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Increasing opportunities for funds management through the financial system inquiry (the Murray Report)

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Contents

The Financial System Inquiry (FSI) final report by David Murray (otherwise termed as the Murray Report) was released on 7 December 2014. The report outlines a number of substantial recommendations and proposed tax reforms for the financial services industry. There are a number of key recommendations in the report that would raise particular interest for those operating in the funds management sector, especially in the middle market and start-up fund space. This bulletin provides detail on a number of those key recommendations and our four key observations that would be of interest to fund managers.

Key observations

Cutting through the report and the 44 recommendations, we believe there are four main areas that could potentially have a significant impact on the fund management space.

1 New initiatives and competitive products

The report contains proposals aimed at increasing the capital adequacy requirements for Australian ADIs and outlines the potential cost increases associated with these measures. This may give rise to opportunities for innovative fund products that seek to compete in the smaller business lending market. Coupled with the proposals regarding crowdfunding and bond issuances, we believe that there will be growing opportunities in this space in the immediate future.

2 Access to capital

There are competing recommendations that could dramatically change access to capital for a number of fund managers. That is, the recommendations relating to superannuation funds, and limiting them to a retirement savings vehicle, could have implications for managed funds in the wholesale and retail space where they rely heavily on this source of funding. However, this may be offset by recommendations that will improve access to funds (e.g. in relation to crowdfunding, bond issuances and APEC developments). These, will be coupled with proposals seeking to simplify disclosure requirements which may also assist.

3 Data analytics and competition

The recommendations relating to data-analytics and data sharing could lead to significant increases in information that is accessible by the public. This may also have an effect on the competitive advantage that may currently exist for fund managers, where they currently have access to this data. It may also reduce barriers for a number of smaller funds wishing to access this real time information.

4 Expanding scope for funds management:

There are exciting developments in the pipeline, with further work being done on the APEC passport, which could provide easy access to Asian investment for our local funds. This will be coupled with developments to the taxation rules on managed investment trusts (to provide certainty to international investors), the investment manager regime (that provide tax incentives for international investors that are managed in Australia) and the CIV review (which could provide alternative fund management vehicles, such as companies, where trusts (MITs) are not properly understood in many jurisdictions).

Further information on these recommendations and our observations are contained in this detailed bulletin.

Overview of the Murray Report

The financial services industry in Australia has experienced significant growth over the past 20 years. In particular, the Murray report highlights that since 30 June 1996 the financial and insurance services sector's output has increased from $41 billion to $133 billion.

The superannuation system has grown from $300 billion of assets to over $1.8 trillion today and our banking institution holdings of domestic assets have increased from $560 billion to $3.5 trillion. This growth in financial services has no doubt been significant, if not exponential.

From a Federal revenue collection perspective, tax collected from this sector is also significant, whereby a total of $38.8 billion was raised in taxes (per the ATO's most recently released public statistics).

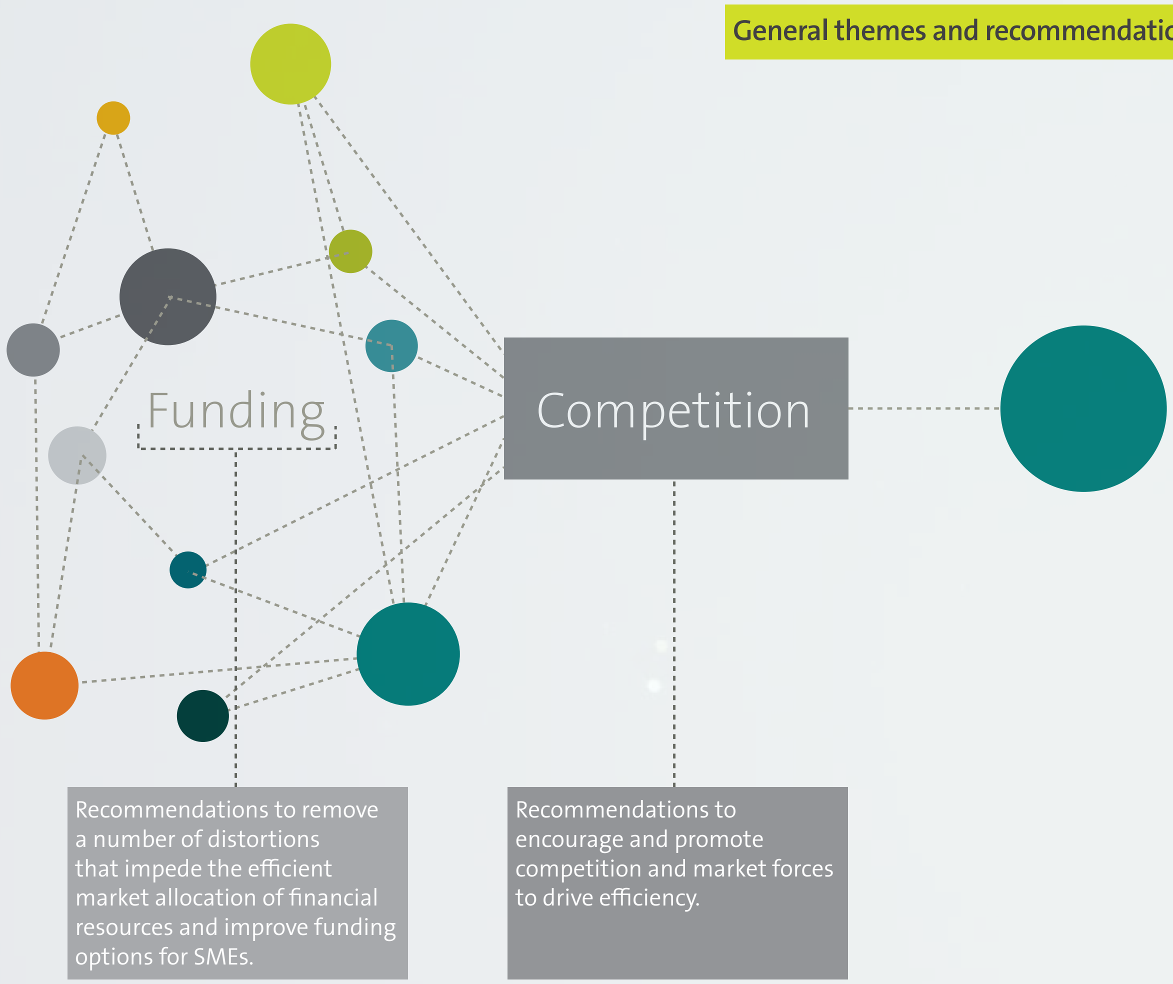
In this context, the objective of the Financial System Inquiry (FSI) (as outlined in its terms of reference) is to assist in the development of the best position for Australia's financial system to meet Australia's evolving needs and to support economic growth. That is, to provide a blueprint for an efficient and resilient financial system over the next 10 to 20 years.

In seeking to achieve this outcome, the Murray Report released on 7 December 2014 has made 44 recommendations, including 13 observations for reforms to the financial system in Australia. Furthermore, it has outlined some significant tax reforms that it has suggested be looked as part of the White Paper review.

The recommendations at a glance

The recommendations contained in the Murray report consist of eight main categories. In particular, the report categorises these into general themes and specific themes. These are summarised in the following diagrams.

General themes and recommendations



Specific themes and recommendations

Resilience

Help ensure that Australia's financial system is resilient to avoid or limit the costs of future financial crisis.

Super and retirement

Increase the scope for the super system to better meet the needs of fund members and provide broader benefits to the financial system and the economy.

Innovation

Help to provide a more facilitative settings that enables innovation, by identifying opportunities, removing impediments, supporting data driven business models and providing flexibility.

Consumer outcomes

Seek to strengthen the current framework to promote consumer trust in the system and the fair treatment of consumers.

Regulatory system

Ensure Australia has a strong, independent and accountable regulatory system to help maintain trust and confidence in the financial system.

Taxation

A number of taxation issues relating to the finance industry (e.g. negative gearing) should be considered as part of the White paper review.

Overview on potential impact for funds management

The comprehensive 350 page report outlines a large number of potential changes that are likely to have a significant effect on the financial services market.

Due to the significant nature of the reforms, consultation and submissions are due to close in March 2015. Based on this timeframe, it is likely that the reform package could take some time to be implemented.

However, that being said, there are a number of key recommendations (as outlined below) that, if implemented, could have a significant impact for fund managers, especially those dealing in the start-up fund space and the middle market space.

While the Murray report is unlikely to be implemented for some time, there are also a number of additional initiatives that are being examined by the Government concurrently that may also assist in promoting innovative funds management.

From a taxation perspective, this includes the (soon to be released) legislation on the taxation of Managed Investment Trusts (MIT regime), the stage 3 implementation of the Investment Manager Regime (IMR regime) and the eagerly anticipated Collective Investment Vehicle report (CIV report) which is expected to contain the Board of Taxation's response to extending the IMR regime to private high wealth groups, as well as providing alternative CIV structured vehicles.

Commentary on key recommendations and taxation matters

This section details some of the key recommendations that we believe will have an impact on fund managers, especially in the start-up and middle market space.

Furthermore, we also outline and provide some information on some key taxation changes that (when coupled together with these proposed recommendations) will help to pave the way and facilitate more creative funds management in Australia.

Recommendation 1

Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.

Recommendation 2

Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

Recommendation 3

Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.

Recommendations one to three are related to capital adequacy requirements of financial institutions.

Given various uncertainties and risks outlined with the financial sector globally, the recommendations are aimed at ensuring that capital adequacy ratios in Australia remain strong. These recommendations were expected.

The report has requested that APRA consider these recommendations in light of setting its capital adequacy requirements, in particular requesting that APRA increase the current requirements for Australia ADIs.

These recommendations will likely have an impact on the cost of financial institutions doing business. That is, the report calculates that raising capital ratios by one percentage point would increase the average loan interest rates by around 10 basis points. The actual cost to financial institutions will therefore be dependent on the response from APRA. The ultimate question will be whether financial institutions will seek to pass this cost on to consumers.

From a funds management perspective, this may give rise to a number of opportunities. A number of the report's recommendations are geared at providing alternative (non-banking) products to consumers, especially around the bond and debt market. The proposals relating to crowdfunding for managed investment schemes (recommendation 18) and the proposals relating to the issuance of bonds by public companies (recommendation 33) could assist in providing access to alternative sources of funding that may become more competitively priced as compared to the major financial institutions.

Recommendation 8: Direct borrowing by superannuation funds

The proposal seeks to remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.

Currently superannuation funds may borrow directly using limited recourse borrowing arrangements (LRBAs)[1].

This recommendation in the Murray Report is aimed at removing the exception for borrowing and thus would seek to remove the borrowing risk being built up in the superannuation system. It also advocates returning the superannuation system to one of a savings vehicle for retirement rather than as a broader wealth management vehicle.

While we agree with these observations in the Murray Report, we believe that the recommendation may be excessive. That is, where appropriate limited recourse debt arrangements are put in place and where asset classes are appropriately segregated, the limited recourse feature contained in debt facility can help to ensure the protection of other (non-debt funded) assets situated in the fund.

Where the borrowings are directly used to fund investments and are not coupled with security or financed using other assets in the fund, the limited recourse nature of the borrowings provides an investment avenue for growing the fund and assisting in creating wealth for the purposes of retirement. Accordingly, we believe there is merit in retaining this exception, albeit in limited cases where appropriate LVRs or asset segregation rules help to remove or reduce the risks outlined in the report.

Furthermore, we highlight that the superannuation industry comprises a major component of the funds management industry in Australia. At 30 September 2014 (ABS), the managed funds industry comprised of $2,439.5b funds under management, whereby superannuation funds comprised $1,789.3b (unconsolidated). Significant changes to superannuation could have dramatic implications for fund managers, either directly or indirectly, and thus could also have substantial implications for our economy as a whole.

1. Section 67A of the Superannuation Industry (Supervision) Act 1993

Recommendation 15: Digital identity

The Murray Report has recommended that we develop a national strategy for a federated-style model of trusted digital identities.

Digital identity is about how parties (individuals, businesses or government) confirm the identities of other parties for online financial transactions.

Currently, this is done by providing identity verification (appropriate papers and ID checks) and identity authentication (for example, via username and passwords).

A federated model of digital identity would involve a decentralised model where multiple identity credentials would be produced by government and commercial providers, which would then be used for access to public and private sector services.

Essentially, the recommendation would be aimed at seeking to improve convenience and security. That is, it would be aimed at: reducing reliance on paper-based mechanisms; enhancing privacy; enabling consumers to choose identity providers; removing repetitive processes undertaken by investors and government agencies; reducing the number of credentials managed by each party; and facilitate innovation and best use of technology.

This recommendation could help provide a gateway for more efficient identity certification and could also help to promote a more responsive application process for funds. This would be particularly helpful in many new types of funds being currently established, where the time required between raising cash and the deployment of cash is critical (for example, in a crowdfunding environment). It could also remove considerable compliance required for fund administrators, which need to have certain investor information in order to be compliant from a KYC and FATCA perspective.

However, that being said, the recommendation will come with added risks that would need to be managed including privacy of information and information security.

Recommendation 18: Crowdfunding

Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

Globally, there is an increasing appetite for crowdfunding. Broadly speaking, there are a number of crowdfunding models that have evolved, including securities-based crowdfunding (where the 'crowd' invests in an issuer in exchange for securities) and peer-to-peer lending (where an online intermediary facilitates lending).

While it is possible to establish a crowdfunding vehicle in Australia currently (e.g. using a managed investment scheme), the Murray Report identifies a number of impediments in Australia including restrictions on the ability to offer securities to the public and licensing requirements for peer-to-peer funding. Accordingly, some of the crowdfunding vehicles being established in Australia are accessing funds through wholesale (rather than retail) investors.

One of the key advantages of the crowdfunding model is that it could allow small business to access funding (e.g. loan capital) in a simpler manner as compared to a traditional loan with a financial institution.

On 8 December 2014, the Treasury released a discussion paper outlining proposals to simplify crowd sourced funding in Australia, titled "Crowd-sourced Equity Funding". The report provides three alternative models to address crowdfunding, including: a regulatory framework based on the Corporations and Markets Advisory Committee (CAMAC) model of June 2013; a regulatory framework based on the New Zealand model; or retaining the status quo.

The key aspects of the CAMAC model and the New Zealand framework are about reducing risks. Accordingly, the models propose investor limitation caps, disclosure caps and other AFSL licence holding requirements. While it may take some time to develop an official crowdfunding regulatory system in Australia, it is clear that crowdfunding is likely to be a growth area for wholesale and retail fund managers in the immediate future.

Recommendation 19: Data access and use

Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

The Murray Report recommends that the Government instruct the Productivity Commission (PC) to commence, by the end of 2015, an inquiry into the costs and benefits of increasing access to and improving the use of data, subject to privacy considerations.

The report identified broad types of information, including increasing access to public sector information, access to personal information, and access to private sector data.

To demonstrate the potential application of the data-sharing proposals, the report provides a number of examples. One of those examples involves a small business entity and its use of data-analytics under the recommendations. The report demonstrates the potential for entities to share their own personal data and obtain access to industry wide data for the purpose of data-analytics as well as for the purpose of obtaining finance or matching financial products for customers.

While the outcomes of this review will only be seen during the 2016 income year, the proposals contained on data access and use could significantly change how data is shared and used in the financial services industry.

Recommendation 23: Facilitate innovative disclosure

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

Currently, Product Disclosure requirements are mandated, which sets the form and content requirements. The Murray Report highlights that these requirements are impeding issuers from developing innovative approaches to communicating disclosure information.

Furthermore, it highlights that consumers could more effectively use information that is accessible, engaging and understandable. Accordingly, by presenting financial product information in shorter disclosure documents (e.g. that are better signposted and that use plain English and graphics), the Murray Report highlights that this could help to improve consumer understanding.

Currently there is an ASIC pilot project looking at innovative forms of disclosure. The Murray Report has endorsed this project and suggests that the results and findings should be examined when looking at changing the laws relating to innovative disclosure. Furthermore, the Murray Report has also highlighted that it believes there should be improved disclosure of risk and a more consistent approach to fee presentation.

Depending on the actual findings of the ASIC pilot, positive changes could be made to the very complex nature and form of the PDS documents that are currently produced as a part of products offered to the market.

Recommendation 33: Retail corporate bond market

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

The Murray Report has recommended that the Government should amend the law to reduce disclosure requirements for large listed corporate issuers of 'simple' bonds.

Essentially, the proposal would be limited to the top 150 companies by market capitalisation on the Australian Securities Exchange (ASX). The reduced disclosure requirements would be similar to the current requirements for a domestic wholesale issue and thus would be expected to reduce issuance costs for bond issues, making them a more attractive form of capital raising going forward.

Recommendation 34: Unfair contract term provisions

Support Government's process to extend unfair contract term protections to small businesses. Encourage industry to develop standards on the use of non-monetary default covenants

The unfair contract term (UCT) provisions under the Australian Securities and Investments Commission Act 2001 currently do not apply to small business loans or business-to-business lending.

Essentially, the Murray Report has extended its support for the Government's public consultation and policy development process, whereby the coverage of UCT protections would be extended to standard form contracts to small businesses.

Questions may arise as to whether the extension of the UCT provisions would impact the crowdfunding proposals contained in Recommendation 18, and whether current and future mezzanine debt funding structures (to small businesses) would also be affected by the UCT proposals. However, as the proposals are not intended to extend to non-standard form contracts, it may be the case that there will be no effect on these types of arrangements.

Recommendation 35: Finance companies

Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institutions.

The Murray Report has made some recommendations regarding Finance Companies and products offered by those companies. Currently, finance companies operate under an exemption from the Banking Act 1959, whereby they are entities that can raise funds by issuing debt securities rather than by accepting deposits. However, one of the problems during the GFC and other downturns (with respects to finance companies) has been that products offered have been marketed as bank account–like products, effectively allowing consumers to access funds at call (similar to deposit accounts).

Instead of banning finance companies from accepting retail products from consumers, the report has recommended that the products offered by finance companies be differentiated from accounts offered by ADIs. Accordingly, there is a recommendation that APRA ban finance companies from offering at-call products to retail consumers and from using bank account–like terminology.

This recommendation could materially impact products offered by finance companies and would also likely have an impact on transitional arrangements offered by these entities.

Recommendation 42: Managed investment scheme regulation

Support Government's review of the Corporations and Markets Advisory Committee's (CAMAC) recommendations on managed investment schemes, giving priority to matters relating to: (a) Consumer detriment, including illiquid schemes and freezing of funds; (b) Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.

There are currently a number of reviews into the operation of managed investment schemes in Australia. These reviews have identified a number of issues associated with the regulation of MIS arrangements.

More recently, the report by CAMAC identified issues associated with recognising our Australian regulatory system in a cross border sense. Australia is currently a member of APEC (Asia-Pacific Economic Co-operation), together with Korea, Singapore, Thailand, the Philippines and New Zealand. The aim of APEC is to develop the Asia Region Funds Passport to facilitate the cross border distribution of managed fund products across the Asia region. Essentially, it would allow collective investment products offered in one Passport economy to be sold to investors in another economy. A discussion paper on the Passport was released in April 2014.

That being said, the report released by CAMAC outlined a number of issues associated with the regulation of MIS arrangements that could impede other jurisdictions from recognising the equivalence of the Australian regulatory regime.

In our view, the creation of the Passport would facilitate a number of the taxation projects that have been initiated by the Government in trying to create Australia as being a financial services hub. That is, the Investment Manager Regime, the review of Collective Investment Vehicles, and the re-write of the Managed Investment Scheme provisions, are all aimed at collectively establishing Australia as a base for conducting a managed funds business in the Asian region. We believe that the Passport would not only help to promote these initiatives, but may also help to provide access to fund capital from investors in the Asian market.

Tax issues raised

The report identifies a number of tax issues that it believes distorts the allocation of funding and risk in the economy. The report has also identified other tax issues that may adversely affect outcomes in the financial system. Unless they are already under active Government consideration, the tax issues outlined below are to be considered as part of the Tax White Paper process.

Without making any recommendations on tax, the Murray Report identifies a number of taxation issues that it believes distorts or adversely affects the financial system.

Accordingly, it has put forward those issues for consideration as part of the White Paper review process. The views outlined in the report include the following:

- **Tax on savings**: The report believes that savings are taxed heavily and thus discourages savings into less productive investment opportunities that are more tax neutral. The report suggests that this be reviewed.
- **Negative gearing and capital gains tax**: The report suggests that the tax incentives encourage leveraged and speculative investment and higher housing debt. The report identifies this as a potential source of risk for the financial system and the economy.
- **Dividend imputation**: With increasing globalisation, the report believes that the dividend imputation system leads to domestic investors favouring investment in domestic equities. Furthermore, refundable franking credits have led to lower revenue collections in terms of lower taxed entities (such as superfunds and individuals).
- **Interest withholding tax**: The report believes that differing withholding tax rates and rules leads to funding distortions. However, it acknowledges that lower more uniform withholding tax rates could lead to potential anti avoidance practices.
- **Research and development incentive**: In line with the Board of Taxation report and in-principle acceptance by the Government, the report believes that simplifying the tax rules for VCLPs and streamlining Government administration of the regime would reduce barriers to fundraising.
- **Tax treatment of collective investment vehicles**: In 2011, the Board of Taxation provided a report on the taxation treatment of collective investment vehicles, with recommendations outlining whether Australia should extend its regime to other legal forms (i.e. other than managed investment trusts). The report has yet to be released by the Government. The paper advocates the consideration of this issue as part of the White Paper review.
- **Superannuation concessions**: The report outlines the view that the concessions provided under the superannuation system are not well targeted to achieve the provision of retirement incomes.
- **Differential tax rates in superannuation funds**: The differential rates of tax in a superannuation fund, as between earnings in the accumulation phase (taxed at 15%) and earnings during the retirement phase (untaxed), has been raised as an issue creating barriers for offering a 'whole of life' superannuation product. The report recommends considering a single rate to encourage innovation on 'whole of life' products and to reduce arbitrage opportunities.
- **Goods and services tax**: GST is not levied on a number of financial services (being input taxed). Accordingly, the report believes that this creates a distortion in the system, whereby households over-consume financial services (as they cannot otherwise claim a credit) and businesses may be reluctant to consume certain financial services.

It is positive that the Murray Report has refrained from making recommendations on taxation aspects and has (instead) asked for these issues to be taken to the White Paper. The issues raised by the Murray Report are very complex and the proposals could have significant economic effects for many industries and the broader economy.

For example, if negative gearing were to be abolished, this could have negative impacts on the construction industry in Australia, which is a major component of our overall GDP and comprises a significant amount of tax revenue collections.

Furthermore, while issues have been raised in relation to the imputation system, abolishing imputation without compensatory adjustments would likely have a significant effect on the investment choices made by superannuation funds, whereby a significant proportion of the $1.8 trillion dollars of superannuation assets are heavily invested (either directly or indirectly through managed funds) in our stock market. A significant shift in asset class choice by superannuation funds could also result in lower stock prices and net asset values for these funds.

While considering the GST treatment of financial services may also be worthwhile, it is noted that it would involve difficult questions of valuation. For example, whether an originated loan of $1 million would result in the imposition of $100,000 of GST, or whether interest charged would result in the imposition of GST. Accordingly, very few jurisdictions have sought to impose GST on financial service products.

As briefly outlined above, the issues associated with the tax measures raised in the Murray Report are significantly complex. Therefore, taking these issues to a White Paper review, rather than recommending changes to these areas, is an appropriate way to consider these issues more systemically.

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