, Fiji, Guam, Kiribati, New Caledonia, Papua New Guinea, Samoa, the Solomon Islands, Timor Leste, Tonga and Vanuatu (see Figure 1.1).

Our super regional strategy is an important, practical means to support the international growth of Australian businesses. We directly support trade and manage risk through our capabilities and on-ground presence. Indirectly, we transfer skills and knowledge to customers assisting them to develop their businesses.

FIGURE 1.1 COUNTRIES AND MARKETS IN WHICH WE OPERATE



Source: ANZ

THE REGIONAL GROWTH OPPORTUNITY

Australia faces challenges over the short to medium term. The Federal budget is constrained while expenditure is increasing as the population ages. Global economic growth rates have reduced, markets are still subject to volatility and Western governments carry high levels of debt.

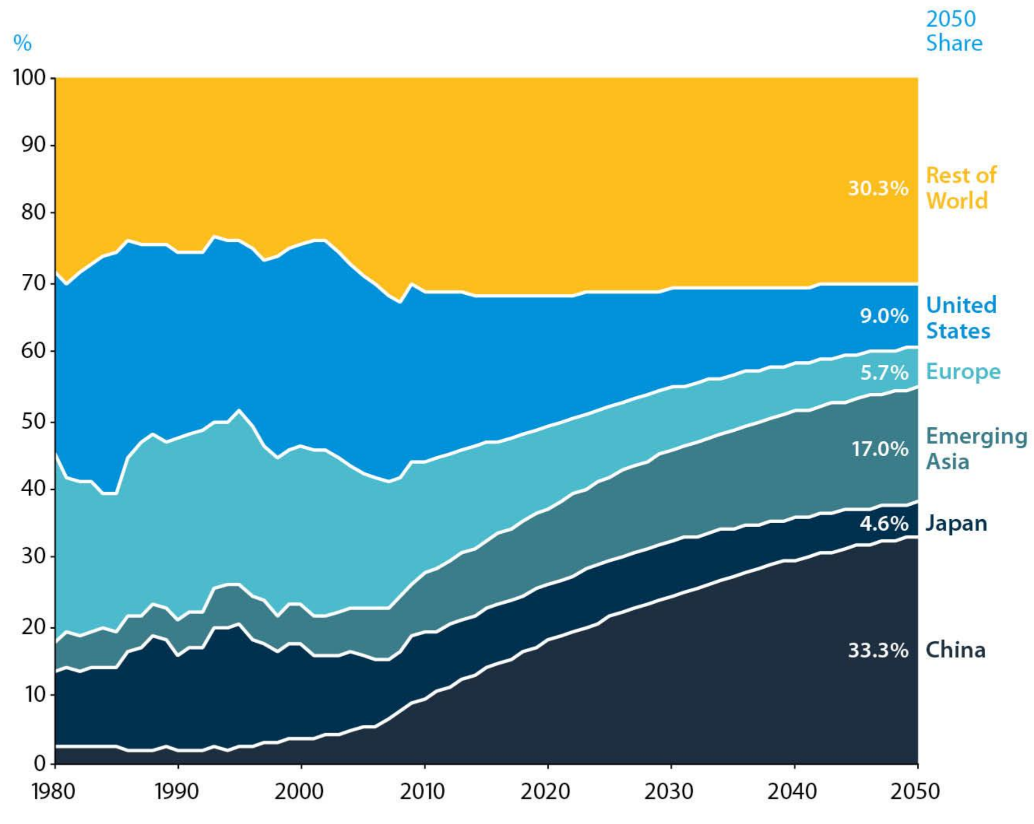
In the past, the Australian economy has met such challenges. The economy adapted to international financial market liberalisation and benefited from increased access to, and competition in, financial markets. Australia's economy demonstrated resilience during the external shock of the GFC.

The issue for the Inquiry is how the financial system can improve the economy's ability to adapt to meet future challenges. The financial services sector is not just an important source of offshore earnings. Banks must fund a broad range of businesses diversifying and strengthening the economy.

Australia's growth is being driven by the urbanisation and industrialisation of Asia. Strong growth in Asia has boosted demand for Australian-produced commodities. The initial impact has been an 82 per cent rise in the terms of trade from 2003–04 to its peak in September 2011.[1] A surge in investment in the resource sector followed as companies sought to meet demand through increased production capacity.

Asia's economy now accounts for a quarter of global economic output, up from 17 per cent two decades ago. ANZ expects Asia's share to rise to 35 per cent in 2030 and be over half the world economy by 2050.[2] The US and Europe currently account for around half of global economic output and will likely account for a quarter of global GDP by mid-century (see Figure 1.2).

FIGURE 1.2: GLOBAL ECONOMY BY REGION, 1980 TO 2050



Source: CEIC and ANZ Projections.

High economic growth in Asia, however, has not yet been accompanied by a deepening of the financial system in some countries. These countries have relatively closed and highly regulated financial sectors. Central banks play a disproportionate role in some markets and exchange rates are highly managed.

An efficient, competitive and transparent financial system is critical to the development of a high-income economy. It sustains rising middle classes and their aspirations for housing, education, health services and retirement savings. Businesses of all sizes need

[1] Michael Plumb, Christopher Kent, and James Bishop, *Implications for the Australian Economy of Strong Growth in Asia*, Reserve Bank of Australia (RBA) research discussion paper, March 2013.

[2] "Caged Tiger: The Transformation of the Asian Financial System", *ANZ Insight*, Issue 5, March 2014.

access to capital and modern financial management. A modern financial system improves the lives and economic welfare of communities in underdeveloped areas.

ANZ believes that in time, countries with developing financial systems will reform and open up the sector to deliver benefits to their societies. It is likely that other reforms will accompany this, such as improving legal and governance structures, political freedoms and pursuing ongoing economic reform. If Asian governments follow a path of continued economic and financial reform, maintaining strong growth rates and productivity, the Asian financial system could account for around half of the global system by 2030 (up from around 22 per cent now).

The rise of the Chinese Renminbi (RMB) capital markets is a clear example of this Asian financial transformation. ANZ expects the Chinese currency and capital markets to dominate regional financial markets within 15 years, with the RMB rivalling the USD as a global reserve currency.

Asian financial institutions are likely to become more important in global finance. China's banks, already some of the largest in the world, will increase their presence as they seek investment opportunities for Chinese savings in the world economy. There is strong potential for wealth management institutions to grow, initially in North Asia, and then throughout the region.

In the medium term, Asian growth is expected to create an infrastructure 'funding gap' particularly as European and, to a lesser extent, US banks withdraw from some markets. This provides an opportunity in relatively nascent Asian bond markets for Australian investors and financial institutions to fill the expected financing gap.

We expect rapid development of Asia's financial centres. Shanghai is likely to rival New York as a financial centre and will serve as an international hub. Singapore is likely to increase its importance given its critical role in South and Southeast Asia. Hong Kong and Tokyo will remain important and second-tier centres will emerge. Seoul, Mumbai and, potentially, Sydney could grow strongly.

Governance and financial regulation is important in mitigating risks in a large, open and sophisticated financial system. Institutions, such as independent central banks, will need to be strengthened. A strong regulatory and supervisory system is required, as well as wider legal and cultural features of a modern financial system.

The continuing development of Asian economies and financial markets presents a huge opportunity for Australia. Australian financial institutions and businesses can grow more quickly than would otherwise be possible and, in doing so, help address the growth, employment and fiscal challenges facing our economy.

AUSTRALIAN POLICY

The Australian model of an open market and a regulatory framework to maintain stability and protect consumers must continue to be the foundation for the financial system. The system has delivered lower costs benefiting savers and borrowers, offers wide choice, and has proved resilient.

Greater priority should now be given to the financial system's potential to generate economic and employment growth, particularly by supporting the development of Australian businesses offshore.

Multinational businesses increase employment, sales and capital expenditures in the home economy as a result of offshore activity.[3] They strengthen domestic growth,

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[3] See Gary Hufbauer, Theodore Moran, Lindsay Oldenski, and Martin Vieiro, *Outward Foreign Direct Investment and US Exports, Jobs, and R&D: Implications for US Policy*, Peterson Institute for International Economics, 2013.

contribute to the diversification of the Australian economy and improve international competitiveness. Australian companies operating offshore also offer opportunities for their people to develop skills and build their experience in Asia, an important means of retaining skilled workers in Australia and avoiding a 'brain drain'.

Recommendation

1. *Greater priority should be given to the financial system's potential to generate economic and employment growth by supporting the development of Australian businesses offshore.*

Financial regulation

ANZ believes the impact of regulation on the international competitiveness of financial institutions and their customers has received insufficient consideration in Australia's implementation of Basel III policies. We are concerned that the adoption of more stringent policy parameters is reducing the relative competitiveness of Australian banks and will affect economic outcomes and the cost of our services to customers.

- **Conservative approach to capital deductions and asset risk settings** – APRA has adopted stricter regulations than those proposed by the Basel Committee in relation to assets that are required to be fully deducted from capital and the risk weighting applied to assets. These stricter requirements result in lower notional capital ratios by ~200 basis points (bps) than would be the case under harmonised Basel III, thereby understating Australian banks' financial strength.
    - Lower 'reported' capital levels have required banks to detail the differences in treatment between jurisdictions. The Basel Committee and APRA have now proposed supplemental standardised reporting templates. This step forward is welcome as it potentially allows capitalisation rates to be compared more easily across jurisdictions. However, significant resources will still be required to analyse and explain the results. Differences in risk weighted asset settings are still be to be addressed.
    - More significantly, the stricter capital treatment by APRA lowers the capital buffer between the reported capital ratio and the explicit or implicit capital triggers in Basel III Tier-1 and Tier-2 securities at which those capital securities are written off or converted to ordinary equity. These lower notional capital buffers lower demand from, and increase credit margins charged by, international investors in Australian bank subordinated capital.
- **Capital deductions** – APRA requires all equity positions, including insurance subsidiaries and banking associates, such as ANZ's investment in Wealth subsidiaries and Asian partnerships in Indonesia, Malaysia and China to be fully deducted from capital. The Basel Committee and most other jurisdictions provide a threshold based upon 10% of the bank's own capital base before a capital deduction is required, with any amount subject to the threshold being risk weighted at 250%. The Basel III treatment reduces the capital allocation to ~25% of that faced by Australian banks, which affects international competitiveness for Australian banks to hold these assets.
- **Conservatism in Loss Given Default –** Credit risk is assessed using banks' quantitative models. A key parameter is Loss Given Default (LGD); that is the loss that would occur if a customer defaults on a loan. APRA informally requires a LGD assumption of greater than 60 per cent for unsecured lending to corporates. This is not supported by ANZ data nor other Australian bank data. ANZ understands that Asian banks typically use 45 per cent and the rate in the USA and Canada is approximately 45 per cent with some variation by loan. In the UK and Europe, the LGD varies by loan but it is typically between 45 per cent and 55 per cent. As APRA's assumption is not formally stated, it is difficult to compare the real risk of Australian

banks to their international peers. Use of a higher LGD assumption impacts small and medium businesses, corporate and multinational business lending, and, for typical loans to mid-sized corporates, can result in a 35 to 80 bps increase in funding costs relative to international peers.

- **Conservatism in Exposure at Default –** Estimated exposure in a company default is an important parameter in credit risk assessment. APRA implicitly requires Australian banks to set this at 100 per cent of the residual limit of lending to companies. ANZ understands that the median used for global banks is 50 per cent of residual limits. We believe that this lower figure is more appropriate given Australian banks' experience. Lending arrangements give the Bank an ability to wind back lending as a company weakens. For typical loans to mid-sized corporate, this approach can result in a 45 to 65 bps increase in funding costs relative to international peers.

- **Trade finance** – The conservatism in Loss Given Default, the conservatism in Exposure at Default and the regulatory treatment of enforcing a minimum tenor of one year for maturity when calculating capital, does not reflect the low risk, short tenor and self-liquidating nature of trade finance lending. International surveys and ANZ experience confirms this lending as low risk with losses on trade finance over the last five years comparable to Australian-based mortgages. Further, the transaction-based nature of trade finance provides strong risk mitigation as it is connected to traded goods linked to the borrower's core business. This leads to lower losses for export finance and lower drawings close to default. Competitor's regulators, particularly those based in Europe and the UK, recognise these low risk aspects of trade. In the current market, trade finance is more expensive for Australian banks than for competitor banks, placing Australian banks and, as a consequence, Australian businesses in a less competitive position. For a typical trade finance loan to mid-sized corporates, these regulatory treatments can result in a 25 to 50 bps increase in funding costs to customers, relative to international peers.

Recommendation

2. *Prudential regulation should be reviewed with the goal of improving the international competitiveness of financial services and more accurately reflecting risk in regulatory requirements. Hurdles to competitiveness, such as excessively conservative treatment of equity investments and trade finance, should be addressed.*

Post-GFC regulatory approach

The early and conservative implementation of the international regulatory agenda in Australia has been made easier by the strength of the sector. But the ability of the sector to absorb these new requirements should not, of itself, obviate the need for regulators to consider fully the wider implications and impacts.

There have been some attempts to judge the wider economic impacts of the wave of changes imposed on banks, and these estimates have represented the immediate costs of changes as minor.[4] For example, the IMF staff discussion note, *Estimating the Costs of Financial Regulation*, assumes that approximately half of the costs of increased regulation will be absorbed by improved bank productivity, capital 'mitigation' or other changes.[5]

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[4] See APRA, Regulation Impact Statement, *Implementing Basel III capital reforms in Australia*, 2012, p10: "APRA's view accords with that of the IMF in that the immediate costs are minor and outweighed by the benefits of maintaining an appropriately conservative level of banking regulation in Australia".

[5] Andre Oliveira Santos and Douglas Elliot, *Estimating the Costs of Financial Regulation*, IMF Staff Discussion Note, September 11, 2012. The Note adopts an interpretation of the Modigliani and Miller (MM) analysis that under specific conditions the weighted average costs of capital is not affected by the level of equity. It is a partial approach because the Note states that increased equity does affect a bank's costs but then it offsets

Given that many of these new requirements are only just being implemented or are yet to be implemented, it is likely that these assessments underestimate the full impact regulatory changes in Australia will have.

Recommendation

3. *New regulatory imposts should be halted while a more considered cost benefit analysis of the impact of current regulatory changes is undertaken. Importantly, this analysis should take into account the protections that are already embedded in the existing policy and economic frameworks operating in Australia.*

Competitive taxation treatment

Issues of international competitiveness and taxation have been considered extensively in Australia but have not resulted in material changes. None of the eight recommendations of the Johnson Report relating to taxation matters has been fully implemented.[6] Other reviews in 2003, 2006 and the 2010 Henry Tax Review also considered international competitiveness with few results.[7]

A particular concern is that aspects of Australia's taxation system place businesses operating offshore at a disadvantage and create incentives for more mobile businesses to move economic activity and even their Australian residence to other jurisdictions. This might be the case for financial services or intellectual property-based activities that do not have networks in Australia or other strong domestic links.

- **Full double taxation of offshore profits** – In most countries, profits earned offshore are typically taxed in the location where they are derived. When an Australian-based company pays post-tax profits earned offshore to its Australian shareholders, the dividends are subject to the full rate of Australian tax. In other words, offshore profits are subject to full rates of tax in the location where they are derived and also in Australia. In the absence of offsets from domestic franking credits, this results in an uncompetitive, high rate of tax on offshore profits derived by an Australian-based company. Other than New Zealand, no other OECD country taxes offshore profits earned by their multinational companies without partial or full recognition that the offshore profits have already been subject to tax. Recognition of tax paid on profits in other jurisdictions would remove a major competitive disadvantage faced by Australian businesses operating offshore.

- **Interest withholding tax** – Unlike most jurisdictions (eg, the US, UK, Singapore, Hong Kong) with which Australia competes for deposits, Australia subjects interest paid on deposits made by non-residents to a withholding tax. This can make it more costly for non-Australian banks to fund their Australian branches. Both the 2009 *Australia as a Financial Centre: Building on Our Strengths* report (the Johnson

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these costs by 50 per cent, as a MM pass through (p14). Real markets violate MM specifications in a number of ways including tax effects, guarantees for deposits, costs associated with raising funds and transaction costs. The MM thesis is erroneously used to argue that imposing higher levels of bank equity is costless. As well violating the specifications of the MM theory, these arguments do not take into account the broad range of regulatory measures already in place to mitigate risk and consequences of reducing the role of banks such as the growth of riskier alternative forms of finance.

[6] *Australia as a Financial Centre: Building on Our Strengths*, Report by the Australian Financial Centre Forum, November 2009. Three of the eight recommendations – considerations of dividends in the Henry Tax Review, removal of state taxes on insurance, and establishment of a task force to monitor changes – did not appear to have been taken up. The Board of Taxation completed a review on Islamic Finance in June 2011 with no subsequent action. A review of the Offshore Banking Unit regime has been deferred to 2016. Removal of a withholding tax on bank deposits was ultimately abandoned. Work has been carried out on an Investment Manager Regime and Collective Investment Vehicles without results to date.

[7] Board of Taxation, *International Taxation – A Report to the Treasurer*, February 2003; Australian Government, *International Comparison of Australia's Taxes*, April 2006; *Australia's Future Tax System Review* (Henry Tax Review), Report to the Treasurer, December 2009

Report) and the 2010 *Australia's Future Tax System Review* (the Henry Tax Review) recommended that this withholding tax be abolished.

- **Tax deductibility of Additional Tier-1** – The GFC and associated Basel III reforms significantly increased the volume and quality of core capital. ANZ's shareholder equity doubled between 2007 and 2013, and increased as a percentage of gross prudential capital from ~61 per cent to ~77 per cent. With less reliance on subordinated capital securities, most overseas jurisdictions, including most of Europe, United Kingdom, Singapore, Japan and New Zealand, have moved to permit Additional Tier-1 securities to be tax deductible. Australia should take the same approach to ensure Australian banks remain internationally competitive on pricing and access to financial markets.

Recommendation

4. *The Inquiry should review the impact of taxation on the international competitiveness of Australian financial services. This should be considered from the perspectives of developing strong offshore businesses and provision of services from within Australia.*

Recognising Australia's offshore businesses

Policy analysis and information on the offshore investment and earnings of Australian financial institutions and other businesses should be improved. Regularly published trade statistics do not measure offshore activity by Australian businesses. Understanding of the importance of outward foreign investment in Australia is limited.[8]

The most recent study on this issue stated that Australia's cross-border financial services exports, as reported by balance of payments statistics, were AUD1.3 billion in 2009–10.[9] It stated that the value of financial, insurance and pension services provided by Australian affiliates offshore, which is not regularly reported in statistics, was AUD35.1 billion. This indicates that most of the value of Australian financial institutions' contributions to exports and trade are absent from regular statistics. Without regular information on offshore activity it will be difficult to develop appropriate policies.

Recommendation

5. *A regular report should be developed on Australia's relative performance in developing offshore businesses.*

Benefits for domestic markets

Improving the international competitiveness of Australian financial institutions will have flow-on impacts for the competitiveness of the domestic market. For example, removal of interest withholding tax on deposits would allow offshore banks to compete more vigorously in Australia. Reducing the impact of prudential regulation on the competitiveness of Australian ADIs would lower costs to Australian customers.

Section 7 of this submission makes further suggestions about how the overall balance between economic outcomes, stability and consumer protection can be struck.

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[8] There is no Australian equivalent to the Canadian Conference Board's Outward Foreign Direct Investment (FDI) Performance Index. It notes that "FDI outflows open access to foreign markets and promote deeper integration into global supply and value chains, making an economy's firms more efficient and competitive. Capital-exporting countries receive repatriated profits, intellectual property royalties, and similar payments."

[9] See *Australia's Outward Finance and Insurance Foreign Affiliates Trade in Services*, Department of Foreign Affairs and Trade (DFAT), 2009–10, p. 7. The WTO classifies four modes of supply of services. 'Mode 3' is income from commercial offshore presence as distinct from 'mode 1', cross-border trade of services, and 'mode 2', services consumption while offshore, and 'mode 4', presence of natural persons offshore. Financial services export measurement excludes mode 3 even though this appears the most important mode.

DEVELOPMENT OF ASIAN FINANCIAL MARKETS

Australia can assist Asian economies by supporting deeper Asian financial markets, offering skills where appropriate, and continuing efforts to liberalise markets. Australia will maximise its opportunity if it is a constructive and positive partner.

Recent changes to global regulation, such as Basel III, are geared towards addressing issues that have arisen out of the global financial crisis in the US and, post-GFC, in Europe. Greater cooperation between Asia Pacific governments and regulators would give the region a stronger voice in shaping global regulatory initiatives. Mutual recognition or convergence of regulation will reduce the costs of doing business.

Recent experience with laws and regulations developed to respond to G20 commitments which have had a cross-border impact suggests that co-operation will be most effective if it starts at an early stage, prior to legislation being passed in the US and EU. This will allow Asia Pacific governments and regulators to align standards which are appropriate to the needs of the region with international best practice as it develops.[10]

Cooperation between governments, regulators and the financial services sector, and firm support of the APEC Finance Ministers is needed to ensure the Asia Pacific Financial Forum (APFF) defines an agenda which is achievable and can be implemented.

The Australian Government has been active in seeking improved outcomes for financial services liberalisation. Deregulation of the financial sector over recent decades has meant that impediments to international trade in financial services are relatively low among OECD countries. However, these impediments remain higher in many Asian countries.

ANZ's ability to expand its business has been impacted by restrictions. Examples include equity limits on foreign investment in local banks, limits on the number of branches and ATMs a foreign bank can own, requirements for pre-approval from the regulator for foreign banks to offer new products or services, and central bank approval of foreign bank personnel. ANZ continues to work actively with government ministers and DFAT on these issues.

Australia has a long record of opening its domestic financial services markets to offshore participants. There are few restrictions beyond complying with local regulatory rules. Australian authorities should continue to push for reciprocal market access in offshore jurisdictions via bilateral and multilateral agreements, particularly in the Asia Pacific, where Australia's trade and capital flows predominate.

Recommendation:

6. *Priority should be placed on reciprocal market access in offshore jurisdictions via bilateral and multilateral agreements in the Asia Pacific.*

[10] One of the lessons from the implementation of G20 commitments on financial reforms – such as the introduction of the US Dodd-Frank Act and European Market Infrastructure Regulation – has been the need for Asia Pacific jurisdictions to collaborate from an early stage to influence global standards. It will be difficult to persuade US and EU regulators (among others) to take into account Asia Pacific policy concerns on future initiatives after the policy and legislative direction has been fixed in their home jurisdictions.

2. FUNDING AND RISK MANAGEMENT

KEY POINTS

- ANZ considers that markets for bank funding operate efficiently and there is no intervention required to facilitate the ongoing funding of Australia's economic growth. The structure of banks' balance sheets and fund profiles are largely a function of management choice, driven by a combination of strategy, market positioning and financial considerations. ANZ's funding is well spread by type of deposit, customer, geographic market and tenor. It is flexible and cost effective while retaining safety and liquidity.

- Australia has long relied on capital inflows to underpin faster economic growth than could be supported by domestic savings alone. The mix of funding between private and public sectors and from foreign direct investment (FDI), equity, debt and capital markets has varied in response to market conditions. Inflows of foreign capital have responded to the attractiveness of investment in Australia's development and should continue to be encouraged.

- The structure of foreign capital inflows at an economy-wide level has changed since the GFC. Banks now play a more limited role. Looking forward, growing resource exports and growing superannuation savings may reduce the Current Account Deficit (CAD) and dependence on foreign capital inflows at the national level.

- Australia continues to have significant medium-term flexibility in how economic development is funded and financial markets have been able to accommodate changing economic circumstances.

- Offshore term borrowing by banks improves liability tenor and diversification of funding sources and can therefore improve the stability of a bank's funding profile. Currency hedging arrangements may also provide a liquidity benefit when the Australian dollar depreciates against other currencies.[11] In addition, offshore borrowing subjects the bank's financial standing to scrutiny and review by lenders.

- Superannuation funds are substantial equity and debt investors in ADIs. While increased investment in fixed interest securities by superannuation funds will be welcomed, an efficient market-based approach is needed. As the level of superannuation funds grows to be larger than the value of banks' deposits, strong, prudent and effective management and governance of the sector is essential.

- The Board of Directors and Management team of ADIs are responsible for the prudent operation of the bank and balancing risk with shareholder returns. ANZ has strong capital and liquidity management and undertakes extensive contingency and risk planning under APRA supervision.

- Robust credit management is a critical function in preventing bank failures. Credit risk is diversified across the countries and sectors in which ANZ operates.

CREDIT DEMAND

Demand for credit has moderated since the GFC. As shown in Figure 2.1, the ratio of credit to GDP increased from around 50 per cent in the early 1980s to around 160 per cent in 2007. Private sector credit growth slowed sharply after 2007, from around 15 per cent per annum to just 3.9 per cent per annum in 2013. As a result, after rising to 216

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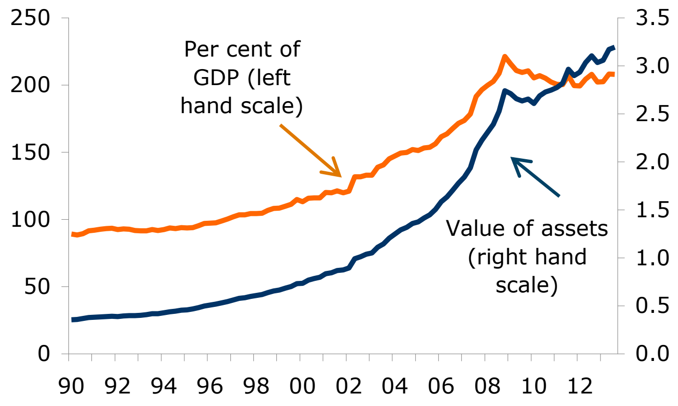
[11] ANZ fully hedges interest and foreign exchange exposures. The derivatives are subject to collateral agreements with counter parties. If the AUD falls, the collateral agreements mean that funds flow into ANZ. This means that even though the hedges are economically neutral, the bank's structural funding position improves with a decline in the AUD.

per cent of GDP in 2008, banking system assets have stabilised as a share of GDP. Bank assets were 208 per cent of GDP in 2013.

Australian households have reduced their debt appetite after the GFC, increasing savings and moderating household spending. Australia's household savings rate is currently at a little below 10 per cent, up around five percentage points since the onset of the GFC. Housing market conditions have improved recently and demand for new loans has strengthened. Customers have been repaying mortgages more quickly than required, reducing overall system credit growth.

The corporate sector remains a net contributor to the CAD, but the manner in which the corporate sector has funded investment has changed in recent years. Historically, strong business investment has been largely funded through intermediated credit. The resources investment boom, however, has largely been funded through mining company cashflows, with corporate sector debt and equity issuance making lesser contributions.[12]

FIGURE 2.1: ADI ASSETS HAVE STABILISED AS A SHARE OF GDP (ADI assets as a percentage of GDP (left), AUD trillion (right))



Source: ANZ, RBA, ABS

NATIONAL DEMAND FOR FOREIGN CAPITAL

Inflows of foreign capital have been a longstanding feature of the Australian economy, with national savings a strong 24 per cent of GDP but investment a stronger 28 per cent of GDP. Offshore investors have capitalised on the growth and development opportunities in Australia. This investment has boosted national economic growth and has been supported by all governments.

Funding for the resulting CAD has, however, changed significantly in recent years.

Prior to the GFC, the CAD was driven by banks' net borrowing and securitisation requirements (refer Table 2.1). Banks were able to use their scale and strength (balance sheets, ratings) to intermediate global wholesale liquidity at relatively cheap prices. From 2010, banks' funding mix changed with greater reliance on domestic deposits, as offshore funding costs rose and demand for offshore funding fell as a proportion of GDP.

Over 2010–11, government debt was the main component of offshore borrowings, as more debt was issued to fund expanding budget deficits. This has continued in 2012–13 but at a slower pace. From 2012 onwards, private non-financial corporations have increased their direct offshore borrowing as monetary stimulus programs substantially

[12] See Ivailo Arsov, Ben Shanahan and Thomas Williams, RBA *Bulletin,* March Quarter 2013, "Funding the Australian Resources Investment Boom". They note funding for mining investment has overwhelmingly come from the profits generated by these companies. External funding sources, such as new debt and equity issuance, have played only a limited role.

reduced the costs of accessing international capital markets and corporate treasurers chose to access deeper offshore markets rather than raising funds domestically.

TABLE 2.1: CURRENT ACCOUNT FUNDING
(Net flows as a percentage of GDP)

	Current account deficit	Banks net borrowing	Securit-isers	Govern-ment debt	Private non-financial corporate debt	Other sectors (incl. net RBA and derivatives)	Net Equity
2006	4.7	4.8	2.1	0.7	0.9	-2.7	-1.2
2007	5.7	3.7	1.9	1.2	1.1	-0.8	-1.5
2008	4.4	-1.9	-1.7	0.7	3.5	1.2	2.4
2009	4.2	6.4	-0.8	2.1	-0.8	-5.1	2.4
2010	3.4	0.2	-0.8	4.3	0.5	-1.8	0.8
2011	2.8	-0.6	0.1	4.4	1.6	-3.8	1.0
2012	4.1	1.0	-0.2	1.4	2.8	-2.7	1.9
2013*	3.4	0.1	0.2	1.2	3.6	-3.0	1.3

Source: ANZ, ABS Cat. 5232 *four quarters to September 2013

The difference between bank loans and deposits has narrowed significantly in recent years. This has been driven by increased household savings (which have increased bank deposits) and weak demand for intermediated credit.

Changes in the demand for offshore funding have also reduced the perceived vulnerability associated with Australia's CAD. A structural improvement in Australia's CAD is likely as resource companies shift to production following the investment phase of the mining boom.

The expected improvement in Australia's current account position implies that a greater proportion of the investment needs of the Australian economy can be satisfied by higher domestic and corporate savings. Even though a modest pick-up in non-mining sector activity is likely to increase demand for intermediated credit, the bank funding gap is unlikely to widen sharply to pre GFC levels.

The key point is that there has been, and there remains, significant medium-term flexibility in how Australia funds its economic development and markets have been able to accommodate changing economic circumstances within Australia and offshore.

SUPERANNUATION

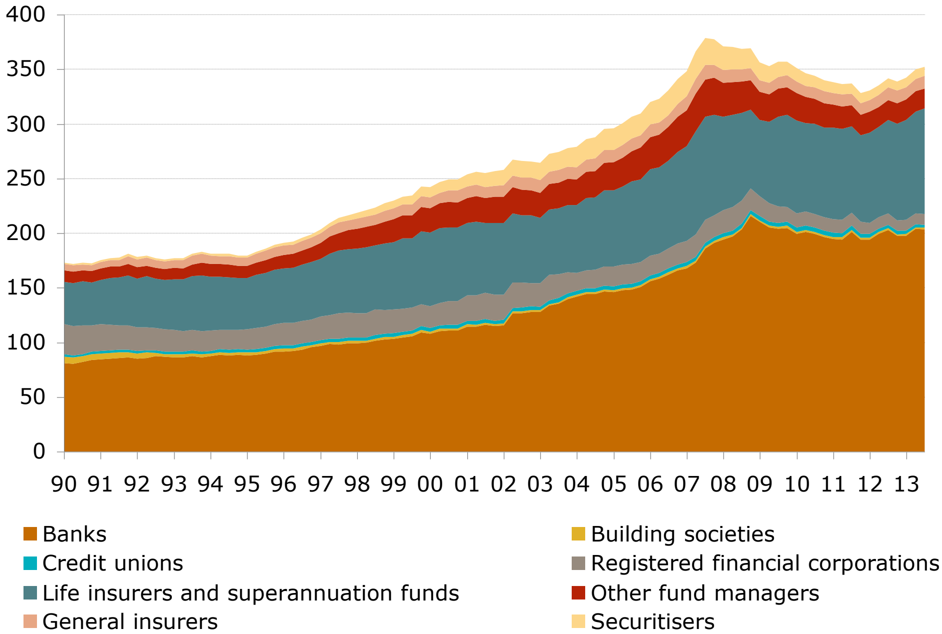
As is widely recognised, the stock of superannuation funds has grown as a proportion of GDP. Superannuation funds and life insurers hold assets equivalent to 97 per cent of GDP, and grew in the year to September 2013 at a rate of 10 per cent of GDP.

Australia's superannuation policy framework supports consumer saving and the economy, and reduces long-term pressure on the Government's fiscal position. An important feature is that control of investment decisions is in the hands of trustees who must act in the interests of the beneficiaries. A second important feature is the development of a competitive market for a diversified range of superannuation products, including simple, low-cost products such as ANZ's Smart Choice Super.

Public confidence in the stability of superannuation policy is important. It is supported by Government commitments that there will be no unexpected, detrimental changes to the superannuation system, and reforms to improve governance, increase transparency and boost competition in default super funds. As the level of superannuation funds grows to be larger than the value of banks' deposits, strong, prudent and effective management and governance of the sector is essential.

Superannuation funds provide support to all sectors of the Australian economy. They are the main suppliers of Australian-sourced wholesale lending to banks and significant equity investors.

FIGURE 2.2: SUPERANNUATION CONTINUES TO GROW
(Assets as a percentage of GDP)



Source: ANZ, RBA, ABS

Recommendation

7. *Superannuation funds should be managed in the best interests of members and fund managers held accountable through market mechanisms. Any proposals to direct Australian superannuation investment into specific sectors or for particular purposes should be rejected.*

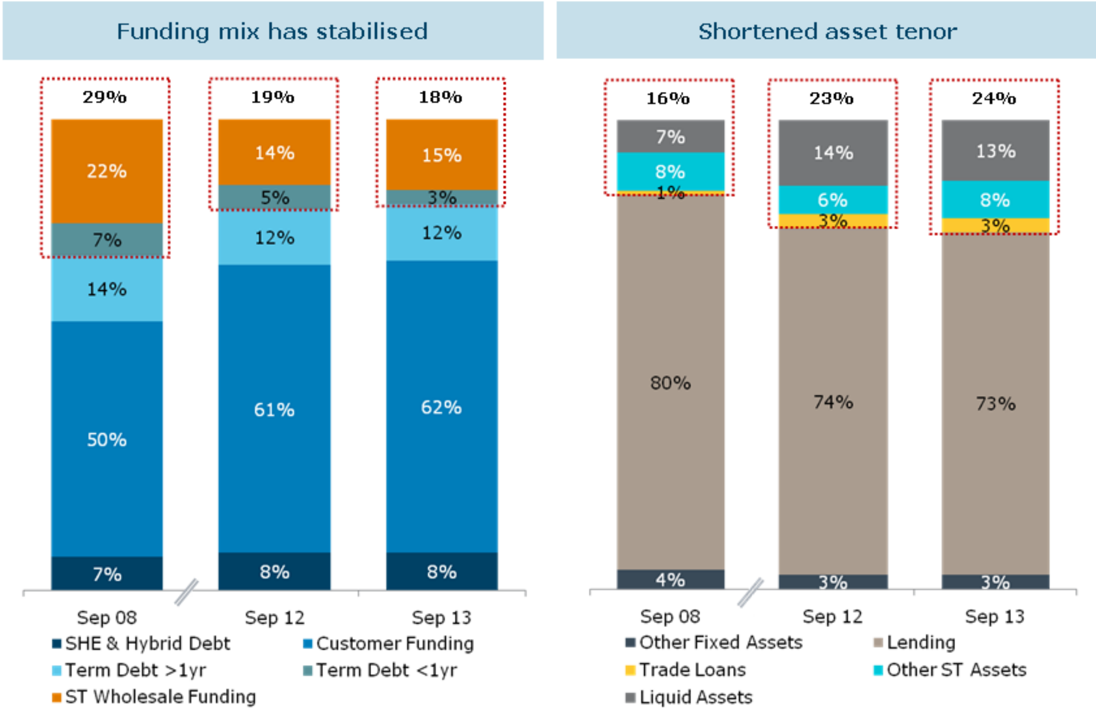
ANZ APPROACH TO FUNDING

Banks raise funds to lend to customers from shareholders, customer deposits and in wholesale markets from domestic and international investors. The cost of raising funds from wholesale markets and customers' deposits are key drivers of the price of credit products.

The structure of banks' balance sheets and funding profiles are largely a function of management choice driven by a combination of strategy, market positioning and financial considerations. For example, banks choose to hold consumer mortgages on balance sheet due to their attractive low risk characteristics and banks' ability to fund these assets at competitive prices. Mortgages comprise around 60 per cent of on balance sheet lending and contribute substantially to the large 'funding gap' in the banking system. This is not the practice in many offshore markets. Should the economics of this market change, due to non-bank investors revising their risk pricing of these assets (the banks' 'originate and hold' approach leads them to rate these assets more favourably than external parties) or banks' costs of funds changing, then alternative funding strategies could be pursued.

ANZ's funding objectives are to diversify its funding base while maintaining responsiveness and prudent maturity profiles for the respective portfolios. We undertake a structured issuance program designed to create a sustainable term wholesale funding profile. Customer deposits are the primary source of funding for lending. Since the GFC, the share of funding sourced from customer deposits has increased from 50 per cent in September 2008 to 62 per cent in September 2013 (see Figure 2.3).

FIGURE 2.3: DEPOSIT AND LONG-TERM FUNDING HAS INCREASED
(Per cent of funding and assets)

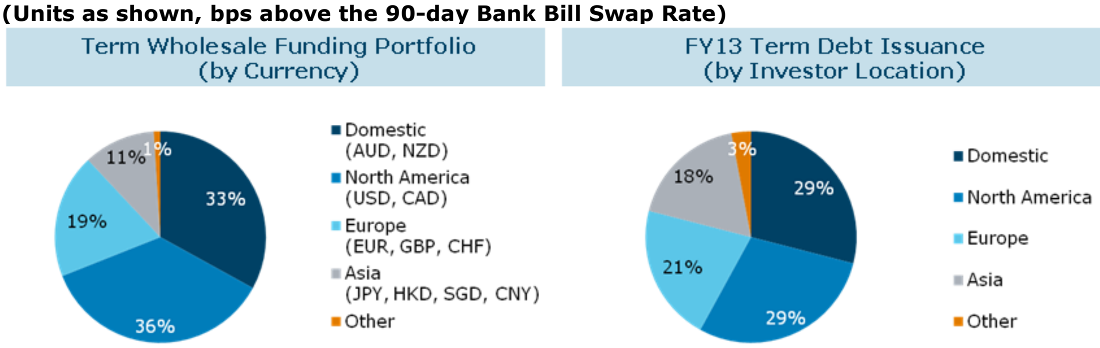


Source: ANZ

ANZ has also strengthened its funding and liquidity profile by shortening asset tenor by increasing the level of liquid and short-term assets in the balance sheet. Portfolio liquid assets have increased from AUD38 billion in September 2008 to AUD122 billion in September 2013. The RBA CLF will be an important safeguard for the financial system in the future, including the allowance of suitable Residential Mortgage Backed Securities (RMBS) to be offered for access to the CLF.

As shown in Figure 2.4, ANZ funding is diversified by currency and risk.

FIGURE 2.4: ANZ FUNDING IS DIVERSIFIED BY CURRENCY AND GEOGRAPHY
(Units as shown, bps above the 90-day Bank Bill Swap Rate)



Source: ANZ

The management of foreign currency wholesale funding by Australian banks is not well understood, creating misconceptions about dependency on offshore markets. Funding in offshore markets is undertaken to improve tenor and investor diversification. Australian banks generally swap foreign currency proceeds back to Australian dollars to fund domestic balance sheets. If offshore markets were temporarily not accessible, bank funding would be accessible domestically.

The cost of both funding through deposits and wholesale borrowing has risen since the GFC although it has drifted lower over the last year. In 2007, the rate offered by ANZ on a 90-day term deposit was very similar to the RBA cash rate. Today, it is around 50 bps above the cash rate. Wholesale funding costs have risen from 20 bps above the 90-day Bank Bill Swap Rate (BBSW) in 2007 to around 110 bps above BBSW today. Decreases in funding costs from the post-GFC highs are contributing to greater price competition in home lending and other markets.

RISK MANAGEMENT

ANZ's risk management frameworks, strategies, policies and processes are clearly defined and regularly reviewed and updated. Key risks include credit, market and operational risk and our compliance obligations. The Risk structure is broken into Global Functional and Divisional lines. Risk's operating model has matrix responsibilities between Geographical Chief Risk Officers (CROs) and Functional leaders. It provides local expertise while being able to leverage the scale of our global functional lines.

The Board is principally responsible for approving ANZ's risk appetite and risk tolerance, related strategies and major policies, oversight of policy compliance, and the effectiveness of the Risk and Compliance Management Framework that is in place. Details of the Framework are in Attachment B.

The Board Risk Committee assists the full Board to effectively discharge its responsibilities for business, market, credit, equity and other investment, financial, operational, liquidity and reputational risk management, and for the oversight of ANZ's compliance obligations.

The Committee can also approve credit transactions and related matters that are beyond the approval discretion of the CRO. The CRO is responsible for assisting the Committee Chair to ensure the Committee operates and is administered efficiently.

Recommendation

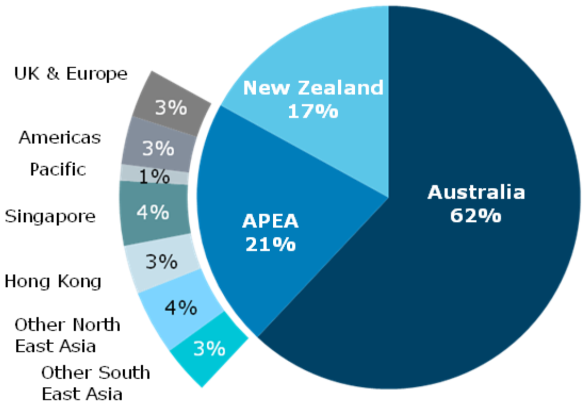
8. *Markets for bank funding operate efficiently and there is no intervention required to facilitate the ongoing funding of Australia's economic growth. The Inquiry should review with industry practitioners the operation of offshore funding with a view to improving understanding of its benefits and risks.*

FIGURE 2.5: ANZ CREDIT EXPOSURE IS GEOGRAPHICALLY DIVERSE

Exposure by Geography

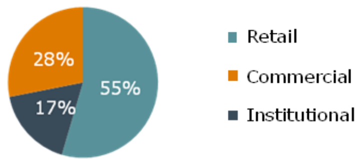
Total Exposure at Default (Sep 13) - $725b[1]

Australia	New Zealand	APEA
$450.6b	$123.6b	$150.8b

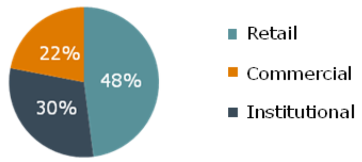


Exposure at Default by Line of Business[2]

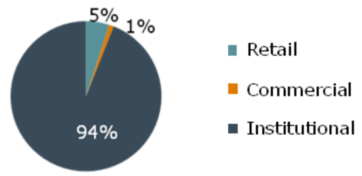
Australia



New Zealand



APEA



1. EAD excludes amounts for 'Securitisation' and 'Other Assets' Basel asset classes
2. Institutional includes exposure to Bank and Sovereign counterparties and ANZ's Liquidity portfolio

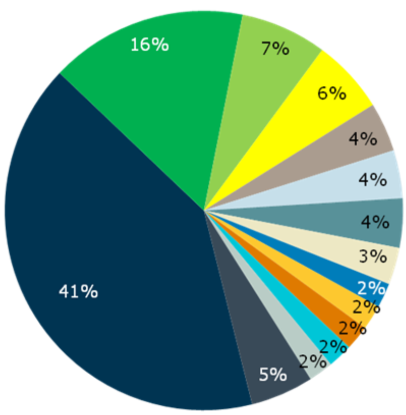
Source: ANZ

FIGURE 2.6: CREDIT RISK IS DIVERSIFIED BY SECTOR

Exposure at Default (EAD) as a % of group total

ANZ Group

Total EAD (Sep 13)
$725b



Category	EAD		% in Non Performing	
	Mar 13	Sep 13	Mar 13	Sep 13
Consumer Lending	40.4%	40.8%	0.2%	0.2%
Finance, Investment & Insurance	16.8%	15.9%	0.2%	0.1%
Property Services	7.1%	7.1%	1.6%	1.1%
Manufacturing	6.1%	6.0%	1.0%	0.7%
Agriculture, Forestry, Fishing	4.2%	4.3%	4.1%	4.1%
Government & Official Institutions	3.9%	4.0%	0.0%	0.0%
Wholesale trade	4.0%	3.9%	0.6%	0.8%
Retail Trade	2.9%	2.9%	0.8%	0.9%
Transport & Storage	2.2%	2.2%	2.0%	1.6%
Business Services	1.9%	2.0%	0.7%	0.5%
Resources (Mining)	1.8%	1.9%	0.2%	1.2%
Electricity, Gas & Water Supply	1.7%	1.7%	0.1%	0.1%
Construction	1.6%	1.7%	1.2%	1.1%
Other	5.4%	5.7%	0.1%	0.9%

Source: ANZ

3. SYSTEM STABILITY

KEY POINTS

- ANZ considers that the stability framework that has been put in place is appropriate and does not require material change.
- Australia had a strong financial structure and system prior to the GFC, supported by prudent bank management and a comprehensive regulatory framework. During the crisis, the Government provided assurance that deposits were safe and supported access to wholesale and securitisation markets.
- Depositors' interests and the overall stability of the system have been protected, while avoiding incentives for imprudent risk-taking and minimising taxpayers' exposure.
- Banks' actions and regulatory changes since the GFC have further strengthened an already strong Australian financial system. Regulatory changes include the Basel III capital and liquidity increases, the RBA CLF, the FCS, derivative reforms, new resolution powers and new consumer protection laws. Further regulatory change should be put on hold until a full assessment of the impact of recent regulatory imposts is undertaken.
- One specific proposal which has emerged post the GFC that needs to be rejected is the argument that banks would be made 'much safer' at essentially little or no economic cost by having them hold far more capital and, as a result, rely less on debt funding to finance economic activity. In practice, the effect of further increases in ADI capital would likely lead to increases in the costs of, or reductions in, bank lending.
- Any decision to 'buttress' the financial system further should not just view regulations in isolation but take into account other structures, policies and practices operating to protect our system from undue risk.
- The FCS creates a level playing field for deposits, benefiting smaller banks. Large banks are not afforded protection from failure. Large banks' lower costs of funds and higher market ratings reflect their strength, diversification and management.

GLOBAL FINANCIAL CRISIS

The impact of the GFC on Australia was mitigated by its strong macroeconomic and fiscal position, the continued strong economic growth in Asia, particularly China, prudent governance and management of Australia's ADIs, and Australia's regulatory and supervisory model.

Banks and regulators reviewed areas where the financial system could be buttressed in response to the crisis. Pragmatic and limited government support was provided to ADIs to protect the economy from potential systemic issues during the most turbulent period of 2008:

- In June 2008, the FCS for ADIs was announced. It initially guaranteed deposits held in Australian ADIs up to AUD1 million per depositor per institution. A reduced permanent cap on the guaranteed deposits, AUD250,000 per person per institution, took effect from February 2012.
- In October 2008, the Australian Government announced guarantees for wholesale funding and domestic depositors. Fees were set for the provision of guarantees, with a sliding cost scale reflecting the contingent risk to the Commonwealth. The wholesale guarantee facilitated access to global term funding markets for Australian banks. Reflecting the sound position of Australian banks, no Australian ADI required a

'bail out' under the guarantees. Banks made use of the wholesale funding guarantee for around six months, allowing them to maintain or extend the contractual tenor of funding through this period. The guarantee scheme is estimated to generate around AUD5.5 billion of revenue for the Government by the time all guaranteed debt expires in 2015.

- In September 2008, AUD16 billion of support for the RMBS market was announced. This maintained liquidity and allowed non-bank lenders to stay in the market, supporting greater competition.

Ultimately, the strength of our ADIs and the mitigants mentioned above ensured that Australia's economy escaped the GFC largely unscathed

REGULATORY CHANGES SINCE THE GFC

Australian banks responded to the pressure of the GFC by building their capital and liquidity positions. Dependence on short term wholesale funding was reduced, while core funding sources, which include 'sticky' deposits, term wholesale funding and equity, were increased. Credit risk management was reviewed and strengthened. Scenario-based contingency planning was undertaken with APRA to ensure that ADIs are well prepared for unlikely but high-impact events.

A wave of international prudential and domestic regulatory changes was also implemented. This included:

- Basel III changes increasing ADI capital and liquidity requirements.[13] These included increased minimum capital, a capital conservation buffer, a time-varying countercyclical buffer and a D-SIB surcharge for large banks, tighter security terms for Tier 1 and Tier 2 capital securities, an unweighted capital ratio (or 'leverage ratio'), a liquidity coverage ratio, and a net stable funding ratio. (ANZ has concerns over how some Basel III rules have been implemented – see under 'Financial regulation' in Section 1).
- The RBA CLF provided as an element of the Basel III implementation. The CLF provides ADI access to liquidity in the event of acute stress. A fee applies to both drawn and undrawn commitments.
- Reforms to permit banks, credit unions and building societies to issue covered bonds. This helped the industry to diversify funding sources and maintain competitive funding costs.
- Over the counter (OTC) derivative reform covering clearing, trade reporting and execution are being implemented, and higher capital charges for uncleared derivatives transactions have been introduced.
- Strengthening of ADI resolution arrangements, through powers to exchange confidential information, allow intervention into a problem ADI and undertake resolution activities. Regulatory authorities and ADIs have developed crisis resolution strategies, including appropriate documentation, and have undertaken crisis simulations.
- New Australian laws, such as the *National Consumer Credit Protection Act 2009* (NCCP), seek to reduce risks of failures that might otherwise impact confidence.

PAUSE TO FURTHER REGULATION

Inevitably, given the costs and dislocation overseas as a result of the GFC, governments and regulators have turned to how economies can best avoid another GFC.

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[13] Basel III requirements come into effect over time: Capital Adequacy in 2013, Liquidity Coverage Ratio in 2015, Capital Conservation Buffer and D-SIB framework in 2016 and the Net Stable Funding Ratio in 2018.

Predicting future 'crises' is not possible, so attention has shifted to examining ways our current system can still be improved. In any assessment, the costs as well as the benefits of any actions need to be carefully judged. In the understandable rush to implement new global regulation post the GFC, the economic and financial consequences have been given less scrutiny.

With much of this regulation yet to have its full effect, we support halting any new regulation until clearer analysis of their cumulative effect can be carried out. This sentiment was strongly endorsed by the G20 Finance Ministers in their February 2014 meeting.

Any decision to further 'buttress' the financial system should not just view regulations in isolation but take into account other structures, policies and practices operating to protect our system from undue risk. In Australia's case, this should include the costs, benefits and effectiveness of:

- The supervisory regime intended to address prudential and credit risks
- The operation of 'automatic stabilisers' protecting the macro-economy from exogenous economic shocks. These include a floating exchange rate; a high proportion of borrowing on variable interest rates which allows rapid transition of monetary policy adjustments; and banks fully hedging offshore funding
- Safeguards operating to protect depositors and taxpayers from loss, even under severe financial strains.

Recommendation

9. *Decisions about proposals to increase prudential or similar regulation should be preceded by assessment of existing structures, policies and practices.*

One specific proposal which has emerged post the GFC that needs to be rejected is the argument that banks would be made 'much safer' at essentially little or no economic cost by having them hold far more capital and, as a result, rely less on debt funding to finance economic activity.

The proposal argues on the basis of finance theory that higher levels of equity funding and lower levels of debt would leave the total cost of funding unchanged. It suggests shareholders are prepared to accept a lower return given the lower risk which reduces the cost of each unit of equity, even though more equity is needed. The resultant smaller debt funding requirement reduces the cost of debt.

In practice, the effect of further increases in ADI capital would likely lead to increases in the cost or reductions in bank lending. The equity-debt trade-off, the so-called stability benefits would not materialise. In 'real world' markets, for example, factors such as tax deductibility makes debt funding more economic while transaction and market costs of raising equity are significant.

We suggest that implementation of appropriate macro-prudential policies at a national level, combined with close risk supervision and effective resolution regimes, is the appropriate policy. It imposes fewer costs than alternatives and produces a superior long-term economic performance for the Australian economy.

PROTECTION FOR DEPOSITORS

The Australian regulatory model protects the interests of depositors in banks through measures such as the FCS. It provides no government guarantee for shareholders or debt holders, and does not protect management of a financial institution in the event of a failure.

The Government's guarantee of deposits up to AUD250,000 provides assurance to depositors and some support for stability of the system when the need arises. As noted earlier, it is funded through an ex-post levy on ADIs after a crisis.

The proposed ex ante levy to support the FCS, providing an earmarked fund for resolution purposes, is problematic. It is in effect a tax on depositors, creating an impact on growth and lending. It is presently unclear how such a fund would be managed over time. Given the strong track record of depositor safety arising from existing protections, it would appear that a post-funded resolution support scheme is sufficient to meet stability concerns.

Recommendation

10. *The present ex post funding of the FCS by ADIs should be retained as the most efficient mechanism.*

DOMESTIC SYSTEMICALLY IMPORTANT BANKS

APRA has announced that the four major Australian banks are Domestic Systemically Important Banks (D-SIBs) and should face higher capital requirements. It requires that their capital conservation buffer Common Equity Tier 1 capital be 1 per cent higher than other ADIs from 1 January 2016. APRA has stated that the designation of a bank as a D-SIB does not make it immune from failure.[14]

While some have continued to argue that major banks are 'too big to fail' and therefore gain a competitive advantage, this was clearly rejected in APRA's announcement of 23 December 2013.

COMPETITION IMPLICATIONS

The primary beneficiaries of the FCS have been smaller institutions. Experience during the GFC indicates that funds are most likely to move from smaller to larger institutions in a time of crisis. Through the deposit guarantee, the FCS supports smaller ADIs and mitigates the risk that individual depositors would shift funds to larger ADIs in times of stress. This benefits the whole financial system by reducing potential volatility and instilling depositor confidence.

Some smaller ADIs have continued to argue that larger banks benefit from a perception that they are 'too big to fail'. The major Australian banks achieve a lower cost of funding and capital due to their strength and diversification of their balance sheet, funding and liquidity, and their strong credit and other risk management capabilities. These factors are reflected in their market-based credit ratings. ANZ rejects the view that its ability to access capital more cheaply than smaller banks is because of a perceived government guarantee.

APRA's AIRB accreditation would reduce risk weighted capital requirements for institutions presently claiming to be disadvantaged by their use of the Standard rating approach. It is reasonable that where ADIs invest to manage risk better, they should be able to benefit from commensurate reductions in capital requirements.

Recommendation

11. *ANZ considers that the stability framework that has been put in place is appropriate and does not require material change. Implementation of appropriate macro-prudential policies at a national level, combined with close risk supervision and effective resolution regimes, is the appropriate policy.*

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[14] APRA, "APRA releases framework for domestic systemically important banks in Australia", media release, 23 Dec 2013.

12. *The Inquiry should recognise that it is not efficient for individual ADIs to hold buffers against extreme system risk. The framework for managing such extreme risk should be reviewed.*

13. *The AIRB accreditation should reflect the benefits of better risk management enabled by AIRB models. Changes to this framework should not be made to achieve policy objectives such as support for a particular sector.*

4. ACCESS TO FINANCIAL SERVICES

KEY POINTS

- ANZ offers consumer, business and international customers a wide range of financial services, from deposits through to insurance services. We invest in high quality customer service, support for customers experiencing hardship and in improving financial literacy.
- Rates and prices for our products and services are set taking into account customer needs, funding costs (including deposits, wholesale funding and shareholder capital), credit risk and competition. For major products, we also consider the implications of price changes on the economy.
- Since the GFC, risk premiums have generally risen, flowing through to increases in bank funding costs and pricing. Depositors have benefited from higher rates.
- ANZ is a major lender to small and medium businesses, including providing unsecured loans. We are growing our share in these markets. There is no rationing of finance to the small and medium business sector and banks have significant capacity to meet increased need.
- The small business sector could be supported by improving its financial management capabilities and the publication of disaggregated statistics on finance to business. Availability of non-bank funding of entrepreneurial activity and equity for small business is an area for further review.
- We are positive about the outlook for farming and agricultural businesses. Demand for agricultural commodities in the growing Asian middle class could see Australian agricultural exports increase to at least AUD73 billion per annum by 2050.
    - The sector is subject to a high level of market, competitive and climate variation which banks and policy need to take into account.
    - Banks will continue to underpin lending in the agricultural sector, but other forms of investment may be needed as well to support these sectors.
- Private funding of public infrastructure is affected by issues such as the impact of regulation on long-duration lending and investments, and management of demand, refinancing and project risk. An improved long-term debt market would support development of infrastructure and products for an ageing population, such as annuities.

ANZ SERVICES

ANZ offers its consumer, business and institutional customers a wide range of banking and financial services in Australia and in the region:

- Our retail businesses offer customers savings and deposit products; credit cards; home mortgages; personal and vehicle lending; investment, superannuation and financial advice; home, life and travel insurance; trustee services; and travel foreign currency services. We aim to provide easy and simple processes for dealing with the bank in a branch, over the telephone, online, through mobile and other channels.
- The Australia Division business adopts a segmented structure: Small Business Banking – banking services to small businesses; Regional Banking – agribusiness and business banking in regional Australia; Business Banking – for mid-sized metropolitan business clients; Corporate Banking – traditional relationship banking and sophisticated solutions; and ESANDA – asset and vehicle financing.

- ANZ Wealth develops and manages investment, superannuation and insurance products and services, and provides private banking services for Australian, New Zealand and regional customers. Wealth services are distributed through our retail, online, broker and other channels.
- The Institutional and International Banking Division provides financial services and solutions to government and large corporations in Australia and the region. It manages retail banking services in the Asia Pacific region, and ANZ's portfolio of strategic banking partnerships in the region.
- ANZ New Zealand offers our customers retail and commercial services and is the largest provider of financial services in New Zealand. It comprises Retail and Commercial business units.

ANZ has comprehensive policies, processes and tools to manage our business to the highest standards of customer service and support. ANZ has well developed processes for managing customer hardship, assistance for disasters and other special circumstances, and for promoting financial inclusion and financial literacy.

ANZ was named as the global banking sector leader in the 2013 Dow Jones Sustainability Index (DJSI) for the sixth time in seven years. Attachment A contains more information about our products, structure and approach to customer support.

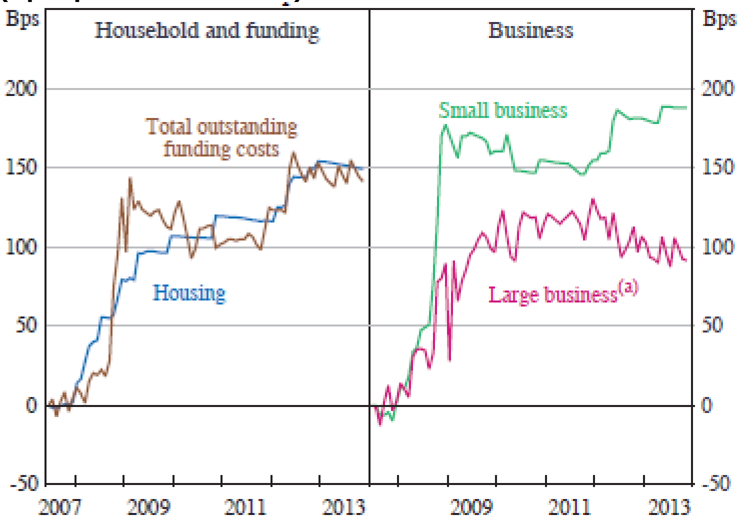
RATES AND PRICING

Decisions about deposit and lending rates and pricing of products and services must strike a balance between a number of factors:

- Attractive returns for depositors: ANZ is committed to providing customers with competitive returns and security for their savings.
- Other funding costs: interest on funds borrowed from wholesale money markets and required returns on shareholder equity.
- Lending risk: The risk of loss associated with the particular segment and product is carefully assessed to take account of expected losses and the value of any loss.
- Competitive position: ANZ is determined to remain competitive by attracting and retaining customers, growing market share and managing our costs.
- Regulatory requirements: ANZ must hold capital reserves and levels of liquidity to operate safely and securely for customers.

Changes in financial markets arising out of the GFC have significantly impacted pricing and rates. The need to raise deposits and the repricing of risk in financial markets led to a step change in funding costs. As the left-hand side of Figure 4.1 shows, funding costs (brown line) and lending housing rates (blue line) have increased in a similar fashion. Increases in funding costs stemmed from both higher wholesale funding costs and higher deposit rates, which benefit customers.

FIGURE 4.1: FUNDING COSTS AND LENDING RATES
(Bps spread to cash rate)



Note: Spreads on outstanding loans. (a) Loans greater than $2 million; includes bill lending
Source: RBA[15] based on ABS; APRA; Perpetual; RBA; UBS AG, Australia Branch

CONSUMERS

We provide a wide range of products and services to retail banking customers. We understand their needs, goals and financial aspirations through our 'A-Z review' and recommend the best solutions for their circumstances.

Our products and services are competitively priced. However, in recognition of the financial circumstances of low income groups we provide a basic transaction account without fees for people who hold Seniors or Pensioner Concession cards, Centrelink Healthcare cards and Repatriation Health cards. In addition, we waive standard transaction account fees for people aged under 18, people aged 60 and over, full-time students and people who receive a disability support pension or mobility allowance from Centrelink.

Risk and financial literacy

It is a question for public policy how much risk individuals should be subject to, especially where they have had little involvement in the creation of those risks. Individuals largely have responsibility for risks that they undertake in financial markets. Stability policy should not seek to eliminate all risk nor should it seek to prevent individuals incurring losses.

ANZ strongly supports the National Financial Literacy Strategy and cross-sectoral efforts to lift Australians' levels of financial literacy to improve management of risk. It is generally accepted that consumers are required to bear higher levels of financial risk than a generation ago given the significantly wider range of financial products and the shift towards people providing for their own incomes in retirement.

The ANZ Survey of Adult Financial Literacy in Australia shows an inadequate understanding amongst people with investments of the relationship between risk and return and, post-GFC, greater uncertainty about how to judge the performance of a superannuation fund or managed investment. Poor understanding of the relationship between risk and return increases the risk of a consumer making investments they might not have made had the risks they were taking been properly understood. There have been a number of instances over recent years of people either approaching retirement or

[15] Chris Stewart, Benn Robertson and Alexandra Heath, "Trends in the Funding and Lending Behaviour of Australian Banks", RBA Research Discussion Paper, 2013–15, December 2013.

in retirement losing their life savings such as occurred with the financial collapses of Storm Financial, Banksia Securities, Provident Capital and Wickham Securities.

Regulation alone will not be sufficient to prevent future collapses and total avoidance of financial losses should not be its aim. Equipping people to make better choices for themselves is a complementary and worthwhile approach to consumer protection regulation.

Consumers equipped to make better choices for themselves exhibit behaviours such as comparison shopping and asking questions to ensure products and services are suitable for their needs and circumstances. Consumers who are engaged with their finances and confident in their money management skills tend to exhibit behaviours which promote competition in markets.

Changes in technology support increased levels of competition and use of comparison sites by consumers in choosing products has emerged in recent years. Online comparison of products is strongest for mortgages. Scope exists for wider use of comparison shopping tools and this is most likely to be taken up by financially literate consumers.

Recommendation

14. *The Inquiry should endorse the importance of improving financial literacy as a means for to equip people to make better choices themselves, and as a complementary and worthwhile approach to consumer protection regulation.*

SMALL BUSINESS

ANZ remains strongly committed to small business lending. ANZ announced in March this year that we would build on our existing AUD1 billion lending pledge to small businesses by making available a further AUD2 billion in new lending to small businesses over the next 12 months.

ANZ's small business segment achieved 15 per cent growth in net loans and advances last year and we approved more than AUD1 billion of lending to new small businesses between April and December of 2013. ANZ generally approves seven out of every 10 applications from new small businesses. ANZ is one of the few banks in Australia that provides unsecured lending to small businesses. As set out in Section 1 of this submission, we are particularly focused on engaging Australian businesses in developing trade and commercial ties with the region.

We are supporting entrepreneurial companies. *ANZ Innovyz START*, a 13-week accelerator program, supports companies commercialising break-through innovations. The *ANZ Innovyz BRIDGE program* takes commercialisation to the next stage by supporting companies moving from 'start-up' and 'initial growth' phases of development.

While ANZ is a strong lender to the sector and supports development of businesses, there are limits on the role of banks. Banks are required to lend prudently, reflecting their critical role in the financial system.

Businesses in the early phases of development may not have the necessary security or proven cashflow to be able to access sufficient funding. There is an important role for equity and non-bank funding of entrepreneurial activity. ANZ believes that this should be an area for consideration in the Financial Services Inquiry.

There are other valuable steps that can be taken to support small and medium businesses. ANZ believes that better statistical information can be developed to give greater insight into lending trends. Today it is difficult to identify lending to small and medium businesses from aggregated data. Financial management education can be improved to reduce risks to small businesses. Resources can be developed to assist small business customers making loan applications.

Recommendation

15. *The Inquiry should consider how the full range of financial services including bank lending, equity and non-bank funding can support entrepreneurial activity and business development.*

Rates for small business credit have been the subject of particular scrutiny.[16] ANZ determines its offerings to small business taking into account the quality of any security, likelihood of repayment and the period of the loan. A high quality security such as a mortgage is taken into account as are other high quality forms of security.

Nevertheless, the higher probability of default and 'loss given default' for small business customers relative to mortgage customers requires banks to hold a higher level of capital and reserve more for bad debt expenses. As indicated by the right-hand side of Figure 4.1, this increases the cost of providing small business loans relative to retail lending generally.

ANZ's main discounted rate for high quality small business loans, that is a small business secured by a residential mortgage and with a low risk of default, is generally close to the ANZ standard variable residential mortgage rate. Rates for other loans to small business will be priced commensurate with the level of security and risk of loss.

Increases in interest rates after the GFC have benefited some small businesses. Small business generally deposits more funds as a sector than are borrowed. At the September 2013 half year, ANZ small business customers had deposits of AUD27.8 billion and had borrowed AUD10.6 billion.

As noted in Section 1, ANZ considers that a less conservative approach to prudential regulation would have benefits for business customers.

AGRICULTURE

Global demand for agricultural output is expected to increase at least 60 per cent by 2050 compared to 2005–7 as developing world incomes and populations grow.[17] Global supply is constrained with little additional land or water coming into production.

Australia has the natural resources, skills and geographic position to increase agricultural exports to a developing Asia. It is estimated Australia could more than double the real value of annual agricultural exports by 2050, to at least AUD73 billion per annum (AUD710 billion between now and 2050). Achieving this will require around AUD600 billion in capital on farms and through supply chains.

Protein consumption in Asia will grow, leading to increased demand for beef, noting that the beef industry continues to feel the impact of the northern drought and the live cattle ban. The high profile takeover activity in the dairy industry demonstrates the promise seen for that sector. Increased protein demand across Asia, and associated demand for animal feed, will support the growth of the grains industry.

The global agricultural sector is continuing to consolidate with vertical and horizontal aggregation of supply chains and food brands. Larger businesses will be investing to further improve production, supply chain and distribution efficiency. This will continue to place pressure on less productive producers and lead to industry restructuring. ANZ expects that investment in Australian agriculture will grow strongly.

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[16] See *Access of Small Business to Finance*, Senate Economics References Committee, June 2010.

[17] Port Jackson Partners, "Greener Pastures: The Global Soft Commodity Opportunity for Australia and New Zealand", *ANZ Insight*, Issue 3, October 2012.

There is a wide range of performance across farming and agriculture making it difficult to generalise. Strongly performing businesses have a high level of access to credit. These businesses have repaid debt and overall lending to the sector has stabilised.

Drought-affected areas of Queensland and New South Wales are currently under pressure. Where farm businesses have experienced declining asset values coupled with cashflow shortfalls, access to credit can be difficult. Lending from non-banks and services providers has increased activity in some areas.

Where farm debt issues arise, we seek to work with customers to secure the best possible outcome from the perspective of the customer and the bank. We use farm debt mediation to work through issues where this is the most appropriate approach. We take into account factors such as produce prices and outlook, gearing and finances, land quality, succession and business capability, and impact on community and neighbouring properties.

Global competition, market and climatic variation have always created uncertainty for agriculture. It is important that the balance between debt and equity for agricultural businesses is appropriate given these uncertainties.

ANZ will be responding to the Government's Agriculture White Paper. The paper focuses on the growth, competitiveness and profitability of agriculture, and will also consider access to investment finance, farm debt levels and debt sustainability. Improving financial management capability and performance indicators would support the sector.

INFRASTRUCTURE

Impediments to private funding of public infrastructure continue to be subject to extensive government examination. While private finance is readily available for commercially viable investments, there are practical issues affecting private investment in public infrastructure.[18]

The GFC repriced risk, increasing the cost of infrastructure financing, and particularly impacting the price of long-duration debt. Support for monoline insurance through rating agencies and availability of suitable derivative products to support securitisation has fallen away. A number of foreign banks have exited the infrastructure market; some of this gap has been taken up by Asian banks. While a smaller group of banks are now the primary providers of private sector debt finance to infrastructure, these institutions have been able to fund all infrastructure to date, primarily due to the paucity of projects brought to the market post GFC.

Regulatory reforms following the GFC have had the unintended consequence of affecting availability of long-term finance for infrastructure. Basel III reforms place a premium on bank liquidity and militate against long-duration debt suitable for financing infrastructure. The changes also raise capital requirements, reducing the availability of capital for more risky projects. This has impacted upon many international banks which were previously strong participants in the Australian market.

Within Australia, APRA reforms focused on improving liquidity of investment in superannuation and minimising fees also affect direct investment in infrastructure. The impact of prudential regulatory changes should be examined in detail to determine if a better balance between stability and incentives for long-term investment can be struck.

[18] ANZ notes the findings of the Productivity Commission draft report on Infrastructure that there is no shortage of private sector capital that could be deployed to finance public infrastructure. As the draft report states, there are many practical issues that affect how efficient decisions can be made, risk can be shared and the role of private sector funding. ANZ will provide information to the Productivity Commission on the specific issues it raises in its draft report. Some ANZ considerations are set out here. See Productivity Commission Draft Report, *Public Infrastructure*, March 2014. See also discussion in Infrastructure Australia, *Review of Infrastructure Debt Capital Market Financing*, February 2014.

Sharing of risk between public and private sectors needs to be considered. Banks have been the principal providers of private sector debt finance for infrastructure since the GFC. Banks have limited ability to provide long-term debt suitable for infrastructure. Consequently, the portion of debt financed by banks will be periodically rolled over, leading to refinancing risk. Governments are currently considering these issues.

Australian experience with infrastructure risk has led to caution. No large scale, greenfield, demand-risk based project has been brought to market since the GFC. Availability funding models and targeted approaches to government risk sharing, government grants in the early stages of projects, and support during refinancing should be considered as measures to address these issues.

Public infrastructure is ultimately funded through user charges, government budgets or asset sales. Limited public acceptance of user charging and pressure on budgets has constrained funding. Australian Government initiatives to encourage sale of existing brownfield assets by States, recycling capital in effect, and to compensate for any impacts on State budgets are very positive initiatives.

Australia does not have a deep corporate bond market, and there is little depth of support for long-term private debt across the investment grade spectrum. Corporate issuers of debt, including infrastructure project companies, have found US and European markets more competitive from a tenor and price perspective due to their needs in those markets to match long dated insurance or pension liabilities.

Relatively low levels of government debt mean that there is limited public sector liquidity which would otherwise form the foundation for the debt market. Governments should be encouraged to support the development of a long-term debt market.

Recommendation

16. *A deeper long-term debt market should be encouraged to assist financing of infrastructure and development of long duration products such as annuities.*

SUPERANNUATION

As the number of older Australians increases, it is important that the financial system facilitates saving, managing risk and investing for retirement. A report by the Productivity Commission into caring for older Australians predicts that the number of Australians aged 85 and over is projected to increase from 0.4 million in 2010 to 1.8 million by 2050.[19]

The present framework for supporting older Australians is built around the three pillar policy – the aged pension as a safety net, a compulsory system of retirement saving through superannuation, and incentives for additional voluntary saving. Compulsory saving has resulted in Australia's pool of superannuation savings which currently stands at approximately AUD1.8 trillion is expected to grow to AUD5.5 trillion by 2030.

ANZ supports Government policy to increase competition in the selection of default superannuation funds. [20] Superannuation is currently subject to overlapping regulation in the selection of default funds for people on industrial awards which has the effect of reducing competition. Funds that comply with the MySuper reforms are subjected to a further assessment process under the Fair Work Commission's superannuation review process. The Government is currently considering submissions to its superannuation discussion paper which examines these issues.

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[19] Productivity Commission, *Caring for Older Australians*, August 2011.

[20] Australian Government, *Better regulation and governance, enhanced transparency and improved competition in superannuation*, Discussion paper, 28 November 2013.

Recommendation

17. *All APRA-approved, MySuper-compliant products should be able to compete equally in the default superannuation market.*

DEVELOPING A MARKET FOR ANNUITIES

As noted earlier in this submission, the ability of superannuation trustees to act in the best interest of fund members is an important, positive feature of the superannuation system. Successive governments have supported the independent role of the trustee and have not sought to direct private superannuation funds into particular sectors.

ANZ considers that with the appropriate policy framework, the market can develop better products and services to meet the needs of older Australians. The market for annuities is underdeveloped in Australia. Annuities can provide an efficient and stable source of income for retirees.

An important reason why the annuities market is underdeveloped is that risks associated with providing these products, principally interest rate risks, cannot be hedged. As noted in the previous paragraphs, deepening the market for long-term debt securities would help financial institutions to offer long-duration products.

IMPROVING LIFE INSURANCE

ANZ believes that functioning of the market for life insurance services can be improved. Life insurance protects people against risk of serious illness, disability and death. It is an important risk management function of the financial system.

In the Australian market, life insurance is provided to the majority of workers through default arrangements in superannuation. In recent times, policy lapse rates have increased and legal fees are assuming an increasing proportion of large insurance payments. Insurance premiums have been rising as a result of these pressures.

ANZ believes that options to maintain affordable provision for life insurance should be considered. These options might include changes to regulation affecting product design, assistance for rehabilitation, reasonable time periods for lodging claims, and the establishment of a low-cost service to assist customers with their insurance claims to reduce legal costs.

Recommendation

18. *The Inquiry, with the assistance of industry and regulators, should assess the operation of life insurance markets with a view to improving the affordable provision of services.*

5. COMPETITION

KEY POINTS

- ANZ competes strongly in the markets in which it operates. Our aim in consumer and business banking is to grow more quickly than the financial system as a whole, in a prudent manner, balancing risk and return and maintaining our asset quality.

- Customers have access to a wide range of products from many different providers. Brokers and intermediaries play an important role in allowing consumers and businesses to compare offers quickly and easily.

- Analysis of the banking sector over the last 10 years shows banks' customers have been the principal economic beneficiaries of competition in banking.

    - A key economic indicator is net interest margin (NIM), reflecting the difference between costs to borrow and interest paid to deposit holders. NIM has consistently trended down, even though it increased immediately following the GFC as risk was repriced. Bank fees paid by households have declined despite increasing numbers of customer transactions.

    - Bank equity levels have increased, meeting regulatory requirements. Bank profits have increased in line with balance sheet growth. The rate of return on shareholders' equity has declined slightly since the GFC.

- Productivity is an important indicator of market efficiency. Australia's financial and insurance services sector has the second highest productivity growth of the economic sectors identified by the ABS over the last 10 years.

ANZ APPROACH

ANZ is committed to providing customers with Australia's most convenient banking services, based on products that are simple to understand and delivered in a responsible manner in accordance with the highest standards of integrity.

ANZ competes strongly in consumer and business markets. A key aim is to deliver consistent 'above-system' growth and win market share in target segments. ANZ seeks to maintain competitive margins, cost discipline and asset quality, while leveraging our super regional strategy.

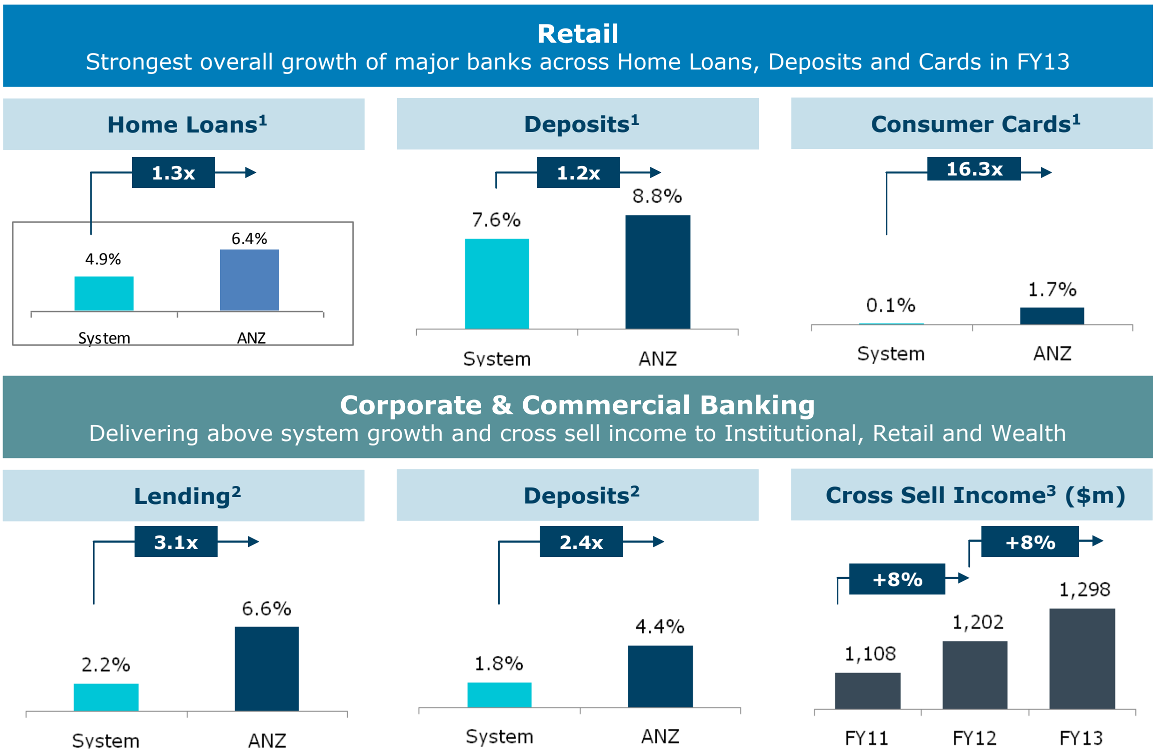
In the financial year 2013, ANZ's retail business achieved the strongest overall growth of major banks across home loans, deposits and cards (see Figure 5.1). We have now achieved 16 quarters to December 2013 of above-system growth in home loans and customer satisfaction ratings of greater than 80 per cent.

In the same period, our corporate and commercial customer numbers grew by 30,000 and we achieved 7 per cent growth in lending. Our lending to corporate and commercial customers has grown for six quarters through to June 2013.

ANZ's Wealth division is competing through innovative products, and improving digital and direct channels to respond to substantial changes in the market. These changes include the continued growth of low cost digital competition, increasing customer focus on value for money, and closely defined regulatory requirements. Examples of Wealth division innovation are contained in Section 6 of this submission.

The ANZ International and Institutional Banking division focuses on priority segments including natural resources, financial institutions, diversified global businesses, agribusiness and Asia commercial businesses. It offers strong financial market and banking solutions, leveraging ANZ's regional network to provide consistent cross-border services and building strong customer relationships.

FIGURE 5.1: ANZ COMPETES TO WIN SHARE



1. Source: APRA Monthly Banking Statistics, Sep 2012 to Aug 2013. System adjusted for new ADI incorporations; 2. Source: Lending – RBA Lending and Credit Aggregates and Deposits – APRA Monthly Banking Statistics, Non-Financial Corporations, Sep 2012 to Aug 2013; 3. C&CB cross sell includes income booked in Retail, Wealth and International and Institutional Banking.

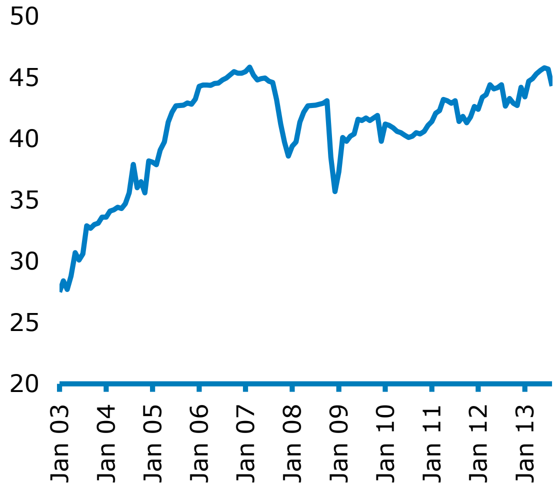
Source: 2013 ANZ Full Year Results Presentation and Investor Discussion Pack.

SERVICES AND PROVIDERS

Australian consumers have access to a wide range of products. For example, Canstar provides information to consumers on 1,908 home loan products from 110 lenders, and 211 credit cards offered by 65 providers.[21] The role of intermediaries, principally brokers and websites, has grown over time. Figure 5.2 shows that brokers now originate 44 per cent of home loans. Intermediaries provide customers with easily accessible information allowing them to compare the value of different products.

[21] See http://www.canstar.com.au

FIGURE 5.2: THE ROLE OF INTERMEDIARIES ACROSS THE INDUSTRY HAS GROWN
(Broker originated loans as proportion of total housing loans)

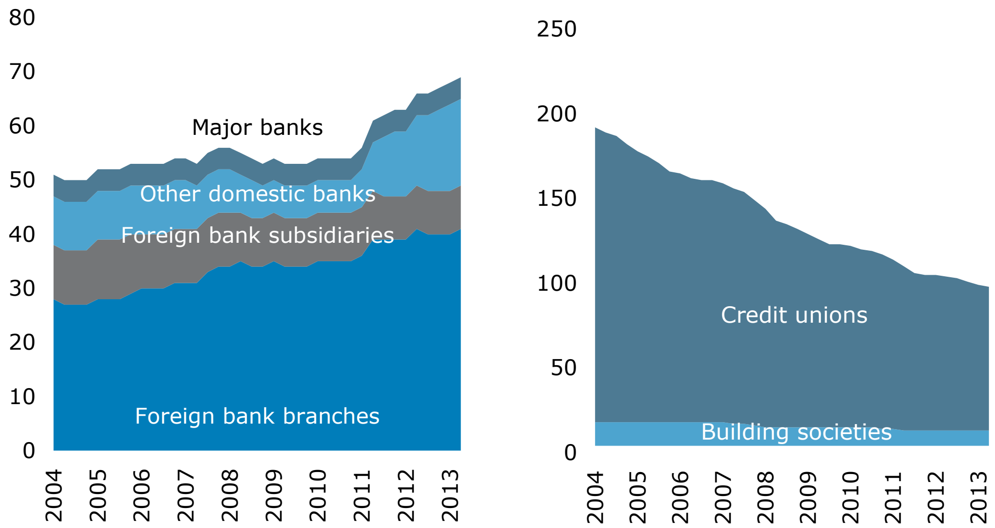


Source: ANZ

In addition to the four major domestic banks, there were nine other domestic banks in 2004. This had fallen to six in 2009, and had risen to 16 by the end of 2013 as some credit unions became banks. Credit union numbers have steadily declined over the past decade: from 174 credit unions in 2004 to 85 at the end of 2013 largely as a result of mergers driven by competition (see Figure 5.3).

Over the same period, the number of foreign bank branches in Australia has grown from 28 in 2004 to 41 by the end of 2013, while the number of foreign bank subsidiaries has shrunk slightly from 10 a decade ago to eight at the end of 2013.

FIGURE 5.3: CHANGES IN ADIs
(Number of ADIs)



Source: ANZ analysis of APRA data

KEY INDICATORS

Competition in the sector has benefited customers. Banks have become far more productive, delivering services at lower cost to customers. Analysis of key indicators for the four major banks provides strong evidence of these benefits.

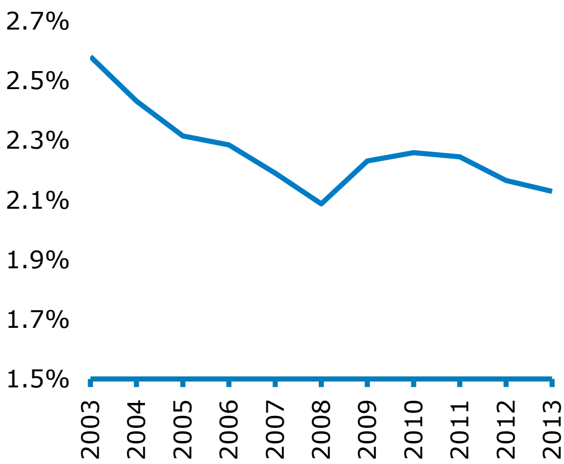
Net interest margin

NIM – the difference between the interest income generated by banks and the amount of interest paid out as a proportion of interest-earning assets – is one indicator of competition between the banks. While NIM is affected by a range of factors, a shrinking NIM shows that retail or wholesale customers are benefiting from higher rates on their lending to banks (deposits) and lower rates on borrowing from banks.

Figure 5.4 shows that over the last decade the NIM for Australia's four major banks has declined from 2.6 per cent to 2.1 per cent. This equates to around AUD11.3 billion in benefits per year accruing to millions of retail or wholesale customers and flowing through to the broader economy. This is based on 2013 interest earning assets of AUD2.5 trillion.

The rate of decline in the NIM over the last 10 years is slightly lower than the overall rate of decline since liberalisation of financial markets in the mid 1980s. RBA data shows that from the mid 1980s to 2008, the NIM fell from around 5 per cent to 2 per cent in 2008.[22] In the immediate aftermath of the GFC, from 2009 to 2010, the NIM increased as lenders required higher returns to compensate for risk. Since 2010, the NIM of the four major banks has trended down.

FIGURE 5.4: BANK NET INTEREST MARGINS HAVE TRENDED DOWN
(Net interest income as share of revenue, four major banks)



Source: ANZ analysis of major bank annual reports

Bank fees

The RBA's 2013 survey of bank fees shows that since 2009, total fees paid by households have fallen by AUD1.12 billion, or 22 per cent, to AUD4.05 billion in 2012.[23] A slight rise in credit card income in 2012 was offset by the decline in deposit fee income. Total household fees are the lowest since 2005 despite increasing customer transactions. Banks have reduced and abolished many fees, and customers are choosing free or lower-cost banking products.

Cost to income ratio

Competition has meant banks have redesigned business processes, restructured and continually sought to lower costs while improving customer experience. Figure 5.5 shows that in 2003 the cost to income ratio of the four major banks was 52 per cent and by 2013, this had fallen to 44 per cent.

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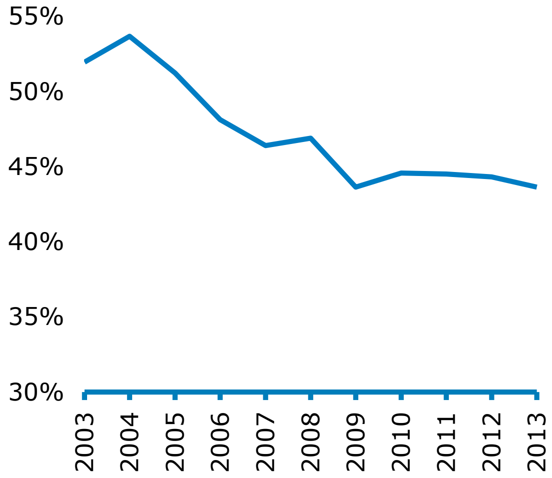
22 *Submission to the Inquiry into Competition within the Australian Banking Sector – Senate Economics References Committee Inquiry*, Reserve Bank of Australia, 30 November 2010, p.20.

23 Reserve Bank of Australia, "Banking Fees in Australia", *The Bulletin*, June Quarter 2013.

FIGURE 5.5: BANK COST TO INCOME RATIO HAS TRENDED DOWN
(Net interest income as share of revenue, four major banks)



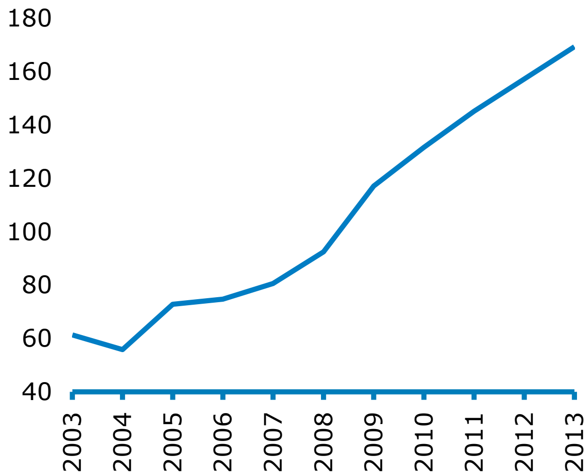
Source: ANZ analysis of major bank annual reports

The benefits of cost reduction flowed to customers as reductions in costs. As illustrated below, shareholders did not gain higher rates of return as a result of productivity improvements. Productivity improvements in effect allowed banks to maintain steady returns to shareholders.

Shareholder equity and returns

Shareholders have substantially increased the level of their investment in the banking sector over time (see Figure 5.6).

FIGURE 5.6: SHAREHOLDERS' EQUITY HAS INCREASED
(AUD bn average ordinary equity, four major banks)



Source: ANZ analysis of major bank annual reports

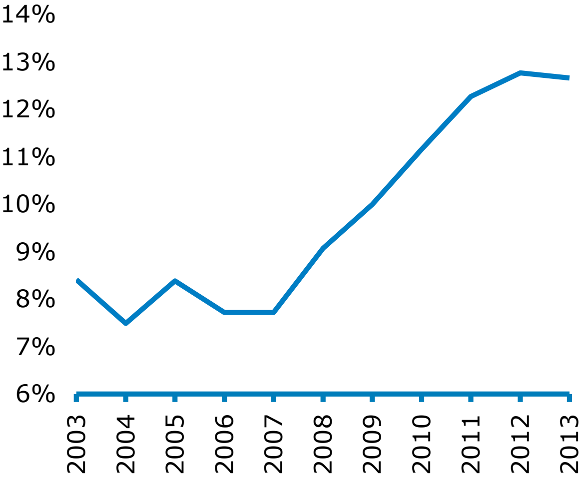
Return on equity was at around 18 per cent on ordinary equity of AUD61 billion in 2003, rising to 20 per cent on ordinary equity of AUD81 billion in 2007 (see Figure 5.7). Following the GFC, banks increased the proportion of equity to assets and return on equity reduced to around 16 per cent on ordinary equity of AUD169 billion.

FIGURE 5.7: BANK RETURN ON EQUITY HAS FLUCTUATED WITHIN A BAND, TRENDING DOWN
(Cash earnings as a proportion of average ordinary equity, four major banks)

Source: ANZ analysis of major bank annual reports

After the GFC, banks substantially increased equity, meeting increased regulatory requirements. In terms of capital leverage, the ratio of ordinary equity to risk weighted assets of the four major banks increased over the last decade from 8.4 per cent to 12.7 per cent (see Figure 5.8).

FIGURE 5.8: THE RATIO OF EQUITY TO ASSETS HAS INCREASED
(Average ordinary equity as a proportion of risk weighted assets, four major banks)



Source: ANZ analysis of major bank annual reports

The RBA Governor has stated that rates of return on bank equity are in line with returns for listed companies in other industries.[24] In our view, the rates of return reasonably reflect the risk the market attaches to investing in banking. If returns are below the expectations of domestic or international investors, then our ability to invest in Australia's financial infrastructure and support ongoing growth will be impacted.

The equity increase was particularly important following the GFC, underpinning the continued expansion of credit to bank customers. It supported economic growth at a time

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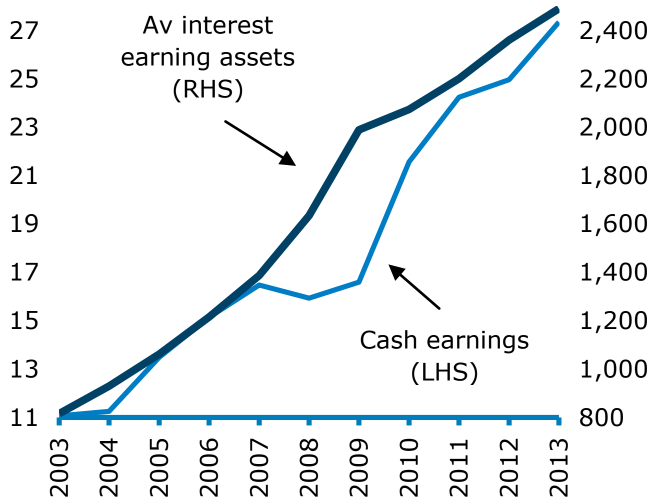
[24] Reserve Bank of Australia Governor, Glenn Stevens, stated in February 2012 that "rates of return on equity in our banks over a lengthy period of time, say 20 years, they are good but they are actually broadly in line with the listed company sector in general in Australia. I do not think it is obvious from that comparison that they are in some sense excessively profitable". *Reserve Bank of Australia annual report 2011*, House of Representatives Standing Committee on Economics, Official Committee Hansard, Friday, 24 February 2012, p.3.

when a contraction of lending would have compounded uncertainty and reduced jobs growth.

Profits increase with asset growth

Bank profits have clearly increased over the last decade. This is a result of increased bank balance sheets with profit increases in line with the level of assets. Figure 5.9 shows that in 2003, banks' interest earning assets stood at AUD816 billion growing to AUD1.39 trillion in 2007, AUD1.6 trillion in 2008 and to AUD2.5 trillion in 2013. Cash earnings grew in line with this from AUD8.1 billion in 2003, to AUD16.5 billion in 2007, AUD15.9 billion in 2008 and to AUD27.4 billion in 2013.

FIGURE 5.9: BANK PROFIT INCREASES ARE IN LINE WITH ASSET GROWTH (AUD billion, cash earnings and average interest earning assets, four major banks)

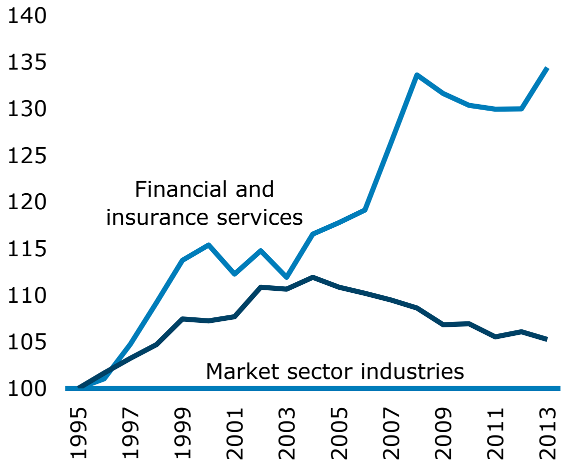


Source: ANZ analysis of major bank annual reports

PRODUCTIVITY IN THE FINANCIAL SECTOR

Productivity is a strong indicator of efficiency and competitiveness. The financial and insurance services sector has recorded strong productivity gains over the past two decades at much higher rates than most other sectors (see Figure 5.10). The financial services sector's contribution to national productivity has been significant. The only sector with a higher rate of productivity growth is agriculture, which is around 30 per cent of the economic output of the financial services sector. The financial and insurance services sector is second to the mining sector in terms of labour productivity in dollar terms per hour worked.

FIGURE 5.10: MULTI-FACTOR PRODUCTIVITY
(Index 1995 = 100, quality adjusted hours worked)



Source: ABS 5260.0.55.002

ENHANCING COMPETITION

Sound and profitable banks underpin a stable, growing economy. The Australian banking and financial services sector is highly efficient, productive and highly stable. Government should continue to support open, competitive markets as the primary mechanism for maintaining an efficient financial system.

The further development of the retail bond market would also facilitate competition as well as providing a source of capital for institutional borrowers and new investment products for clients. Up to now, the majority of Australian companies have chosen to go to deeper and lower risk overseas markets when issuing bonds. With an ageing population, there is likely to be increased demand for fixed interest securities in the future. Measures should be taken to remove any impediments to the successful operation of a bond market in Australia.

For example, retail bond market depth could be improved by lowering the cost of market access through targeted and simple regulatory requirements. Liquidity and efficiency of the bond market could be maximised by using common platforms and markets such as allowing the ASX-CGS market bridge to be adapted for corporate issuers.

As noted in Section 1 under the heading Competitive taxation treatment, removal of interest withholding tax on deposits would assist non-Australian banks to fund their Australian branches and may be considered a pro-competitive change.

Recommendation

19. An open market should continue to be the primary mechanism for maintaining an efficient, competitive financial system. Improvements to retail bond markets and removal of interest withholding taxes would promote efficient competition.

6. INNOVATION

KEY POINTS

- ANZ welcomes digital enablement and competition to drive innovation and improve the range, quality and cost of financial services. ANZ accords high priority to remaining at the forefront of technological innovation to better service customer needs.
- Banks are responsible for technological innovation and improvement of their businesses, however Government plays an important role in creating a regulatory framework to support innovation. Some regulatory obstacles to digital uptake should be reviewed:
    - For example, State and Federal Electronic Transactions legislation facilitates the provision of online banking products, however the legislation does not validate 'tick' acceptance of terms and conditions provided online. The legislation could be amended to provide certainty.
- Regulation will need to adapt to the growth of global and digital services.
    - Cross-border provision of financial services is hampered by national laws creating inconsistent or costly requirements. Government efforts to improve consistency should be encouraged.
    - Improved and more practical disclosure is needed for digital services. Today, few customers familiarise themselves with the extensive documentation on financial products which is currently provided.
    - The growth of alternative electronic payment systems should be monitored to ensure that the stability and security of the financial system is not compromised.
    - If new service providers offer deposit-taking or other prudentially regulated services, they should be subject to the same requirements as existing providers.
- The ability to make payments remotely via the internet or mobile devices adds additional risk into the payment system and underlying networks. We should continue to build on existing strong cooperation between government and industry. Some areas for further work are:
    - Developing secure verification and authentication solutions, improving security and ease of use
    - Reforms to improve sharing of information about criminal behaviour.

INNOVATION AT ANZ

Technological innovation to provide better value, security and an improved experience for customers is a high priority at ANZ. We invest heavily in new applications, information technology, channels, training and people,[25] at the same time rationalising existing systems and products, and simplifying business processes.

Retail

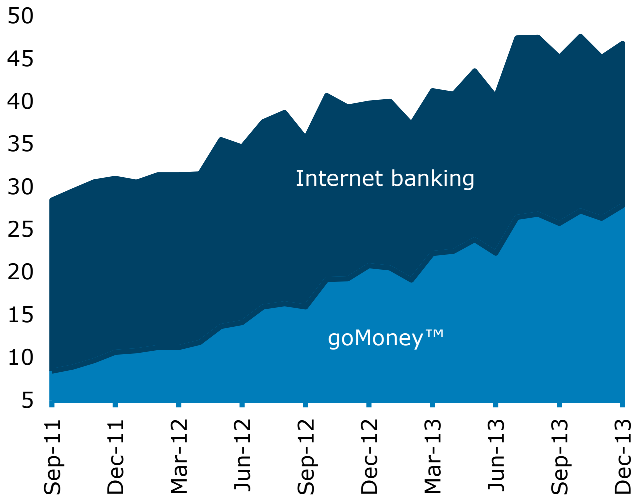
Digital and mobile technologies are growing in importance for banks and customers.

[25] In the financial year 2013, ANZ spent AUD780 million on acquiring and developing software and AUD1.2 billion on computer expenses. See *Consolidated Financial Report*, ANZ full year results.

Banking on Australia is ANZ's flagship business transformation program for Australia. It aims to build the bank's lead in mobile and digital services, transform distribution channels, simplify products and processes, and accelerate growth through customer insights.

ANZ's goMoney™ mobile application has more than one million active users sending and receiving mobile payments and conducting internet banking. It has over 25 million logins per month (see Figure 6.1) and AUD75 billion in transactions have been processed.

FIGURE 6.1: MOBILE CHANNELS ARE GROWING STRONGLY
(ANZ logins per month, million)

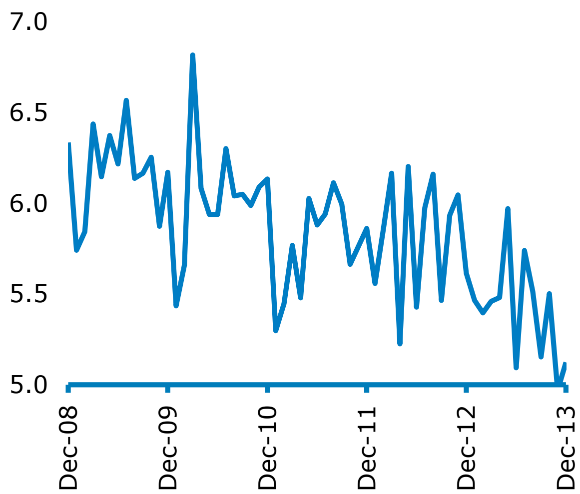


Source: ANZ

Other ANZ internet services are also experiencing rapid growth. Customers researching our home loan pages on anz.com are increasingly using real-time 'chats' via ANZ Live Chat to talk to bank staff. More than 400 Smart ATMs have been rolled out, enabling more customers to 'self serve' simple transactions such as cheque deposits.

The average number of transactions per branch is falling slowly (see Figure 6.2) and by 2015, digital will be the preferred channel for simple transactions. However, person to person contact through branches will continue to be important. ANZ is transforming its retail network to support branch staff to focus on more complex customer interactions; 85 new-look sales-focused branches have been rolled out to date.

FIGURE 6.2: TRANSACTIONS PER BRANCH ARE REDUCING
(Average number of transactions per month per ANZ branch, thousands)



Source: ANZ

Business

A particular focus of ANZ's super regional strategy is to provide Australian businesses with access to our regional network using technology-based solutions.

- We open and support business accounts in Asia to allow Australian companies exporting to the region to receive payments from their customers.
- Businesses can also access cross-border trade and foreign exchange services to help manage trade and currency risk.
- ANZ Transactive is an online cash management platform that provides centralised management of liquidity for companies operating across different markets.
- Business customers can use ANZ FastPay™ to process credit and scheme debit sales securely from an iPhone or iPad.

We have deployed mobile tablets to our Corporate and Commercial frontline bankers featuring the 'Super Regional' application, connecting our staff and customers across markets and facilitating cross-border customer services such as video access to specialists.

Wealth

ANZ's Wealth division has developed new superannuation products that offer customers lower cost and more convenient options than traditional retail funds.

- ANZ Smart Choice Super has low fees, provides online access linked to ANZ Internet Banking and goMoney™, and investment options that are matched to a customer's life stage.[26]
- ANZ Self Managed Super has a comprehensive establishment and ongoing online administration service for self managed superannuation fund trustees. It offers integrated application access to ANZ products such as cash, term deposits and equities broking (E*Trade).

COMPETITION AND POLICY

Technological innovation allows global and small players to compete with existing financial institutions. Such competition improves the value of services offered to customers and drives efficiency in the financial system more broadly. There is wide discussion of the nature of competition that might emerge. For example:

- Agile digital-based service providers are expected to become more significant competitors to traditional banks as transaction, deposit and lending services continue to move online. The decreasing use of cash for transactions will support the growth of these providers.
- Third party payment providers and new entrants, such as Square, Google Wallet and PayPal Here, are entering the payment markets to offer alternative means for merchants and card holders to take and make payments. These third parties challenge the traditional role played by banks in both merchant acquiring and card issuing services. The largest of these companies are operating globally, establishing a minimal physical presence in a particular location.
- Internet-based intermediaries are growing, providing services that improve customer choice and information. A simple form of intermediation service is the comparison website, providing information about the relative benefits of different offerings. These

[26] *Money* magazine has recognised ANZ in the 'Best Innovative Investing Product' category as part of their 2014 Best of the Best awards. ANZ Smart Choice Super was awarded Lowest-Cost Super and Lowest-Cost Pension.

may be further developed by use of customer information to provide direct comparisons and optimised offers based on customer needs. A further form of intermediation seeks to provide a means where a customer can seek direct offers from financial service providers, for example, for a car loan.

- Internet-based funding services are growing significantly and may over time affect mainstream financial institutions. Crowdfunding is being applied to equity raising, peer-to-peer lending, insurance services, and equity.[27]

Recommendations

20. The policy framework should support the growth of innovative services subject to appropriate regulatory safeguards.

21. The growth of alternative electronic payment systems and virtual currencies should be monitored to ensure that the stability and security of the financial system is not compromised.

22. Where innovative service providers undertake prudentially regulated activities, appropriate safeguards should be put in place. For example, if new digital payment providers in effect accept deposits, they should be subject to the same requirements as existing deposit-taking institutions.

REGULATORY BARRIERS TO DIGITAL SERVICES

Banks are responsible for innovation in their businesses. However, regulation can impede development of capabilities that would improve business processes or value to customers. In many cases, a perceived compliance risk means banks adopt a cautious interpretation of regulation and are reluctant to improve systems. In other cases, there are 'black letter' obstacles to be reviewed.

- *Privacy Amendment (Enhancing Privacy Protection) Act* 2012 – APP 5, APP 6 and APP 8 relate to collection, use, disclosure and cross-border transfer of customer information. This customer information can be used to identify likely customer needs and best offers. The operation of these principles is subject to interpretation. The resulting uncertainty limits use of information that could improve customer experience.

- Prudential Standard APS 222 – Associations with related entities – APS 222 requires an ADI to disclose to customers any associations with related entities and maintain arms-length dealings. The requirement limits development of integrated online portals and limits the ability to offer customers a seamless experience.

- *Electronic Transactions Act 1999* ('ETA') – Greater clarity of laws governing the retention of hard copies of documents is required to realise operational benefits from only exchanging and retaining digital versions.

  The ETA regulations are unclear on the form of consent required before documents can be sent to customers electronically. ANZ therefore requires customers to provide prior written consent. It would be preferable for the ETA regulations to be consistent with the Act and clearly state that consent to receive electronic communications can be in forms other than writing.

  The ETA together with the state *Transfer of Lands Acts* will require hard copies of certain documents (eg, issuance and storage of credit contracts and mortgages) to be retained by ADIs after the rollout of electronic conveyancing. This is costly and inefficient.

[27] See *SEC Issues Proposal on Crowdfunding*, US Securities Exchange Commission, 23 October 2013, press release, and Chance Bennett, *Top 10 Crowdfunding Sites For Fundraising*, *Forbes* magazine, 8 May 2013.

- Evidence Acts (Commonwealth and States) – Reform of state and federal Evidence Acts should be considered to ensure equal weight is given to digital documents and paper documents in evidence before a court. Original paper documents can potentially be viewed as 'better' than digital copies by the courts.

- *Financial Services Reform Act 2001*, *Corporations Act 2001*, s763A – Digital channels fall within the FSRA definition of 'financial products'. This requires ANZ frontline staff to have Tier 2 accreditation in order to have detailed discussions with customers about the benefits of using digital services. Without accreditation, staff can only have 'scripted' conversations with customers. This overly onerous training requirement for frontline staff is a barrier to efficiently advising customers on financial products and restricts the use of digital channels.

Areas in which policy development could help development of digital services include:

- The operation of the disclosure regime, which should be improved as it does not appear to meet its objective of informing customers before they agree to proceed. There is an opportunity to develop approaches to disclosure that will better meet customer needs in a digital environment.

- Coordination is essential between industry bodies concerned with payment clearing activities to minimise inconsistencies and duplication of work.

- Government should continue to work to migrate from paper to digital payments, champion digital payment and remove any legal barriers that mandate cheque use.

Detailed, ongoing cooperation between government, industry and stakeholders is often required to move from paper-based processes to digital services. Establishing a commercial model to meet an industry need is likely to be the most efficient approach. Examples of current approaches are:

- Reform of Australia's property conveyancing system and development of the Property Exchange Australia (PEXA) was overseen by the National e-Conveyancing Development Limited (NECDL), formed in 2010.

- In 2012, the Real-Time Payments Committee established the Australian Payments Clearing Association (APCA) to administer what is now known as the New Payments Platform under RBA reforms.

- Veda, a listed credit reporting company, was originally established in 1967 as a mutual organisation, the Credit Reference Association. It was demutualised in 1998 and in 2007 became a fully privatised company. Since then it has made a number of acquisitions and expanded its service offering.

Recommendations

23. *The Inquiry should seek out examples of specific regulatory barriers and policy gaps affecting the development of online financial services. It should consider best practice approaches to dealing with complex issues in migration to digital services.*

REGULATION OF CROSS-BORDER INFORMATION FLOWS

Every day, customers send business and personal information across borders as they transact business over the internet. Cross-border flows of information will grow as uptake of technology increases and data transmission costs fall. New information technologies, such as 'cloud' central data storage and 'big data' analysis, will reinforce the trend.

Cross-border information flows need appropriate regulation to protect the security and privacy of data. Differences between national regulations mean, however, that fully complying with relevant laws across all borders is costly and challenging.

There are two scenarios which provide particular challenges to financial institutions with operations in many jurisdictions. The first is where local law requirements prevent, or make it extremely costly and inefficient, to share data within different branches of the financial institution, which results in the financial institution needing to build duplicate systems for data storage and analysis within the local jurisdiction. For example, the local law requirement may prevent an Australian financial institution from sharing some types of data obtained in one Asian jurisdiction with its head office in Australia. A second scenario which is challenging is where a financial institution has obligations to report information externally, for example to an Australian regulator, but the local law requirement prevents this or imposes significant requirements before this information can be provided.

In either of these scenarios, the Australian financial institution may be faced with the difficult choice of complying with local law requirements or Australian law requirements, or ultimately ceasing the particular activity.

The requirement to fully comply in each jurisdiction means that otherwise economically efficient activity may be limited, because of the privacy and confidentiality requirements that vary from jurisdiction to jurisdiction even where similar or identical activity is involved. It becomes increasingly costly and complex to ensure ongoing compliance with all relevant requirements. As a consequence, the benefits of competition and new digital services may not be fully realised. These issues are a practical impediment to the development of regional markets and competition in Australia.

Recommendation

24. *Improving mutual recognition or harmonising regulation of cross-border information flows, in a manner consistent with protection and security of customers, should be a policy priority.*

TAXATION IMPLICATIONS OF MASTER TRUST REFORM

Taxation rules have created barriers to adopting a direct investing superannuation fund structure, impacting the ability to deliver lower cost and more innovative solutions to customers.

The ANZ Wealth Master Trust is a complying superannuation fund. Member contributions to the Trust are invested through a master life policy issued by a life insurance company. Over time, investments made through this legacy life insurance company structure have led to complexities in back office processes and higher administration costs. It is now common practice in industry to move towards a direct investing structure, reducing the inefficiencies and costs.

Under existing taxation laws, a movement of assets held by the life company to the superannuation fund with the direct investing structure would trigger the application of the capital gains tax rules. Although some loss rollover and asset relief rollover arrangements are in place, these do not effectively deal with the problem.

ANZ believes that loss rollover and asset rollover relief should be extended to allow assets within the life company structure to move to a direct investing structure within the umbrella of the same Master Trust without triggering the application of capital gains tax that would otherwise be borne by members.

Recommendation

25. *The Inquiry should seek examples of, and consider the role of, taxation, in impeding development of more efficient models of service delivery.*

CYBER SECURITY AND FRAUD

Government recognises the importance of cyber security. The Inquiry is an opportunity to build on the strength and security of Australia's financial system.

Financial institutions invest in sophisticated technology infrastructure and fraud detection systems designed to protect customers and the institutions themselves from financial and reputational losses. As internet bandwidth increases and the uptake of new technologies allows customers to be constantly online, appropriate cyber security controls are required.

Protecting financial infrastructure

Financial institutions continue to invest in ensuring critical banking infrastructure is resilient to cyber attacks. Increased bandwidth across telecommunications networks may create vulnerabilities to attack using high volume traffic, as experienced by US financial institutions. Telecommunications and financial institutions need to have appropriate defences in place, particularly at international network boundaries.

Identity theft

Identity fraud and cyber theft are increasingly commonplace and, in 2013, were estimated to cost approximately AUD3.3 million per organisation surveyed, a rise of 26 per cent from the previous year.[28] ANZ anticipates the risk of fraud, and the amount lost via fraud, will increase with the introduction of payments straight through processing in 2016.

The identification and verification of individuals and entities across Australia's financial systems presents challenges. The growing use of remote channels makes it increasingly important for banks to be sure they are dealing with the actual customer.

Changes are occurring in criminal behaviour, with increased criminal focus on identity theft. Theft of customer credentials (internet banking logins or credit card details) continues. Financial industry intelligence highlights the increasing sophistication of professional criminal organisations, which are increasingly commoditised and more profitable.

Financial institutions rely on government and non-government organisations to maintain the same standard of controls around identity verification that banks employ.

Recommendation

26. Banks and government need to continue to work together to improve secure verification and authentication solutions.

Threat intelligence and collaboration

ANZ participates in a number of joint committees between government and industry to share intelligence on cyber and fraud threats.

The Australian Federal Government & Banking Industry Security Governance Forum has been established to share cyber security intelligence. The new committee is improving collaboration and intelligence sharing to combat cyber security threats. This model of intelligence sharing between the US Government and US financial institutions has been successfully implemented.

The National Fraud Exchange (NFX) is currently being created to share fraud intelligence across the Australian financial community. Reforms to allow the sharing of fraud intelligence, currently protected under privacy laws, would improve intelligence sharing

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[28] "2013 Cost of Cyber Crime Study", Ponemon Institute, October 2013.

initiatives. Continued support and funding of these committees is paramount to improving banking security.

Recommendation

27. *The Inquiry should review current arrangements for sharing intelligence between government and business with a view to reducing fraud.*

Impacts on customers and victims

Financial institutions are commonly the identification point for fraud which impacts customers. Financial institutions therefore play an important role in supporting victims of fraud and in educating customers to prevent future attacks.

ANZ supports government security and fraud awareness campaigns. With the evolution of new technologies and increasing sophistication of security and fraud threats, these campaigns are important. Increased funding is required to educate the community about the risks of fraud and preventive measures.

Recommendation

28. *Education of the community about fraud risks and preventive measures should continue to be a priority.*

7. POLICY AND REGULATORY PROCESSES

KEY POINTS

- The Australian regulatory model establishes each agency as an independent body focused on its particular objectives. The Council of Financial Regulators, comprising the RBA, APRA, ASIC and Treasury, has proved an effective peak coordination body for the Australian financial system. The present arrangements could be enhanced:
    - Mechanisms are needed to provide guidance from government to regulators on the appropriate balance between broad economic outcomes, system stability and consumer protection.
    - A more formal approach should be considered for coordinating macroeconomic and monetary policy with bank prudential regulation as macroeconomic and monetary policy plays an important role in financial system stability.
    - Access to high quality commercial and economic advice and expertise to assist regulators in carrying out their functions should be encouraged.
- Since the GFC, banks and other financial institutions have implemented a massive program of regulatory change including Basel III and other G20 changes, Competitive and Sustainable Banking System Package, NCCP, FOFA, MySuper and the US *Foreign Account Taxation Compliance Act* (FATCA). These changes should be completed, bedded down and their impacts assessed.
- There are opportunities to learn from this period of extensive change. Improving regulation in the future requires:
    - Ensuring that subordinate regulation is consistent with case law, the *Corporations Act 2001 or* other laws, particularly in relation to the responsibilities of Boards and managements.
    - Better assessments of the benefits, costs, time frames and complexity of changes, including the interaction between prudential regulation and existing taxation, securities, corporate and solvency laws.
    - Increased planning of, and reporting on, regulatory changes, and clarity about the role of different agencies would be valuable. An annual assessment by the regulators or an independent body should be undertaken to test the regulation's efficacy and impact on the market.
    - A continued focus by the Australian Government on managing the implementation of international cross-jurisdiction regulation.

BALANCING ECONOMIC OUTCOMES WITH STABILITY

The Australian regulatory model – the RBA responsible for monetary policy and payments, APRA responsible for prudential regulation and ASIC responsible for market conduct and disclosure – establishes each agency as an independent body focused on its particular objectives. Treasury has policy responsibility for the operation of the financial system through the Treasurer.

The Council provides a coordinating and oversight function for the financial system. During and following the GFC greater emphasis has been placed on coordination of policy through the Council. The Council does not have formal decision-making powers and each regulatory agency retains its statutory independence.

Guidance from Government on policy

The financial system supports the real economy. Regulatory objectives should be set and outcomes assessed, taking into account wider impacts on the economy. A range of possible mechanisms to improve guidance to regulators on the government's economic policy might be considered.

Government could make a statement setting out its policy preferences if it wants regulators to take account of broader economic policies. Another option is to provide stronger guidance in the statutory objectives of the regulators. It may be valuable for the RBA as Chair of the Council to report to Parliament on broader economic outcomes including the overall impact of regulation on the financial system, as it currently does on monetary policy.

Recommendation

29. *Mechanisms should be considered to provide guidance from government to regulators on the appropriate balance between broad economic outcomes, system stability and consumer protection.*

Coordination of monetary policy with bank regulation

It is reasonably well accepted that macroeconomic policies can assist prudential regulation in addressing asset bubbles and supporting financial stability. In some jurisdictions this has led to banking regulation being incorporated into the central bank to facilitate coordination and to resolve competing policy responsibilities of institutions.

In Australia, responsibility for the execution of these policies relies on close cooperation between the RBA and APRA. While these arrangements have been successful in the past, there may be merit in more formal mechanisms being established to coordinate macroeconomic and monetary policy with prudential policy and bank regulation.

Recommendation

30. *A more formal approach could be established for coordinating macroeconomic and monetary policy with bank prudential regulation.*

Commercial and economic expertise

Regulators should take a broad perspective on the economy and the financial system into account in their decision-making. The structure of the RBA Board, including six non-executive members with wide commercial and economic experience, assists the RBA to take such a perspective. ASIC is established as a Commission of executive officers. It has appointed an External Advisory Panel to gain a deeper understanding of developments and risks within the financial services industry.

ANZ considers that the Inquiry should examine structural arrangements for ensuring regulators have access to high quality commercial and economic advice and expertise.

Recommendation

31. *Formal arrangements should be put in place to ensure all regulators have access to high quality commercial and economic advice and expertise.*

RESPONSIBILITIES OF BOARDS

ANZ notes that APRA appears to have increasing expectations of the role of Boards which extends the role from one of oversight into the realm of management responsibilities. For example, these expectations appear to be contained in Risk Management standards setting out requirements for Boards being involved in the development of policies and detailed risk appetite settings, and ensuring these are implemented. The distinction between Board and Management responsibilities is an important corporate governance principle defined by the *Corporations Act 2001* and case law and needs to be recognised by APRA.

Recommendation

32. Prudential regulation should be consistent with case law, the Corporations Act 2001 or other laws, particularly in relation to the responsibilities of Boards and managements.

IMPROVING REGULATORY PROCESSES

The GFC and Australian corporate collapses brought a greater focus on investment risk and reward. Falls in investment returns and some losses also focused attention on fees charged by fund managers. As a consequence the Government introduced legislation such as NCCP, FOFA and StrongerSuper (see Attachment C for an overview of major regulatory changes).

Over the same period, the banks and financial institutions implemented many other regulatory changes such as those arising from Basel III, the Competitive and Sustainable Banking System package, unclaimed moneys measures, OTC derivatives, FATCA, and AML enhancements.

Completing the program of regulatory change

Much of the resulting program of regulatory change will bring benefits to consumers such as improved protections against fraud, better disclosure, lower-cost access to superannuation and uniform national consumer credit laws. The post-GFC consumer protection legislation, when completed, will form a solid foundation for the future protection of consumers.

As noted in Section 1 under the heading Post-GFC regulatory approach, ANZ considers that the post GFC program of change should be halted while a considered cost benefit analysis is undertaken. Given the extent of change, it is appropriate to understand the performance and wider consequences of the change before further material changes are considered. ANZ welcomes the Coalition policy at last year's federal election to support a pause on significant regulatory change for the financial sector.[29]

Clarification about levels of government protection for different products, through a statement of principle and continuing supporting public communications, would help in setting expectations. This may assist consumers to make better-informed decisions and avoid complex future regulation.

Recommendations

33. Raising awareness of the level of protection for different types of financial products through regulator statements and continuing public education is important.

Better regulatory impact statements

Greater understanding is needed of the benefits and costs of regulatory change, particularly the time and complexity involved. The business impacts of changes, often affecting remuneration and staffing, business processes, information technology systems, training and compliance, are often underestimated. Improved business input on impacts in areas such as information technology, staffing and processes are likely to reduce costs and aid timely and successful implementation.

We fully support the Government's initiatives to reduce unnecessary regulation and improve regulatory processes. Important principles have been set out. Regulation should not be the default option; it should only be imposed where it offers an overall net

[29] "The Coalition's Policy to Boost Productivity and Reduce Regulation", July 2013

benefit; cost burdens should be offset by reductions in other regulation; every substantive regulation should be subject to a regulatory impact statement; and genuine and timely consultation should be undertaken. We welcome increased transparency such as the requirement that the information upon which policy makers base their decisions must be published at the earliest opportunity.[30]

Recommendations

34. *Assessments of the benefits, costs, implementation time frames and complexity need to be addressed before proceeding with regulatory change. Practical business issues and interaction between prudential, taxation, securities and corporations regulation need to be taken into account.*

Cross-agency regulatory changes

Better planning may be needed to deal with simultaneous domestic and international regulatory changes involving multiple agencies. Regulatory changes affecting financial institutions have involved the Treasury, the three principal financial regulators, as well as DFAT, the ATO and a range of departments.

Treasury, or one of the existing agencies, should be appointed as the lead agency for coordinating cross-agency regulatory changes. The task could involve developing and maintaining a timetable, and regularly reporting outcomes. It should include both international and domestic regulatory changes. A similar role is carried out by the Financial Stability Board reporting to the G20 on the status of post-GFC regulatory changes. Related to this, a process for reporting on regulatory change across the different agencies, and on the effectiveness and costs of regulation would be valuable.

An example of an area where coordination of activities can be improved is the relationship between SuperStream and the RBA New Payments Platform initiatives. The New Payments Platform has the capability to provide rich data with payments. This would allow enhanced employer direct credits so superannuation funds can reconcile and allocate member monies, a key efficiency goal of the SuperStream reforms.[31] The two programs should be aligned.

Recommendations

35. *Treasury or one of the existing agencies should be appointed as the agency for coordinating cross-agency regulatory changes. A lead agency should develop and report on timetables for, and outcomes from, regulatory changes.*

Managing international regulatory change

As noted in the previous Section, ANZ believes regulation of cross-border information flows is an area where government assistance in promoting more consistent international approaches would be valuable.

The Australian Government has sought to reduce uncertainty about, and the costs of implementing, international regulation affecting banking. A significant example of such regulation is FATCA. FATCA's introduction was particularly challenging because of variations between national approaches across the jurisdictions in which ANZ operates, new operational and information system requirements, and complex legal issues including privacy, confidentiality and data transfer. Tight deadlines for implementation exacerbated the challenge.

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[30] Australian Government, *The Australian Government Guide to Regulation*, March 2014 at www.cuttingredtape.gov.au.

[31] ANZ will be seeking deferral of SuperStream compliance from 1 July 2014 to 1 July 2015 to allow this program to be aligned to the RBA New Payments Platform capabilities.

ANZ encourages Treasury to work with the OECD to ensure harmonisation of FATCA and the OECD equivalent announced in February, the 'Common Reporting Standard'. Harmonisation is important to reduce implementation costs.

ANZ strongly supports the efforts of the Australian Government to manage implementation of international regulation in areas such as taxation. Business input on implementation impacts will be particularly important in providing guidance to Government on practical impacts.

Recommendations

36. *The important role of Government in managing implementation of international regulation should be supported and strengthened.*

ATTACHMENTS

ATTACHMENT A. OVERVIEW OF ANZ PRODUCTS AND SERVICES

CONSUMER PRODUCTS AND SERVICES

ANZ offers retail customers a range of product solutions including home loans, credit cards, personal loans, merchant services, transaction banking, savings accounts and deposits to our consumer customers, using capabilities in product, analytics, customer research, segmentation, strategy and marketing. It also provides a range of solutions for businesses including physical payment instruments (cash and cheques) as well as online and electronic payments.

- Home Loans provides housing finance to consumers in Australia for both owner occupied and investment purposes, as well as providing housing finance for overseas investors.
- Cards and Payments provides consumer and commercial credit cards, personal loans and merchant services.
- Deposits provides transaction banking, savings and investment products, such as term deposits and cash management accounts.
- Retail delivers banking solutions to customers across multiple distribution channels including the Australian branch network, ANZ Direct, specialist sales channels and digital channels (including goMoney, Internet Banking, anz.com).

The retail distribution network provides retail and wealth solutions to consumers, as well as providing small business solutions and meeting the various cash and cheque handling needs of corporate, commercial and institutional customers.

BUSINESS PRODUCTS AND SERVICES

Business needs for financial services are more sophisticated and vary by segment and industry. For example, ANZ has particular expertise in supporting regional trade, and customers value in-country support across the region, technology to manage transactions, and assistance to manage trade and currency risk. Customers in agriculture use commodity derivative products to help manage risks arising from primary production.

Corporate and Commercial Banking delivers business services including Corporate Banking, Business Banking, Regional Business Banking, Small Business Banking and Esanda:

- Corporate Banking provides a full range of banking services including traditional relationship banking and sophisticated financial solutions, primarily to large private companies, smaller listed companies and multinational corporation subsidiaries.
- Regional Business Banking provides a full range of banking services to non-metropolitan commercial and Agricultural (including corporate) customers.
- Business Banking provides a full range of banking services to metropolitan-based small to medium-sized business clients with a turnover of AUD5 million up to AUD125 million.
- Small Business Banking provides a full range of banking services to metropolitan and regional-based small businesses in Australia with a turnover of up to AUD5 million and lending up to AUD1 million.
- Esanda provides motor vehicle and equipment finance.

INVESTMENT, SUPERANNUATION AND INSURANCE

Our investment, superannuation, insurance products and services, as well as private banking for customers across Australia New Zealand and Asia, are provided by our Global Wealth Division and OnePath, a wholly owned subsidiary of ANZ. Products and services are distributed through the ANZ network, OnePath channels and financial service providers.

The Global Wealth division comprises Funds Management, Insurance and Private Banking which provides investment, superannuation, insurance products and services as well as Private Banking for customers across Australia, New Zealand and Asia.

- Global Private Banking specialises in assisting individuals and families to manage, grow and preserve their wealth. The businesses within Private Banking & Other Wealth include Private Bank, ANZ Trustees, E*Trade, Investment Lending, Super Concepts and Other Wealth.

- Funds Banking Management and Insurance includes OnePath Group (in Australia and New Zealand), ANZ Financial Planning, ANZ General Insurance, Lender's Mortgage Insurance and Online Investment Account.

INSTITUTIONAL AND INTERNATIONAL SERVICES

Our largest international customers outside Australia and New Zealand are served by the International and Institutional Banking Division. We offer financial and capital management, transactional and other banking solutions, as well as supporting major financing projects. Within Australia, we seek to meet the particular needs of customers through customer segment based groups serving retail, commercial, property, agriculture, utilities and infrastructure, diversified business, resources and financial institution customers.

Our Institutional business in Asia is growing quickly, focused on the fast-growing cross-border trade and capital flows, with particular emphasis on regional treasury centres like Hong Kong and Singapore, and products like Cash Management, Trade, Foreign Exchange and Debt Capital Markets. Returns in our Asian retail business are improving, with a focus on productivity and building our brand across the region.

- Global Institutional provides global financial services to government, corporate and institutional clients with a focus on solutions for clients with complex financial needs based on a deep understanding of their businesses and industries with particular expertise in natural resources, agriculture and infrastructure. Institutional delivers transaction banking, specialised lending and markets solutions in Australia, New Zealand, Asia Pacific, Europe and America. This includes:

    - Transaction Banking which provides working capital solutions including deposit products, cash transaction banking management, trade finance, international payments, and clearing services principally to institutional and corporate customers.

    - Global Markets which provides risk management services to corporate and institutional clients globally in relation to foreign exchange, interest rates, credit, commodities, debt capital markets, wealth solutions and equity derivatives. Global Markets provides origination, underwriting, structuring and risk management services, advice and sale of credit and derivative products globally. Global Markets also manages the Group's interest rate risk position and liquidity portfolio.

    - Global Loans which provides term loans, working capital facilities and specialist loan structuring. It provides specialist credit analysis, structuring, execution and ongoing monitoring of strategically significant customer transactions, including project and structured finance, debt structuring and acquisition finance, loan product structuring and management, structured asset and export finance.

- Retail Asia Pacific which provides retail and small business banking services to customers in the Asia Pacific region and also includes investment and insurance products and services for Asia Pacific customers.
- Asia Partnerships which is a portfolio of strategic partnerships in Asia. This includes investments in Indonesia with PT Bank Pan Indonesia, in the Philippines with Metrobank Cards Corporation, in China with Bank of Tianjin and Shanghai Rural Commercial Bank, in Malaysia with AMMB Holdings Berhad and in Vietnam with Saigon Securities Incorporation.
- Relationship & Infrastructure includes client relationship management teams for global institutional and financial institution and corporate customers in Australia and Asia, corporate advisory and central support functions. Relationship and infrastructure also includes businesses within International & Institutional Banking which are discontinued.

NEW ZEALAND

ANZ New Zealand is the largest provider of financial services in New Zealand, and accounts for 19 per cent of ANZ customer lending. We offer our New Zealand customers a full range of retail and commercial services.

The New Zealand division comprises Retail and Commercial business units, and Operations and Support which includes the central support functions (including Treasury funding).

- Retail – includes Mortgages, Credits Cards and Unsecured Lending to personal customers in New Zealand.
- Commercial – Commercial & Agribusiness provides financial solutions through a relationship management model for medium-sized businesses, including agri-business, with a turnover of up to NZD150 million. Asset Finance (including motor vehicle and equipment finance), operating leases and investment products are provided under the UDC brand. Small Business Banking provides a full range of banking services to small enterprises, typically with turnovers of less than NZD5 million.

CUSTOMER SERVICE AND SUPPORT

ANZ has a comprehensive framework of policies, processes and tools to manage our business with customers in a responsible manner and with the highest standards. Through this framework, we seek to reduce the causes of customer hardship and manage adverse outcomes. This includes programs to maintain high standards of conduct by bank employees, support customers in hardship, manage customer complaints and concerns and improve financial literacy.

CUSTOMER CHARTER

The ANZ Customer Charter sets out standards customers should expect us to meet. It reflects both the products and services that we currently offer and the high standards towards which we aspire. It includes protection against fraud, provision of simple to understand products and information, transparency around fees, service standards, and complaint resolution processes and standards.

COMPLAINTS MANAGEMENT

ANZ complaints management standards are set out in the Customer Charter. We aim for first-contact resolution and to resolve the majority of complaints within two business days and more complex complaints within five business days. In 2013, we resolved 90% of complaints within five business days.

A customer who is not satisfied with the outcome of a complaint offered by ANZ internal processes may seek resolution through the ANZ Customer Advocate or through the Financial Ombudsman Service (FOS). The Customer Advocate operates independently of ANZ's businesses and reports to the Chief Executive Officer (Australia Division). The Customer Advocate provides an independent and impartial approach to the resolution of customer complaints and disputes, including those involving small business customers. ANZ is bound by the Customer Advocate's findings in all cases.

CUSTOMER HARDSHIP

The ANZ customer hardship program, 'Customer Connect', is designed to make it easy for customers in Australia facing financial difficulty to get the assistance they need. The program aims to support customers at a time of difficulty and build a positive and lasting relationship with ANZ. Hardship Awareness training is also provided to frontline staff to help them to assist customers in hardship. In 2013 we assisted approximately 37,000 customers facing financial difficulties.

When a customer seeks hardship assistance, ANZ Customer Connect will assess the customer's request and consider their circumstances and financial position. We will seek information about how the customer's circumstances have changed, review options for repayment, and assess suitable products.

Assistance measures offered to customers depend on the customer's individual circumstances, financial position and loan type. They may include a short-term extension of the loan to reduce the amount of each ongoing repayment, deferring some repayments or a short period of reduced repayments with arrears capitalised into the balance of the loan, or refinancing. Credit card repayments may be reduced for a period of time with the credit card being closed so the customer does not get into further debt.

If a customer's situation has permanently changed, or they are experiencing long-term financial difficulties, then a change in their loan contract may not necessarily be in their best interests as it may just postpone inevitable default under their credit contract. In these circumstances, other options such as property sale may need to be considered and ANZ recommends customers seek financial advice, either from a financial planner or from an independent, community-based Financial Counsellor.

The Australian Bankers' Association (ABA) has recently worked with its members, including ANZ, and consulted with consumer and community groups to develop a package of hardship initiatives. These initiatives include an industry guideline, consumer fact sheet, standard forms for financial counsellors, and improvements to the 'Doing It Tough' consumer website, training and branch disclosure commitments.

In August 2013, ANZ launched a dedicated financial hardship micro website as part of the industry commitment to improve access to information about hardship. Our new site includes:

- Online hardship awareness training to help frontline staff identify customers who may be experiencing hardship and understand how we can best help them
- Introduction of a shorter, simpler hardship application form to make the process easier for customers

- Revising our hardship assistance options for customers in need, for example, a new debt consolidation loan is now available for credit cards, personal loans and overdrafts.

CODE OF BANKING PRACTICE

ANZ subscribes to the ABA's Code of Banking Practice which is the banking industry's customer charter on best banking practice standards. The Code sets out the banking industry's key commitments and obligations to customers on standards of practice, disclosure and principles of conduct for their banking services. The Code applies to personal and small business bank customers.

Among the many commitments in the Code, is an obligation to exercise the care and skill of a diligent and prudent banker in the provision of credit.

SPECIAL CIRCUMSTANCES

ANZ provides targeted assistance in natural disasters or special circumstances. There are times when retail and small business customers may be affected by special circumstances or natural disasters such as bushfires or floods.

For example, as part of our assistance package during the October 2013 New South Wales bushfire crisis, ANZ offered to suspend loan repayments; waive fees associated with restructuring business loans affected by bushfire; consider temporary adjustments to customer lending limits including credit cards to assist with unexpected costs arising from the fires; and waive fees associated with replacement of damaged business EFTPOS/credit card terminals. ANZ contacted customers in affected areas to ensure they were getting the assistance they needed and donated AUD75,000 to the Australian Red Cross NSW Disaster Relief and Recovery Appeal.

ANZ has supported customers and communities affected by natural disasters in other regions in which we conduct business. For example, following the devastating impact of the November 2013 Typhoon Haiyan in The Philippines, ANZ donated AUD100,000 (PHP4m) to the Red Cross to support recovery efforts. ANZ staff fundraising generated a further AUD102,000 which ANZ matched, bringing our total contribution to AUD304,000.

Similarly, ANZ has actively supported regional commercial customers during times of difficulty. For example, following the Australian Government's suspension of all live cattle exports to Indonesia on 7 June 2011, ANZ provided assistance for its regional commercial and farming customers affected by the ban and the period of uncertainty that followed. Regional commercial customers were encouraged to contact their relationship manager to discuss their circumstances and assistance options such as deferring business loan repayments (with interest capitalised); waiving fees associated with restructuring business loans considered necessary; and waiving fees associated with accessing business term deposits early.

CORPORATE RESPONSIBILITY AND SUSTAINABILITY

Governments, regulators and communities in Australia and across the other 32 countries where ANZ operates expect responsible, ethical and sustainable decisions and actions from us. Integral to achieving this is our ability to manage social and environmental risks and to capitalise on emerging opportunities.

ANZ has developed a strong framework to meet these expectations and respond responsibly to issues. Details of this framework are set out in the 2013 Corporate Sustainability Review.[32] ANZ has been named as the global banking sector leader in the 2013 Dow Jones Sustainability Index (DJSI) for the sixth time in seven years.

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[32] See "2013 Corporate Sustainability Review", ANZ. The ANZ full Global Reporting Initiative.

Our approach involves three broad steps of identification, prioritisation and review of issues. We analyse a wide range of sources which provides us with information about issues and impacts, perceived and actual. We assess the materiality of issues, considering how they may impact our business, their significance to key stakeholders, and the extent to which they may have notable social, environmental and economic consequences.

We review progress against our strategy and targets through our quarterly Corporate Sustainability and Diversity (CSD) committee meetings, chaired by our CEO. Material risks are also considered at our quarterly Reputation Risk Committee (RRC), chaired by our Chief Risk Officer. The outcomes are embedded in internal processes and reported externally. We consider material issues in reviewing and setting our Sustainability targets and priorities. These are determined by our CSD Committee, and reviewed and approved by our Board Governance Committee.

To support delivery of our business strategy we have set ourselves clear Sustainability priorities and targets. Our priorities are integrating social and environmental considerations into business decisions, products and services, building the most diverse and inclusive workforce of any major bank in the region, and improving the money management and saving skills of people across the region.

Our Sustainability targets for 2014 are outlined in the Review and we report our progress. Our reporting includes external assurance against international reporting standards. We achieved or made good progress against 80 per cent of our targets. Our public reporting and comment on specific issues takes into account privacy and other obligations.

FINANCIAL INCLUSION

ANZ's focus over the past 10 years has been on understanding through research the groups in the Australian population with relatively low levels of financial literacy and the key issues. We have developed and run programs in the community aimed at building the money management skills and savings of lower income people. Our programs are delivered in partnership with community organisations and the Australian Government.

Saver Plus is a matched savings account developed by ANZ and the Brotherhood of St Laurence. The program is open to people on lower incomes whose savings in an ANZ account over a 10 month period are matched by ANZ. Matched savings must be spent on either their own or their child's education. The program instils long-term savings habits in participants and research by RMIT shows that 87 per cent of participants are still saving the same amount or more up to 12 months post completion. More than 80 per cent of people who participate in Saver Plus encourage their children and other family members to save. Saver Plus participants have saved an estimated AUD8.9 million while on the program in the past 10 years. Since its inception in 2003, more than 16,000 people have participated in the program.

MoneyMinded is an adult financial education program that improves basic budgeting, savings and money management skills. It is delivered by financial counsellors and community partners. It helps people to learn to live within their means, increase their savings, manage credit and debt, and plan for the future. It provides unbiased consumer education and does not directly promote ANZ products. More than 240,000 people are estimated to have participated in our MoneyMinded over the past 10 years.

MoneyBusiness is MoneyMinded adapted for Indigenous participants. It is delivered in more than 215 communities across Australia by the Australian Government and community organisations. More than 27,000 Indigenous people have participated in MoneyBusiness.

(GRI) G3 A+ reporting for 2013 consists of this review, our annual report and information on our website www.anz.com/cr. KPMG has provided external assurance on the reports contents.

ATTACHMENT B. RISK MANAGEMENT AT ANZ

Risk management is a core competency at ANZ. To ensure that risks are identified, assessed and managed appropriately, ANZ has:

- An independent risk management function, with both central and enterprise-wide functions (which typically cover such activities as risk measurement, reporting and portfolio management), together with embedded risk managers within the businesses; and
- Developed frameworks to provide structured and disciplined processes for managing key risks. These frameworks include articulation of the appetite for these risks, portfolio direction, policies, structures, limits and discretions.

ANZ is exposed to a range of interrelated risks.

Credit Risk – is the risk of financial loss resulting from the failure of ANZ's customers and counterparties to honour or perform fully the terms of a loan or contract. ANZ has a comprehensive framework to manage credit risk and support sound growth for appropriate returns. The framework is defined by credit principles and policies. The effectiveness of the framework is assessed through various compliance and monitoring processes.

Market Risk – is the risk to earnings arising from changes in market risk factors, including:

- Interest rate risk: exposure to changes in the level and volatility of interest rates, slope of the yield curve and changes in credit spreads
- Currency rate risk: exposure to changes in foreign exchange spot and forward prices and the volatility of foreign exchange rates
- Commodity price risk: exposure to changes in commodity prices and the volatility of commodity prices
- Equity price risk: exposure to changes in and the volatility of equity prices.

The Markets Risk function is a specialist risk management unit independent of the business that is responsible for measuring and monitoring market risk. Markets Risk have implemented policies and procedures to ensure that ANZ's market risk exposures are managed within the appetite and limit framework approved by the Board.

Operational Risk – is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This includes legal risk, the risk of reputation loss, or damage arising from inadequate or failed internal processes, people and systems. It does not include strategic risk. Key operational risk themes include business disruption, rogue trader and mis-selling. Business units are responsible for the day-to-day management of operational risks through a framework that facilitates the identification, analysis, assessment, monitoring, treatment and escalation of operational risks.

Compliance Risk – is defined at ANZ as the probability and impact of an event that results in a failure to act in accordance with laws, regulations, industry standards and codes, internal policies, and procedures and principles of good governance as applicable to ANZ's businesses. Group Compliance is accountable for designing a compliance program that allows ANZ to meet its regulatory obligations. It also provides assurance to the Board that material risks are identified, assessed and managed by the business.

Reputational Risk – at ANZ means the risk of loss caused by adverse perceptions of ANZ held by the public, shareholders, investors, regulators, or rating agencies that directly or indirectly impact earnings, capital adequacy or value. We have established decision-making frameworks and policies to ensure our business decisions are guided by sound social and environmental standards and take into account reputation risk. An executive management Reputation Risk Committee has been established to assist ANZ businesses, Risk, Corporate Affairs and Legal to manage reputation risk in relation to environmental, social, business and regulatory issues.

Insurance Risk – is the risk of loss due to unexpected changes in current and future insurance claim rates. In life insurance business, insurance risk arises primarily through mortality (death) and morbidity (illness and injury) and longevity risks. For general insurance business, insurance risk arises mainly through weather-related incidents and similar calamities, as well as adverse variability in home, contents, motor, travel and other insurance claim amounts. Insurance risk is managed by: product design (to price all applicable risks into contracts); reinsurance (to reduce liability for large individual risks); underwriting (to price/reserve for the level of risk associated with an individual contract); claims management (to admit and pay only genuine claims); insurance experience reviews (to update assumptions); and portfolio management (to maintain a diversity of individual risks).

Reinsurance Risk – Reinsurance is an agreement in which one insurer ('the reinsurer') indemnifies another insurer for all or part of the risk of a policy originally issued and assumed by that other insurer. Reinsurance is a risk transfer tool between the insurer and reinsurer. The main risk that arises with reinsurance is counterparty credit risk. This is the risk that a reinsurer fails to meet their contractual obligations, ie, to pay reinsurance claims when due. This risk is measured by assigning a counterparty credit rating or probability of default. Reinsurance counterparty credit risk is mitigated by restricting counterparty exposures on the basis of financial strength and concentration. ANZ does not reinsure other businesses.

Strategic Risk – is the potential for loss arising from a failure in ANZ's strategies. This could include strategies designed to address or anticipate changes in the competitive, client, political or regulatory environments.

Business Risk – is the risk of financial loss due to unexpected movements in volume, profit margin, and operating expenses (excluding risks elsewhere defined) arising from unexpected changes in the business environment, customer preferences and/or competitor actions.

Liquidity Risk – is defined at ANZ as the risk that ANZ is unable to meet its payment obligations as they fall due – payments include repaying depositors or maturing wholesale debt, or that ANZ has insufficient capacity to fund increases in assets. The timing mismatch of cash flows and the related liquidity risk is inherent in all banking operations and is closely monitored. ANZ maintains a portfolio of liquid assets to manage potential stresses in funding sources. The minimum level of liquidity portfolio assets to hold is based on a range of ANZ-specific and general market liquidity stress scenarios such that potential cash flow obligations can be met over the short to medium term.

Equity Risk – is the potential loss that may be incurred on equity investments in the banking book.

Securitisation Risk – is the risk of credit-related losses that are greater than expected due to a securitisation failing to operate as anticipated, or if the values and risks accepted or transferred do not emerge as expected.

ATTACHMENT C. OTHER REGULATORY REFORMS

Section 3 System Stability outlined major reforms related to financial system stability. Described below are other major Australian and international regulatory changes affecting banking.

BANKING COMPETITION

- In February 2008, the Treasurer announced an *Account Switching Package* of measures. The package included a listing and switching service, a consumer complaints hotline, a consumer education website, and an ASIC review of entry and exit fees. The listing and switching service required banks to provide information on direct debit and credit transactions, avoidance of fees, and deal fairly with customers.

- In December 2010, the Australian Government announced its *Competitive and Sustainable Banking System Package,* a more extensive package of changes to the banking industry. It included a ban on exit fees on new home loans; new powers for the ACCC to prosecute anti-competitive price signalling; steps to make it easier to transfer deposits and mortgages; a new fact sheet for home loans; easier account switching; responsible lending reforms for credit cards; a third tranche of support for the RMBS market and accelerated development of bullet RMBS market for smaller lenders; covered bond initiatives and development of the corporate bond market.

NATIONAL CONSUMER CREDIT PROTECTION

- In July 2008, the Council of Australian Governments (COAG) agreed that the Australian Government would assume responsibility for regulating all consumer credit products with the Australian Securities and Investment Commission (ASIC) as the sole regulator. A two-phased implementation plan was put in place.

- Phase one of the *National Consumer Credit Protection Act 2009* came into effect from 1 July 2010 and established a national licensing regime for providers of consumer credit and credit-related brokering services and advice; required licensees to observe a number of general conduct requirements including responsible lending practices; and mandated membership of an external dispute resolution (EDR) scheme. It also extended the scope to include lending for the purposes of residential property investment. A primary objective of responsible lending obligations was to ensure that consumers are not placed in a credit contract which does not meet their requirements or objectives or would cause them to be in financial hardship.

  Further credit card regulatory changes were announced in March 2011 and commenced in July 2012. These included requiring credit card lenders to allocate repayments to higher interest debts first, preventing lenders from charging over-limit fees without consumer consent, a ban on written credit card limit increase offers without consumer consent, and requirements to inform consumers about the implications of making minimum repayments. It also included new disclosure requirements in the form of a key fact sheet to be provided to customers on application forms.

- In September 2011, the Government introduced NCCP Enhancement provisions including changes to consumer credit related to reverse mortgages. This included a no-negative equity guarantee for reverse mortgages and changes to the definition of 'financial hardship' and the circumstances in which an individual is considered to be in hardship under the National Credit Code. These changes came into effect on 1 March 2013.

In February 2013, the Government announced it would defer consideration of aspects of the *National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012* concerning the small business lending regulatory proposals. Proposed changes relating to investment lending have not progressed at this stage.

FUTURE OF FINANCIAL ADVICE

- In April 2010, the Rudd Government announced *Future of Financial Advice* reforms. The reforms were the Government's response to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into financial products and services following the collapses of Storm Financial, Opes Prime, and Westpoint.

  The principal changes were a prospective ban on conflicted remuneration structures including commissions and volume-based payments, the introduction of a statutory fiduciary duty so that financial advisers must act in the best interests of their clients, increased transparency in payments for financial advice, limits on the charging of percentage-based fees, and expansion of the availability of low-cost 'simple advice' to provide access to and affordability of financial advice. The powers of the Australian Securities and Investments Commission (ASIC) to act against unscrupulous operators were increased. The Abbott Government is currently considering amendments to legislation to clarify the statutory fiduciary duty, permit commission payments for general advice and make other changes to reduce complexity.

STRONG SUPER

- In December 2010, the then Government announced the *Strong Super* package of changes to superannuation law. The package of reforms arose from response to the Cooper review and resulting recommendations. The key changes were the introduction of a low-cost and simple default superannuation product called 'MySuper', heightened duties for superannuation trustees, and *SuperStream* changes (enhancing back office processes such as data standards and use of tax file numbers as identifiers). Changes to trustee obligations introduced 13 new APRA prudential standards and new reporting requirements; disclosure obligations for executive remuneration fees and investment performance and portfolio holdings. Changes were also made to requirements for self-managed superannuation funds.

  The Government's legislative program for Stronger Super was completed in June 2013 although some technical issues are yet to be addressed. The Abbott Government is currently consulting on changes to give effect to election commitments to improve governance, increase transparency of information provided by super funds and boost competition and transparency in the selection process of default super funds in modern awards.

PAYMENTS INNOVATION

- In June 2012, the RBA released the conclusions of its *Strategic Review of Innovation in the Payments System*. The review determined an agenda of reform including the following objectives: same-day settlement of all direct entry payments, real-time retail payments, low-value payments outside normal banking hours, more complete remittance information with payments, and addressing payments in a simple manner. It proposed the establishment of a new payments platform, based on hub-based architecture for providing real-time payments, including a settlement hub provided by the Reserve Bank. It also advised that it would establish an enhanced industry coordination body which would engage in more direct dialogue with the Payments System Board (PSB).

  ANZ supports these goals and was a member of the Real Time Payments Committee (RTPC), an industry committee that proposed an industry-based project to deliver a 'fast payments' solution for Australia, consistent with the aims of the review. Following the RBA agreement, the RTPC completed the first design and plan phase of the New Payments Platform (NPP) Program in December 2013. In November 2013, same-day settlement of direct entry payments was introduced. In October 2013, the

RBA and APCA commenced a process of consultation on the enhanced industry coordination body, the Australian Payments Council. In conjunction with the establishment of the Council, the RBA will launch a new 'User Consultation Group' to provide a structured mechanism for users of the payments system to contribute to policy formulation.

The Payments System Board's first set of Strategic Objectives has provided the industry with high-level direction for future capability development for payments in Australia, with the focus now turning to the realisation of these objectives.

PRIVACY

- The *Australian Privacy Principles* (APPs), a single set of privacy principles applying to both Commonwealth agencies and private sector organisations, were created through the *Privacy Amendment (Enhancing Privacy Protection) Act 2012*. The APPs replaced the old Information Privacy Principles (public sector) and the National Privacy Principles (private sector). The framework introduced more comprehensive credit reporting with improved privacy protections, and new provisions on privacy codes and the credit reporting code.

  The amendments allow credit providers to have access to more complete and reliable consumer information, improving lending decisions. Currently ANZ participates in 'negative' credit bureau reporting. The legislative changes allow access to additional credit bureau data about payment history; that is 'positive' reporting.

OTHER AUSTRALIAN REGULATORY CHANGES

- The Minister for Financial Services and Superannuation made announcements in April 2011 concerning the *Future Regulation of Financial Planners* providing tax advice. This provided for registration of planners providing advice, rules covering provision of general tax advice and tax advice, and registration as a tax agent. These changes were developed as elements of the Future of Financial Advice policy.

- The Treasurer announced in May 2011 a *50 per cent discount for interest income* up to $1,000 of interest income in a year. The Government determined that it would not proceed with this measure in the following year.

- The Minister for Financial Services and Superannuation announced changes to the *Product Disclosure Statement* requirements in June 2011. He stated that the introduction of a mandatory eight-page-long disclosure statement was a key deregulation and consumer protection measure.

- The Treasurer announced the *unclaimed moneys measures* in October 2012 in the 2012–13 Mid-Year Economic and Fiscal Outlook. These measures reduced the period of inactivity before a bank account or life insurance policy is required to be transferred to ASIC from seven years to three years, effective from 31 December 2012.

ANTI-MONEY LAUNDERING AND COUNTER-TERRORISM FINANCING

The *Anti-Money Laundering and Counter-Terrorism Financing Act* places obligations on financial institutions and other entities in relation to customer identification and verification of identity, record keeping and maintaining an AML/CTF program. The first tranche of changes under the main 2006 legislation were completed in 2008. A second tranche of changes was proposed in 2007 and was implemented in the following years. The Australian Anti-Money Laundering regulator, AUSTRAC, is currently proposing rules to increase regulatory requirements for customer due diligence and 'Know Your Customer'.

FOREIGN ACCOUNT TAX COMPLIANCE ACT

FATCA was enacted in 2010 to reduce offshore tax evasion, particularly in relation to American account holders at foreign (non-American) financial institutions internationally. Under FATCA, non-US financial institutions must report to the Internal Revenue Service (IRS) on their American clients. If a financial institution is not compliant with FATCA, particular payments to it from the US become subject to 30 per cent withholding tax.

Discussions about an Inter Governmental Agreement have been underway between the Australian and US Governments to reduce the overall burden on Australian business and improve reciprocal tax information-sharing arrangements. The US Treasury and IRS have deferred commencement to 1 July 2014, particularly to allow conflicts between FATCA and national privacy laws to be resolved.

OECD is developing international standards to implement a global version of the US FATCA measures, designed to combat tax evasion and maintain integrity of tax systems through the exchange of information. The G20 endorsed the development of new global standards and called on the OECD to take the lead on tracking its progress. Common reporting standards (CRS) covering reporting and due diligence were released by the OECD on 13 February 2014. The CRS draws extensively on the intergovernmental approach to implementing FATCA, taking account of the multilateral nature of the CRS system. Australia expects the standards will be adopted no earlier than 2016.

OTC DERIVATIVES REFORMS

A number of major Australian financial institutions are subject to global reforms to the derivatives markets as part of the G20 OTC derivatives commitments, including the US *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the 'Dodd-Frank Act') and the European Market Infrastructure Regulation. Foreign regulations impose obligations on Australian financial institutions relating to matters including recordkeeping, derivatives transaction reporting, central clearing and trade execution.

The Dodd-Frank Act also introduces the 'Volcker Rule' which will, from 1 July 2015, prohibit a number of Australian financial institutions with US assets from engaging in proprietary trading in certain assets and prohibit investments in certain 'covered funds'.