Book

Competition in the Australian financial system

Reference: (2018). Competition in the Australian financial system. Canberra.

Australian Government
Productivity Commission

Competition in the Australian Financial System

Productivity Commission Inquiry Report

No. 89, 29 June 2018

ISSN 1447-1337 (online)
ISSN 1447-1329 (print)
ISBN 978-1-74037-661-7 (PDF)
ISBN 978-1-74037-660-0 (print)

Publications enquiries

Media, Publications and Web, phone: (03) 9653 2244 or email: mpw@pc.gov.au

The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Australian Government
Productivity Commission

Canberra Office
Level 2, 4 National Circuit
Barton ACT 2600
GPO Box 1428
Canberra City ACT 2601
Telephone 02 6240 3200
Facsimile 02 6240 2199
Melbourne Office
Telephone 02 6240 3200
www.pc.gov.au

29 June 2018

The Hon Scott Morrison MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report into *Competition in the Australian Financial System*.

Yours sincerely

Peter Harris	Julie Abramson	Stephen King
Presiding Commissioner	Commissioner	Commissioner

Terms of reference

I, Scott Morrison, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby request that the Productivity Commission (the Commission) undertake an inquiry into competition in Australia's financial system.

Background

The financial system undertakes a number of key functions both directly for households and in support of the operation of the whole economy. These include allocating capital, aiding the smoothing of consumption, helping manage risks, and providing payment services. The financial sector itself is the largest sector in Australia - accounting for around 10 per cent of our economy.

The 2014 Financial System Inquiry (the Murray Inquiry) considered that although competition generally appears adequate, the high concentration and degree of vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time.

The Murray Inquiry recommended that the Government strengthen the focus on competition in the financial system, including by reviewing the state of competition in the sector every three years. In response, the Government agreed to implement periodic reviews of competition in the financial system, and to tasking the Productivity Commission in 2017.

Following other recommendations of the Murray Inquiry, the Government has already commissioned other Productivity Commission work of direct relevance to furthering competition in the financial system, which this inquiry is intended to build on and complement. That work concerns data availability and use, and the efficiency and competitiveness of the superannuation system.

Scope of the Inquiry

The Commission is to review competition in Australia's financial system with a view to improving consumer outcomes, the productivity and international competitiveness of the financial system and economy more broadly, and supporting ongoing financial system novation, while balancing financial stability objectives.

Without limiting related matters on which the Commission may report, its report to the Government should:

1. consider the level of contestability and concentration in key segments of the financial system (including the degree of vertical and horizontal integration, and the related

business models of major firms), and its implications for competition and consumer outcomes

2. examine the degree and nature of competition in the provision of personal deposit accounts and mortgages for households and of credit and financial services for small and medium sized enterprises
3. compare the competitiveness and productivity of Australia's financial system, and consequent consumer outcomes, with that of comparable countries
4. examine barriers to and enablers of innovation and competition in the system, including policy and regulation
5. prioritise any potential policy changes with reference to existing pro-competition policies to which the Government is already committed or considering in light of other inquiries.

The Commission should have regard to the Government's existing wide-ranging financial system reform agenda and its aims to:

- strengthen the resilience of the financial system
- improve the efficiency of the superannuation system
- stimulate innovation in the financial system
- support consumers of financial products being treated fairly
- strengthen regulator capabilities and accountability.

Process

The Commission will commence the inquiry on 1 July 2017.

The Commission should undertake appropriate public consultation processes, including holding hearings and inviting public submissions.

It should consult widely, including with consumers, financial institutions and the agencies that regulate the financial system, in particular the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Reserve Bank of Australia. The Government has asked the regulators to consider making submissions on matters that relate to their areas of expertise.

The final report should be provided to the Government within 12 months of commencement.

Scott Morrison
Treasurer

[Received 8 May 2017]

Disclosure of interests

The *Productivity Commission Act 1998* specifies that where Commissioners have or acquire interests, pecuniary or otherwise, that could conflict with the proper performance of their functions during an inquiry they must disclose the interests.

All the Commissioners on this Inquiry, or their families, own shares, either directly or indirectly, in financial institutions.

Acknowledgements

The Commissioners express their appreciation to the Commission staff who worked on the Inquiry report and underlying analysis.

The Inquiry was led by Rosalyn Bell. The Inquiry team included Miriam Veisman-Apter, Melissa Bray, James Sergeant, Troy Podbury, Bill Henderson, Paulene McCalman, Bonnie Nguyen, Ishita Acharyya, Roger Hassan, Cordelia Foo, Lawson Ashburner, Henry McMillan, Ken Quach, Tracey Horsfall and Jasna Rogic. Chris Holder, Lisa Chan, and Elle Saber were also part of the team undertaking analysis for the Draft Report.

The assistance of the Commission’s legal consultant, John Scala, was much appreciated throughout this Inquiry.

Contents

Terms of reference		iv
Disclosure of interests		vi
Acknolwedgements		vi
Abbreviations		xi
Key points		**2**
Overview		**3**
Findings and recommendations		**36**
1	**An Inquiry focused on competition**	**55**
1.1	Why this Inquiry?	56
1.2	Australia’s financial system	57
1.3	The Commission’s approach to the Inquiry	62
2	**Examining competition in the financial system**	**67**
2.1	Competition in the financial system — what it looks like and why it matters	68
2.2	How we assess competition in the Australian financial system	77
3	**Market power in the banking system**	**97**
3.1	How do ADIs gain — and boost — market power?	99
3.2	The current balance of market power	104
4	**Can new players change the game?**	**119**
4.1	Entry, exit and contestability in banking	120
4.2	Foreign bank impacts are limited to select markets	124
4.3	Fintechs can change the rules of the game	130
5	**Can consumers change the game?**	**145**
5.1	Consumer switching	146

5.2 Consumer feedback and negotiation 152
5.3 Recent policy activity 156
5.4 Consumers and demand-side pressure 165
6 Policy settings and interventions affect competition 171
6.1 Prudential standards 172
6.2 Targeted prudential interventions 179
6.3 Government policy measures 182
6.4 Ownership restrictions 189
7 Banks' responses to pervasive regulatory action 197
7.1 The prudential regulatory landscape is changing — and ADIs are changing along with it 199
7.2 Targeted interventions by regulators can have dramatic effects on competition 208
7.3 Explicit inducements and their effect on competition 214
8 Funding models and their effect on competition 221
8.1 Mix and cost of funding for different types of lenders 222
8.2 Regulatory influences on funding models 236
9 Integration in the financial system 249
9.1 How integrated is the Australian financial system? 251
9.2 How has integration affected competition? 258
9.3 Is there a case for forced structural separation? 268
9.4 A Principal Integrity Officer for all ADIs 274
10 Financial advice 279
10.1 The financial advice sector — a brief introduction 281
10.2 Seeking a new source of competition in home loan distribution channels 284
10.3 General advice — a case for reform 290
10.4 More information about APLs to enforce the current best interest duty 295
10.5 Scope for digital advice to increase consumer access to financial advice 299

11 Are mortgage brokers a force for competition? 301
11.1 Overview of the mortgage broking market 303
11.2 Why do consumers use brokers? 307
11.3 Why do lenders use brokers? 310
11.4 Mortgage broker commissions 319
11.5 A best interest obligation 333
12 More transparent home loan pricing 347
12.1 Poor price information in the home loan market 348
12.2 How do consumers choose the best home loan? 354
12.3 Access to actual home loan interest rates via an online calculator 356
13 Lenders mortgage insurance 363
13.1 What roles does LMI perform in the financial system? 365
13.2 Competition in the LMI market 372
13.3 LMI and borrowers 377
14 General insurance providers and products 387
14.1 The general insurance sector 389
14.2 Who are the providers of general insurance? 390
14.3 State of competition in general insurance 394
14.4 Reforms to promote competition in general insurance markets 410
15 Add-on financial products 415
15.1 Competition concerns with add-on insurance 418
15.2 Improving competition and consumer outcomes 424
16 Provision of finance to SMEs 435
16.1 Finance provided to SMEs 436
16.2 Is there a problem in accessing finance? 438
16.3 Can the provision of finance to SMEs be improved? 447
17 The payments system 465
17.1 Competition in the retail payments system 466
17.2 Addressing distortions in the payments system 476

17.3 Barriers to innovation can stem from regulation 497
17.4 The New Payments Platform 504
18 Where does competition fit in the regulatory architecture? 517
18.1 Australia’s system of financial regulation 518
18.2 The regulators’ biggest challenge: balancing competition and systemic stability 524
18.3 Who regulates the regulators? 532
19 Reforming the regulators to support competition 539
19.1 A champion for competition 540
19.2 A new approach to transparency 556

Appendixes

A Inquiry conduct and participants 561
B The regulatory environment 571
C The Australian banking and wealth management sectors 595
D How do consumers make decisions? 629

References 635

Abbreviations

ABA	Australian Banking Association (formerly Australian Bankers' Association)
ABS	Australian Bureau of Statistics
ABSFEO	Australian Small Business and Family Enterprise Ombudsman
ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
ADR	Alternative dispute resolution
AOFM	Australian Office of Financial Management
APL	Approved product list
ASIC	Australian Securities and Investments Commission
APRA	Australian Prudential Regulation Authority
ARPL	Australian Reinsurance Pool Corporation
ATM	Automatic Teller Machine
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BIS	Bank for International Settlements
BCBS	Basel Committee on Banking Supervision
BSB	Bank state branch identifier number
CALC	Consumer Action Law Centre
CCI	Consumer credit insurance
CET1	Common Equity Tier 1 capital
CIFR	Centre for International Finance and Regulation
CFR	Council of Financial Regulators
COBA	Customer-Owned Banking Association
D-SIB	Domestic systemically important bank
ESA	Exchange Settlement Account
FBAA	Finance Brokers Association of Australia
FCA	Financial Conduct Authority (UK)
FCS	Financial Claims Scheme
FOS	Financial Ombudsman Service
FPA	Financial Planning Association of Australia

FSG	Financial Services Guide
FSI	Financial System Inquiry
GAP	Guaranteed asset protection (insurance)
GFC	Global Financial Crisis
HHI	Herfindal–Hirschman Index
HoRSCE	House of Representatives Standing Committee on Economics
HQLA	High quality liquid assets
ICA	Insurance Council of Australia
IMF	International Monetary Fund
IRB	Internal risk-based
LCR	Liquidity Coverage Ratio
LGD	Loss given default
LMI	Lenders mortgage insurance
LVR	Loan-to-value ratio
MEI	Mutual equity interests
NCC	National Competition Council
NPP	New Payments Platform
NSFR	Net stable funding ratio
OECD	Organisation for Economic Cooperation and Development
PC	Productivity Commission
PSB	Payments System Board
PPF	Purchased payment facility
RBA	Reserve Bank of Australia
RMBS	Residential mortgage-backed securities
ROE	Return on equity
SERC	Senate Economics References Committee
SOA	Statement of Advice
SME	Small and medium enterprise
SVR	Standard variable rate
UK	United Kingdom
US	United States (of America)
UFI	Unauthorised foreign insurer

OVERVIEW

Key points

- The Australian economy has generally benefited from having a financial system that is strong, innovative and profitable.
- There have been past periods of strong price competition, for example when the advent of mortgage brokers upset industry pricing cohesion. And technological innovation has given consumers speed and convenience in many financial services, and a range of other non-price benefits.
- But the larger financial institutions, particularly but not only in banking, have the ability to exercise market power over their competitors and consumers.
  - Many of the highly profitable financial institutions have achieved that state with persistently opaque pricing; conflicted advice and remuneration arrangements; layers of public policy and regulatory requirements that support larger incumbents; and a lack of easily accessible information, inducing unaware customers to maintain loyalty to unsuitable products.
- Poor advice and complex information supports persistent attachment to high margin products that boost institutional profits, with product features that may well be of no benefit.
  - What often is passed off as competition is more accurately described as persistent marketing and brand activity designed to promote a blizzard of barely differentiated products and 'white labels'.
- For this situation to persist as it has over a decade, channels for the provision of information and advice (including regulator information flow, adviser effort and broker activity) must be failing.
- In home loan markets, the mortgage brokers who once revitalised price competition and revolutionised product delivery have become part of the banking establishment. Fees and trail commissions have no evident link to customer best interests. Conflicts of interest created by ownership are obvious but unaddressed.
- Trail commissions should be banned and clawback of commissions from brokers restricted. All brokers, advisers and lender employees who deliver home loans to customers should have a clear legally-backed best interest obligation to their clients.
- Complementing this obligation, and recognising that reward structures may still at times conflict with customer best interest, all banks should appoint a Principal Integrity Officer (PIO) obliged by law to report *directly* to their board on the alignment of any payments made by the institution with the new customer best interest duty. The PIO would also have an obligation to report independently to ASIC in instances in which its board is not responsive.
- In general insurance, there is a proliferation of brands but far fewer actual insurers, poor quality information provided to consumers, and sharp practices adopted by some sellers of add-on insurance products. A Treasury working group should examine the introduction of a deferred sales model to *all* sales of add-on insurance.
- Australia's payment system is at a crucial turning point. Merchants should be given the capacity to select the default route that is to be used for payments by dual network cards — as is already possible in a number of other countries. The New Payments Platform requires a formal access regime. This is an opportunity — before incumbency becomes cemented — to set up regulatory arrangements that will support substantial competition in services that all Australians use every day.
- More nuance in the design of APRA's prudential measures — both in risk weightings and in directions to authorised deposit-taking institutions — is essential to lessen market power and address an imbalance that has emerged in lending between businesses and housing.
- Given the size and importance of Australia's financial system, and the increasing emphasis on stability since the global financial crisis, the lack of an advocate for competition when financial system regulatory interventions are being determined is a mistake that should now be corrected. The ACCC should be tasked with promoting competition inside regulator forums, to ensure the interests of consumers and costs imposed on them are being considered.

Overview

Australia's financial system must be strong and stable. But equally, it should ensure that the households and businesses who use the financial system are well served.

It is most often competition that can deliver the price rivalry between providers that is necessary for consumers to share fully in the benefits of having a strong financial system.

More than just price rivalry, competition drives innovation and overall value for customers.

Some innovation in Australian financial services is clear. Australians have ready access to funds at all hours of the day, can get rapid home loan approvals, quickly and safely move money between accounts, pay for products with the tap of a card, smartphone or watch, and have investment portfolios managed by robo-advisers.

Value for customers is less obvious. Prices are not transparent and product choice is often vague or overwhelming. Regulation is dense and it may act against customers' interests. Those who advise and assist customers face conflicting, unclear incentives.

In brief, we find that households and businesses may be paying, through unnecessary fees and low-value products, for a system that is exposed to use of entrenched market power.

This Inquiry focusses on competition in Australia's financial system as a means to improve consumer outcomes, enhance the productivity and international competitiveness of the financial system and the broader economy, and support ongoing innovation — without undermining financial stability objectives. Our recommended reforms are aimed at getting Australia's financial markets to be workably competitive, with higher standards of respect for customer interests.

Competition is inevitably constrained

Financial markets are inevitably regulated. From a consumer's perspective, financial products are both complex and critically important to their welfare — trustworthy deposit, loan and insurance products and a reliable payments system are all critical. Regulation of the businesses that sell and advise consumers on financial products helps deliver a financial system that both protects consumers and is stable.

However, regulation is present in all markets and need not undermine workable competition. In contrast, competition is poor in many of the financial markets we have examined. We investigate why this is the case: what are the drivers of poor competition and how can the situation be improved. In some key markets — for small business credit, consumer product insurance, and consumer credit insurance — competition and beneficial consumer appear particularly constrained by factors that may be alleviated by regulatory reform.

Current state of competition

Australia's financial system is dominated by large players — four major banks dominate retail banking, four major insurers dominate general insurance, and some of these same institutions feature prominently in funds and wealth management. A tail of smaller providers operate alongside these institutions, varying by market in length and market share (figure 1). Market shares of major banks are highest (over 75%) in markets for loans to small businesses, housing loans, personal deposits and issuance of credit cards. Among general insurers, market shares are highest (80% or higher) for lenders mortgage insurance, reinsurance and travel insurance.

Australia's smaller financial institutions (such as some regional and customer-owned banks and foreign-owned banks) achieve comparatively high market shares in targeted markets — consumers in their home state, employees in a particular profession, or dual nationals from their base country. Focussing on such groups allows institutions to overcome the disadvantages of potentially limited scale, higher funding costs, or in the case of foreign-owned banks, limited public-facing branches.

High market concentration does not necessarily indicate that competition is weak, that community outcomes will be poor or that structural change is required. Rather, it is the way market participants gain, maintain and use their market power that may lead to poor consumer outcomes.

Indeed, the Commission has concluded that changes to the structure of Australia's financial markets are not very prospective as a means for improving market outcomes. Too many regulatory imposts — most readily displayed by persistent attachment to the Four Pillars policy — act against that. Nor are forced divestitures likely to improve competition. Instead, they risk creating unviable businesses that are 'unscrambled' from existing businesses as regulators are never able to check that the parent entity has relinquished control of the key customer information, intellectual property, technology and staff that are needed to make the separated entity competitive.

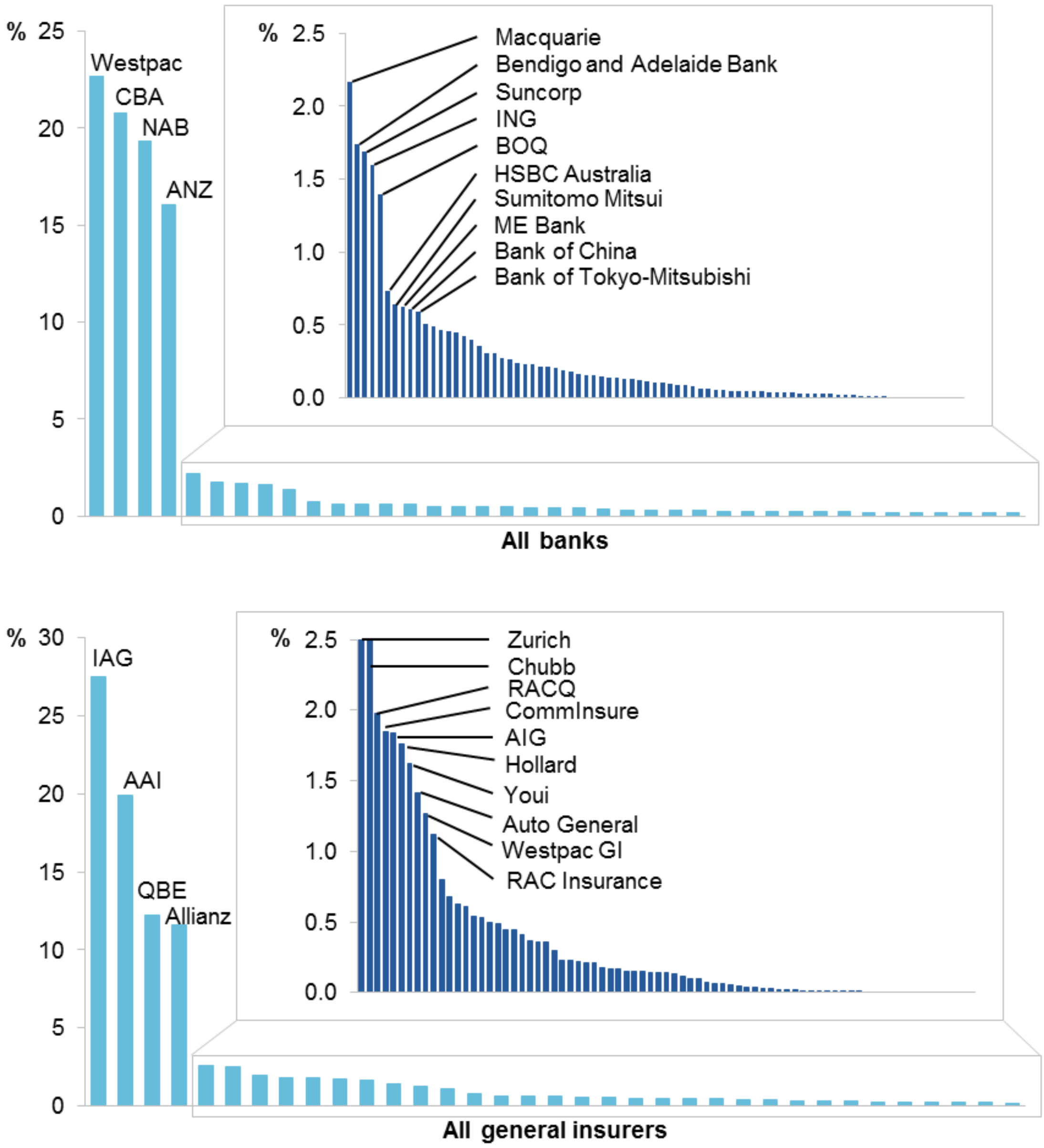
Rather, reforms that alter incentives of Australia's banks, brokers, insurers, and advisers, aimed directly at bolstering consumer power in markets, and reforms to the governance of the financial system, should be the prime focus of policy action.

The major banks' market power is a defining feature of the financial system

While some of the major banks argued that they do not, individually, exercise market power, they have been able to insulate themselves from competition and sustain returns despite the massive system-wide shock of the global financial crisis. There is evidence that they have sustained prices above competitive levels, offered inferior quality products to some groups of customers (particularly those customers unlikely to change providers), subsumed much of the broker industry and taken action that would inhibit the expansion of smaller competitors in some markets. All are indicators of the use of market power to the detriment of consumers.

What follows is not a list of failings, but rather features of the Australian market that must not be ignored if we are to ever develop workable solutions to improve competition.

Figure 1 **Banking and insurance are dominated by large players — and long tails of other providers**[a,b]



a Bank share of assets held on banks' domestic books, as at end-2017. **b** Insurer share of gross written premium, as at end-2017. Calculations based on level APRA 1 insurers, with level 1 IAG insurers aggregated. For the purposes of this chart, 'general' includes direct general insurance only, and excludes reinsurance and lenders mortgage insurance.

What allows market power to be sustained in Australia's financial system is a combination of features evident in the way providers, consumers and regulators operate:

- *Market power as a result of established presence:* The substantial geographic reach of the major banks — which account for 60% of all branches — along with their scale and longevity contributes to their brand recognition and the perception that they are safe, stable institutions compared to smaller rivals, and that the government will step in to help them if needed. This is despite the Government's (little known) Financial Claims Scheme, which protects retail deposits at all authorised deposit-taking institutions (ADIs) — large and small institutions alike. The major banks are also strongly represented in other distribution networks, including being on the vast majority of mortgage aggregator panels. This widespread presence can make it more difficult for small institutions to be seen by consumers as a practicable alternative source of financial services.
- *Market power as a result of regulatory arrangements:* Regulatory arrangements can further entrench the market power of those incumbents that have the expertise and resources to cope with regulatory requirements. The cost of regulatory capital for major banks compared with smaller competitors is one instance of this. On one hand, the major banks (as well as Macquarie and ING) use internally developed risk models, approved by Australian Prudential Regulation Authority (APRA), that in effect lower their funding costs compared with all other ADIs, which use APRA's standard risk weighting. On the other hand, it is only the major banks that are required by APRA to hold additional capital because of their size and complexity. This requirement can be costly for the major banks, but it can also support them to the extent that it is viewed by international credit rating agencies as an indirect recognition of their 'too big to fail' status.

  The net result of these regulatory measures is a funding advantage for the major banks over smaller Australian banks that rises in times of heightened instability.
- *Market power as a result of funding advantage and operational efficiency:* The cost of sourcing funds is the single largest expense for all lenders in the Australian financial system. It is, in turn, a key influence on institutions' ability to compete in the market for lending (or to increase profits). With their better credit ratings and a perception of being 'too big to fail', the major banks are able to source funds from investors and depositors at lower interest rates than are smaller institutions. The smaller entities (especially non-ADIs that are unable to accept deposits) both compete against the larger institutions and at the same time rely on them to access some of the funds that allow them to continue competing. A substantial gap also remains between the average operating costs of Australia's major banks and its smaller institutions.
- *Market power reinforced by integration:* Australia's largest financial institutions have in the past leveraged their incumbency and scale to move into parallel markets and activities either side of them in the supply chain (such as financial planning), allowing them even more control over pricing, as well as entry into and exit from some markets (figure 2). Cross-product (horizontal and conglomerate) integration gives the larger institutions the opportunity to cross-subsidise and offer consumers an integrated bundle of services, which can also bind customers to them.

Figure 2 **The major bank networks**[a,b]

Select subsidiaries and other entities of major banks

[a] Percentages are total assets of major bank group as % of total assets of all authorised deposit-taking institutions and Registered Financial Corporations. Banks include Australia and New Zealand Banking Group (ANZ), Commonwealth Bank Group (CBA), National Australia Bank Group (NAB), Westpac Banking Corporation (WBC). [b] Entities listed may fall within more than one category and may not reflect investment or divestment activity since annual reports were released. The listed entities do not comprise an exhaustive list, do not show exclusive contracts, and are generally entities incorporated in Australia.

- *Market power reinforced by consumer inertia:* Little switching occurs — one in two people still bank with their first-ever bank, only one in three have considered switching banks in the past two years, with switching least likely among those who have a home loan with a major bank. Low levels of consumer switching and a general disengagement of consumers from financial services are a clear sign that current information provision (by regulators, advisers and brokers) is failing. This makes it harder for new competitors to gain significant market share. Competition is most apparent in those product markets in which holding multiple versions of the product (such as transaction accounts and some credit cards) is of low cost to consumers, and so whether or not switching is possible is of less relevance.

The market power of Australia's large general insurers is similarly entrenched by operational efficiencies and very low levels of consumer switching on products for which switching would be a key source of consumer pressure for competitive outcomes. The prudential requirements (including capital requirements) for insurers similarly contribute to the premiums insurers charge. We have not, however, observed similar issues in the regulatory arrangements for insurers of different size.

Price rivalry in banking is — and will remain — constrained

At a fundamental level, the setting of the cash rate in response to market conditions, as well as capital holding requirements and other prudential interventions mean that the Reserve Bank (RBA) and the APRA indirectly determine and broadcast the costs of funds for ADIs. This form of price leading is not evident in many industries. From a competition standpoint, it means ADIs' ability to compete on price is constrained, and this is unlikely to change.

In setting prices in the Australian banking system, smaller institutions generally behave as market 'followers' and mirror the major banks' pricing decisions.

While some small institutions offer consistently higher interest rates to attract deposits, history suggests that even when Australia's smaller ADIs are given a regulatory advantage over the major banks, they do not noticeably take advantage of rises in major bank loan interest rates by holding down their own loan interest rates in an attempt to gain market share. Rather, they seek to also raise prices in near lock-step, and improve margins earned from their existing customer base. That this occurs is evident in the margins earned.

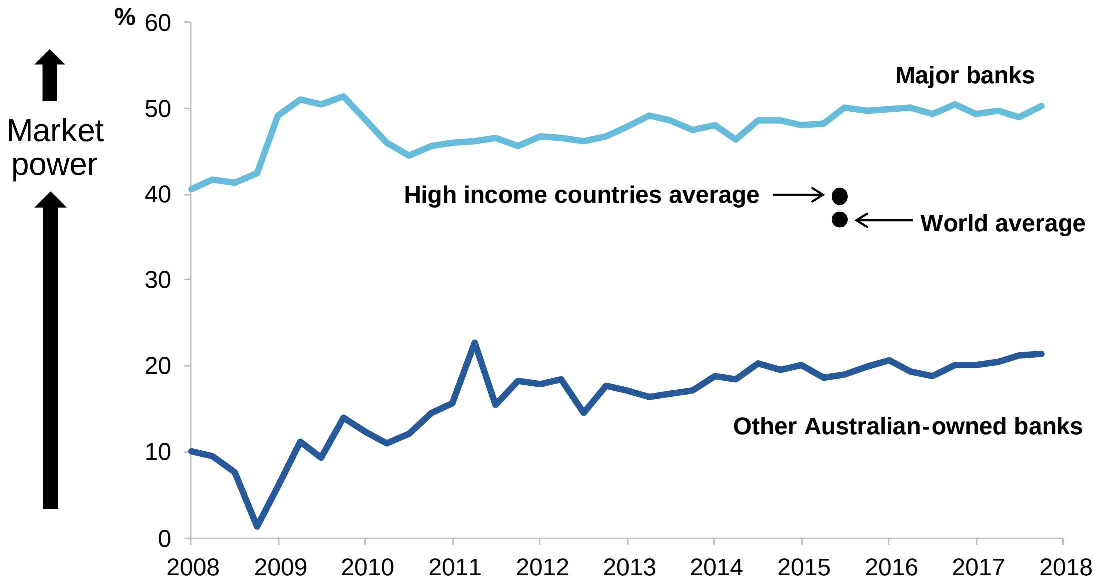
Although there is no explicit encouragement for banks to cluster around a particular level of return or interest rate, their observed tendency to do so is a persistent feature of the market. Wherever possible, rate movements are couched with reference to regulator actions.

This approach is unlikely to result in prices that are reflective of the cost incurred by the most efficient institution; at best, it will result in prices that reflect the costs of the least efficient major bank (or in some markets, the higher marginal cost of smaller, competitive fringe institutions). For competition analysis it is significant that the market is in a state that persistently allows this.

An exception may be the *mutual* ADIs, which do not face the same shareholder pressures as other ADIs. The Customer Owned Banking Association reports its members' standard variable rate on home loans averages 0.4 to 0.8 percentage points lower than the major banks' rates. However, their scope to lower lending rates further is potentially more limited than other ADIs simply due to narrower sources of funding.

Consistent with these observed outcomes, the data shows that both the major banks and some other-Australian owned banks hold a degree of pricing power. But the major banks are the dominant force in the market — able to charge higher premiums above their marginal costs, compared with other institutions. Approximately half of the average loan price that major banks charge is estimated to be a premium over the marginal cost — double the margin that other Australian-owned banks have and well above that of banks in other high income countries (figure 3).

Figure 3 **The major banks are using their market power to keep interest rates high on loans and low on deposits**[a]



[a] This chart shows the Lerner Index, calculated by the Productivity Commission for groups of different banks. The Lerner index shows the extent to which prices (or in the case of banking, interest rates) exceed marginal cost. In a competitive market, prices are expected to equal marginal cost, and therefore the value of the index would be zero. Any number above zero indicates pricing power. High income countries average and world average are World Bank estimates.

Barriers to entry are falling — but new entrants will not induce a widespread improvement in outcomes

Australia's banking industry has experienced substantial consolidation over recent decades, with numerous mergers of small or struggling institutions. But this is not necessarily a concern for competition. Periods of heightened competition in the financial system in the past have typically been driven not by established providers but by new entrants. For example, Aussie Home Loans provided home loan competition in the 1990s and early 2000s, foreign banks such as ING introduced online-only banking, and Rabobank provides services dedicated to medium/large agribusinesses.

Almost all new entrants to the banking system over the past decade have been foreign bank branches, usually targeting important but niche markets (and these have evidenced only limited growth in market share). Similarly, many of our fintechs are small, focusing on niche areas of the financial system, making it difficult for them to compete against incumbents with full service offerings. Indeed, many fintechs are looking to collaborate with incumbent banks rather than compete against them.

For now, neither foreign entrants nor fintechs appear to pose a substantial threat to major banks' dominant positions: more entrants alone are not a panacea to drive sustained competition across Australia's financial system.

In recent years, the Australian Government and APRA have progressed reforms to reduce unnecessary barriers to entry: ADIs no longer need to hold $50 million in safe capital before they can call themselves a 'bank'; and prospective banks can more easily apply for a new (restricted) banking licence.

The reduction or removal of similar barriers should be high on the Australian Government's and regulators' priority lists. This includes initiatives already in train, such as proposed changes to the ownership cap under the *Financial Sector (Shareholdings) Act 1998* (Cth) and the introduction of Open Banking.

Protection against takeover can shelter poor practices

Australia's Four Pillars policy, aimed at ensuring that whatever other consolidations occur in retail banking, the four major banks will remain separate, has been an underlying feature of the financial system policy landscape throughout this period of considerable consolidation.

It is an ad hoc policy that, at best, is now redundant, as it simply duplicates competition protections in the *Competition and Consumer Act 2010* (Cth) and governance protections in *Banking Act 1959* (Cth) and the *Financial Sector (Shareholdings) Act 1998* (Cth). And the existence of the policy has allowed some to believe, unwisely, that competition is somehow enhanced because of it.

Together with other restrictions on bank ownership, the policy minimises the threat of takeover — the most direct form of market discipline for inefficiency and management failure — and so encourages complacency. Raising the cap on ownership would offer a greater threat of market discipline, while maintaining strong general protections from anticompetitive acquisitions.

Poor market outcomes are evident

Prices are used to maintain returns

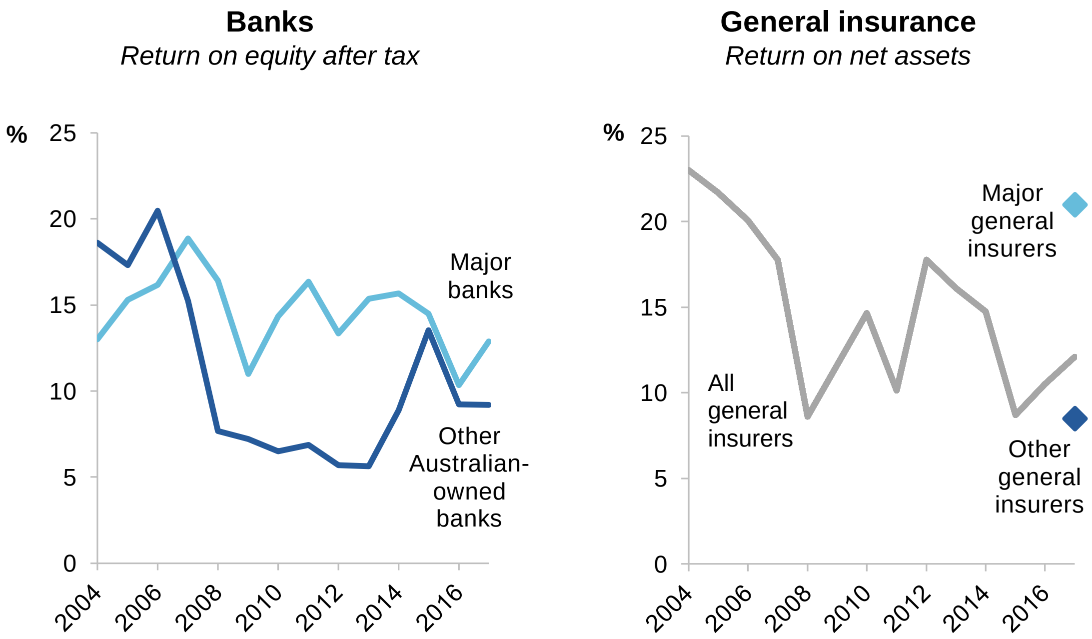
Banks, and in particular the major banks, exhibit substantial pricing power. The major banks' market power has allowed them to set interest rates to borrowers and depositors that enable them to remain highly profitable — without significant loss of market share. This has continued to occur even in the face of market shocks (such as the global financial crisis) and notable regulatory changes that have increased their costs and would otherwise have eroded the return on equity (figure 4). Australia's large general insurers have similarly maintained very high returns compared with their smaller competitors.

The consistently high returns of Australia's largest financial institutions are over and above those of many other sectors in the economy and in excess of banks in most other developed countries post GFC. In recent times, regulatory changes have put pressure on bank funding costs, but by passing on cost increases to borrowers, Australia's large banks in particular have been able to maintain consistently high returns on equity (ROEs).

Banks and insurers alike almost invariably argue that price shifts are tied to a shift in costs. But the ability across a sub-set of firms in a market to maintain prices and profitability in all market conditions (changes in not just industry-wide costs but also business-specific cost changes) is a very clear sign of market power.

Some have suggested that competitive pressures prevent lenders from passing on increased costs as a result of regulatory changes, but apart from some ADIs choosing to exit product areas that offered lower returns (such as wealth management), the evidence is that this has not eventuated.

Figure 4 **Profitability**



Simply accepting lower returns on equity is uncommon among Australia's financial institutions — banks in particular. Rather, it appears that achieving ROE targets is an important factor in major banks' interest rates decisions, and one that has tended to lead to higher rates charged to existing borrowers, rather than aggressive discounting intended to expand market shares. And the standard loan documentation makes the repricing of all loans convenient for the bank, an issue of significance in recent attempts at targeted macroprudential intervention.

The ACCC has concluded that the major banks would need to win a significant number (and value) of additional new borrowers to achieve the same revenue as they can generate simply by increasing their headline variable interest rates, which affects both existing and new borrowers.

In some cases, the high profitability is a (possibly unintentional but entirely predictable, as we discuss below) result of regulatory intervention. Interest rates on home loans are a case in point. The ROE on interest-only home loans doubled, to reach over 40% after APRA's 2017 intervention to stem the flow of new interest-only lending to 30% of new residential mortgage lending (reported by Morgan Stanley). This ROE was possible largely due to an increase by banks in the interest rate applicable to *all* interest-only home loans on their books, even though the regulator's primary objective was apparently to slow the growth rate in *new* loans. Competing smaller banks were constrained from picking up dissatisfied customers from this re-pricing of the loan book because of the direct application of the same lending benchmark to them. Profit-taking was locked in. This behaviour should have been anticipated. The additional cost to the community was unnecessary.

A highly profitable financial system is not a bad thing. Consistently strong and profitable institutions can be beneficial for consumer and investor confidence, which, in turn, lowers the cost of funds and return required on investment. But if the market were workably competitive, keeping prices high in order to deliver profits would cause a significant number of consumers to switch and encourage a lower price provider, with profits shifting along with shareholder expectations. It is, at least in part, the stickiness of consumers with their current bank, insurer or adviser that allows these providers to maintain profits without loss of market share.

A blizzard of barely differentiated products

Many consumers find financial product information somewhat less enthralling than other consumer products and, in most of Australia's financial system, face difficulties in readily finding and/or understanding the product information presented to them. This reduces the scope for consumers to collectively apply competitive pressure on providers to improve product offerings.

With some financial and credit products, there is a large array of options presented for individuals to choose between. For example, there are nearly 4000 different residential property loans on offer and over 250 different credit cards. Many general insurance lines are similarly characterised by a large number of products, which are ultimately all underwritten by the same insurers — for example, the largest four general insurers underwrite more than 30 brands, while two of the smaller insurers underwrite more than 50 brands between them, with the Hollard Insurance Company underwriting 23 of 25 identified brands of pet insurance on the Australian market.

While the existence of a large number of marginally different products can allow a closer tailoring to consumer needs, it typically is a choice overload for consumers. It also creates an illusion of choice, and the perception of a greater degree of competition among providers than actually exists.

In some parts of the financial system (such as insurance and funds management), the proliferation of products with slight variations in features has, over time, become a burden not just for consumers but also for providers. The Financial Planning Association of Australia noted that, with a lack of transparency around product features and performance objectives, it has become increasingly difficult for its planners to compare products for each client.

The costs for providers of product proliferation become magnified where dated products, often on legacy IT systems, are used by a comparatively small number of customers with contracts that cannot readily be varied. This burden does not yet appear to have deterred most institutions from creating yet more product variations, though some are now seeking to simplify their range.

Exploiting customer loyalty

The huge product variety combined with price obfuscation provides latitude for exploitative price discrimination, with associated profit opportunities for the relevant financial institutions. Typically, it is existing customers that get a poor offer, as institutions jostle to attract new customers with products that offer temporary benefits (such as discounted interest rates and fee-free periods) to consumers — relying on their lassitude for switching to generate high margins off them in the years to come.

For example, insurers may offer policies with relatively high premiums to existing customers compared to new customers posing a similar level of risk. In the banking industry, the variable interest rates paid by existing home loan customers have been reported by the RBA to average about 0.3 to 0.4 percentage points higher than rates on new home loans. These higher rates are paid by about 15% of existing customers and equate to an extra $66 to $87 per month on the average home loan balance.

Exploitation of existing customers is supported by the very low levels of customer switching of either the financial products held or their relative use of them and a reticence of consumers to negotiate with providers.

Satisfaction of consumers with their own financial institutions is still high. This is a positive characteristic, but when considered in conjunction with what we know about a lack of responsiveness to better offers, it indicates a substantial failure in financial product information and advice. With the relative explosion in advisory services in the last decade or so, this is surprising and suggests an important avenue for potential reform.

Improving scope for competition

Australia's financial system has no real voice that can mount the case for competition, when regulatory interventions aimed at enforcing system stability are deliberated.

The vital importance of financial services to the ongoing operation and the growth prospects of the economy, as well as the extent of information asymmetry, build a strong case for a high level of regulatory intervention. The objective of intervention is to reduce risk, generally. The objective of competition is to take risk, in an attempt to satisfy consumers. One objective is much more heavily emphasised in regulators' activities than the other.

Australia's key financial regulators — the RBA, APRA and the Australian Securities and Investments Commission (ASIC) — work together to create a stable financial system, coordinated, where required, through the Council of Financial Regulators (CFR).

Regulators worldwide have (particularly since the GFC) been emphasising stability over competition, which has been viewed at times as a source of risk. This view has taken root in the Australian regulatory culture, to the point that the lack of competition is viewed at the very top level as a positive factor, said to have insulated us from the worst of the GFC.

Competition and stability can, and should, co-exist, but this is unlikely at the extremes of market structures. A market composed of a plethora of small banks may be competitive, but is unlikely to have the reserves to cope with sudden serious adverse circumstances, while a single or dominant entity may survive a shock, but only at an unacceptable ongoing cost to the economy in order to maintain its dominance. Australia, with an oligopolistic banking system, is not at either extreme and so can (and should) seek to give genuine attention to both competition and stability.

While this requires careful fine-tuning of financial regulation, other countries have taken steps to realign the regulatory balance towards competition, without losing sight of the need for stability. Countries such as the UK and the US that were badly affected by the GFC — much more so than Australia — have been changing their regulatory structures. Prudential regulators in Canada, the UK and Europe have followed the Basel standards closely and so have a wider range of risk weights than does Australia. In Australia, however, while there is much hand-wringing about competition, there has been little shift in the regulatory culture. The emphasis on stability — best represented by the repeated use of the phrase 'unquestionably strong' — persists.

An important step towards addressing this imbalance is for regulators themselves to recognise better the effects that their actions may have on competition, and take steps to minimise them where closer study may show that scope exists to do so. The current processes of policy development include consultation between the regulators, but there is no counterweight that can advance the benefits of competition and possibly influence regulators before they intervene in the financial system. Discovery of alternatives relies entirely on in-club thinking, amongst whose members the strongest legislated mandate for competition is simply to 'balance' it with other objectives while promoting financial system stability.

Yet we do not argue for legislated change. If regulators cannot be convinced by the existence of thoughtful alternatives put forward by a well-considered submission, black letter law will not alter their thinking either.

A competition champion must be appointed amongst the financial regulators who shape policy. The purpose of this change is to create an opportunity to stress test the competitive implications of an intervention before it is made. This can help preserve as much competitive spirit as is possible, even as intervention occurs. There are additional reforms (described further below) needed to improve simple, reliable information flows to consumers and align reward with customer best interest. The effectiveness of these will be magnified in their impact if there is a designated competition champion in place.

A competition champion

Competition must be given serious consideration when regulators intervene in financial markets

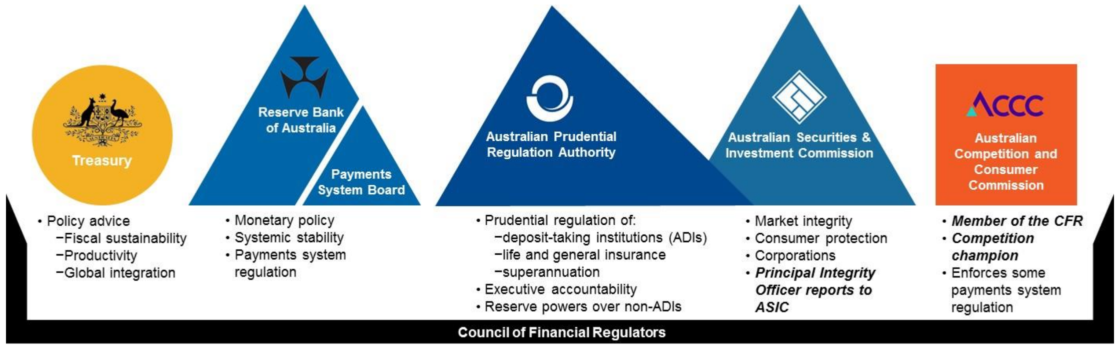
It is a fundamentally important fact that no Australian financial system regulator has the responsibility of putting competition first. Indeed, ASIC does not yet even have competition in its objectives. Nor, until this Inquiry, did other members of the Council of Financial Regulators emphasise that interest in a discernible fashion. Quite reasonably, they all have other purposes, that are often more pressing (figure 5). But the existence of a competition mandate provides a powerful incentive to consider the damage to competition, and thus to consumers. No regulator is specifically tasked by the Treasurer with challenging the others, although we accept that this does happen from time to time.

In the absence of a competition advocate in the financial system, the role of juggling competition and financial stability falls mainly to APRA — but is not a role that it is well placed to fulfil. In every marginal judgment — and most judgments will by their nature be finely-balanced (crises are an exception) — APRA must surely favour its overarching requirement to promote stability. An entity such as APRA can never reasonably be challenged by outsiders for being too conservative. But it might be badly damaged if it were ever shown to be too liberal.

Thus, we do not propose to change the nature of APRA's obligations with regard to competition — it is unrealistic to expect a regulator tasked with maintaining financial stability to actively encourage competitive outcomes in all circumstances.

Yet the benefits of competition need to be heard. In the current environment of emphasis on maintaining 'unquestionably strong' institutions, and with macroprudential interventions likely to feature more notably in regulator activity for some years to come, it is evident that finesse in the application of regulatory decisions that impact on competition can and should be improved.

Figure 5 **Embedding competition and consumer interests into financial system regulatory structures[a]**



[a] Text in bold and italic denotes recommended reforms to current arrangements

Both the Wallis and Murray financial system inquiries (FSIs) considered that there was no need for an agency dedicated to advancing competition in the financial system (the Murray FSI made other recommendations intended to promote competition, but progress on these has proved slow).

Given the size and importance of Australia's financial system, and the increasing emphasis on stability since the GFC, the lack of an advocate for competition when financial system regulatory interventions are being determined is a mistake from the Wallis FSI outcomes that should now be corrected.

The Commission envisages that a designated competition champion would not be a new regulator. The role we have in mind for the chosen regulator is to champion the interests of competition for its benefits to consumers and aspirant firms alike. This proactive behaviour is not a role needed in many other markets, but here the influence of regulators is so pervasive in manoeuvering product prices and limiting the ability of firms to take risks (a necessary part of innovation and competition) that a competition champion is required to offset monological thinking.

Such an entity should undertake functions that include analysis of impacts of prudential and other regulatory measures on competition before such measures are implemented; publishing regular analyses and reports on financial system competition; and ex-ante testing of the impacts on competition and community outcomes from additional provider integration.

The ACCC as a competition champion in the financial system

The Australian Competition and Consumer Commission (ACCC) is a natural fit for the role due to its long standing expertise in competition issues and its emerging skill set in the financial system. It has an enthusiasm for the role and that will be important to sustaining it in the face of a regulatory culture of indifference or hostility to competition. The ACCC will also be able to recognise the distinction between competition and competitive neutrality —

markets may be competitively neutral and yet impede innovation and effective competition (evenly) across all players.

There is no legislative change required for the ACCC to take on such a role. Its ability to act effectively in the financial system will depend substantially on the co-operation of existing regulators. APRA has indicated to this Inquiry that it has recently found discussion with ACCC prior to CFR and decision-making to be beneficial. The appointment of ACCC as a competition champion would supplement this and give substance to an interaction that will endure beyond MoUs, current appointees and internal structures in each organisation. The ACCC would require explicit support from the Treasurer to take a role within the formal and informal forums that shape financial system regulatory activity.

The primary forum for cooperation between the financial regulators is the CFR, of which the ACCC is currently not a permanent member. The CFR, with the inclusion of the ACCC, would be a key avenue through which consideration of competition impacts could be promoted, analysed and made more transparent. It would be tasked with providing an assessment that examines in depth the competition implications of a proposed regulatory intervention. This would be discussed at the CFR meeting prior to the intervention design being finalised.

The sheer size of the financial system makes the role of champion a matter of gradual change. Serious capability needs to be maintained by the champion, including obtaining a high level of awareness of commercial market thinking.

Why not others?

In the Inquiry Draft Report, we considered two possible candidates for the champion competition: the ACCC and ASIC. APRA and the RBA were not included as options since in our competition analysis, their primary focus is, and should remain, financial stability.

ASIC, as the financial product regulator (in the way we have categorised regulator roles) would, in principle, be well placed to become the champion. However, both stakeholders and ASIC itself appeared to have reservations. ASIC did not express any active interest in taking on such a role, but simply emphasised instead the need for regulators to work together to consider competition issues.

Even without being the designated competition champion, ASIC's role in considering competition is set to expand; and desirably so. In early 2018, the government introduced legislation to expand ASIC's mandate to consider the effects its regulatory interventions will have on competition in the financial system. APRA is already required to consider competition alongside a number of other factors in the pursuit of financial stability. Given no regulator presently has any primary responsibility for competition, ASIC's objective of working together with other regulators in support of competition is likely to fit better once the ACCC is the designated competition champion.

The Treasury has suggested it already fulfils this role in the CFR deliberations and so there is no need for a champion as such. The desire for other parties at CFR to fulfil this role is a welcome development. But the Treasury's mandate is to develop advice for government, taking into account and balancing the views with a much wider-angle lens than the ACCC, ASIC or even the RBA.

Moreover, the role of competition champion is intended to be overt at times, with the CFR confirming via its minutes that a debate was held. The Treasury must publicly stand above the adoption of a contending position in any such debate.

Likewise, the RBA — which offered important assurances to this Inquiry that the CFR discussions do give weight to competition — cannot be tasked with this role, as its primary role is ensuring financial stability. And as CFR Chair, it would need to sum any discussion to a conclusion.

The RBA has also expressed concern that adding competition analysis to CFR deliberations may slow down decision making. This is unrealistic. It is highly unlikely that when a financial crisis occurs, any emergency measures would be delayed due to concerns about competition. Debates in forums such as these occur in the time available. But crisis is uncommon and (as we know from many other policy reform processes involving the Productivity Commission) uncommon events are not a sound basis for choosing not to improve the thinking when the opportunity is there to do so.

Transparency can assist in managing market expectations

As part of the broader adjustment in regulatory focus, transparency around decision-making by the financial regulators, including the CFR, is likely to prove valuable.

As a matter of priority for the Government, the Statement of Expectations for APRA needs to be updated from its 2014 version; and the recently updated Statement of Expectations for ASIC should be published.

In both cases, actions taken to fulfil government expectations should be reported annually. Such statements provide financial regulators with the Government's perspective on their strategic direction and most crucially, allow assessment after the fact to see if performance matched expectations. This report should influence those documents.

The discussions at the CFR that underpin regulator decisions are profound in their impact on the financial system and the economy but there is no public transparency around them. As central banks have discovered and effectively applied over the past twenty years or so, publication of minutes can assist in managing market expectations. What can be achieved by press release may save tens of millions in additional cost.

The fact of the CFR's consideration of competition analysis (and other market interventions) should be minuted and published, as the RBA Board meetings are. Simple confirmation that the competition versus stability conundrum is under regular consideration would improve both market and regulator behaviour, if as we expect, conditions of significant market power among the largest banks persist. Transparency gives confidence that competition still matters.

Regulators should, in their Statement of Expectations, be required to consider amending policies to alleviate adverse impacts on competition.

Finally, the ACCC should publish a bi-annual financial system competition report, which would be the competition equivalent of the RBA's Financial Stability Review.

Achieving better outcomes for consumers in home loan markets

The competition benefits of mortgage brokers have become compromised

From a relatively small industry in the 1990s, mortgage broking has grown such that just over 50% of all new home loans now originate through a broker. The competitiveness of Australia's home loan market is now substantially dependent on the decisions of home loan providers, brokers and aggregators (intermediaries between lenders and brokers). The intimidatingly complex and confusing nature of the home loan market, and the absence of a direct cost to consumers from using brokers, are strong motivators for consumers to increasingly choose brokers over direct contact with lenders.

For smaller lenders and those without widespread branch networks, brokers enable diversification and growth in their loan portfolio. For example, non-bank lenders and foreign banks operating in Australia rely on brokers for over 90% of their loan book. We calculated that, on average, each smaller lender would have needed to open 118 new branches to generate the equivalent market share achieved through use of brokers.

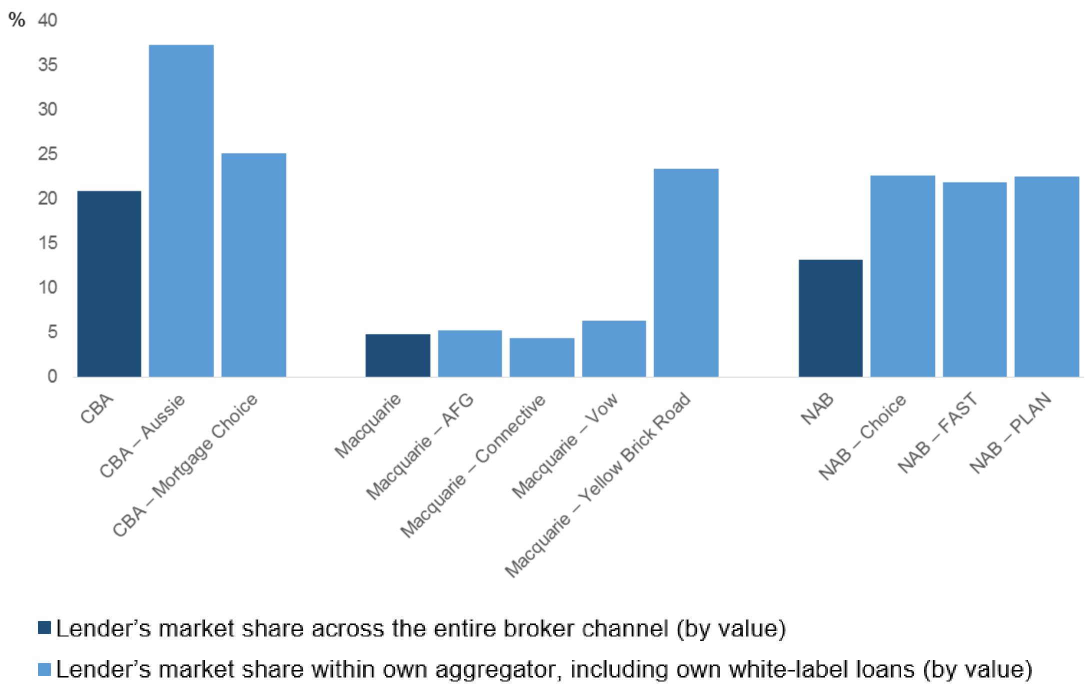
For the major banks with large branch networks and brand recognition that motivates customers to initiate contact with them, brokers are generally *not* a cheaper distribution channel for their loans (except perhaps in some regional markets).

Lenders controlling loan distribution networks

Yet the major banks have not only survived the emergence of the broker model, they have leveraged their market positions to, quite literally, make it their own. The major banks source around 40% of their loans through brokers, are represented on the vast majority of broker panels, and account for just over 60% of the total loans that brokers generated. And all the major banks, except ANZ, have an ownership stake in at least one mortgage aggregator.

Examining market outcomes, it is not apparent that aggregator ownership *alone* has granted a market advantage. Yet (according to ASIC survey data) through use of white label loans, lenders *do hold a disproportionate share* of loans placed through those aggregators that they own — suggesting that other lenders have disproportionately lower access to consumers through those aggregators owned by lenders (figure 6). For example, CBA has just over 20% market share across the broker channel, but represents around 37% of the loans written through one of its aggregators, Aussie Home Loans. In terms of loan interest rates, there is no consistent and significant difference in the rates the major banks have charged between the aggregators they own and do not own, and for loans via direct channels.

Figure 6 **Market shares with bank ownership of mortgage aggregators**



The benefits to lenders of aggregator ownership appear to be gaining market share (largely through white label loans), potentially greater control of the broker distribution channel and competitors' use of it, and the scope to recoup a portion of commissions paid.

Lenders were not forthcoming when we asked them to explain further the basis for aggregator ownership. But regardless of whether their ownership allows them to exercise influence over the aggregator, the potential for them to do so is unchallenged and the consequent adverse ramifications for competition and consumer outcomes should not be underestimated.

A broken model of broker remuneration

Mortgage brokers are remunerated through commissions, which are paid by lenders. Commissions are determined as a proportion of the loan value and include both upfront payments and trail payments that are paid over the life of the loan. Industry participants have committed to removing bonus commissions (that increase motivation for a broker to maximise loan size beyond a customer's need), but this has not yet been widely implemented.

Our primary concerns about broker remuneration, from a competition perspective, include that recovery of such payments by lenders (for example, through higher mortgage interest rates across their portfolios) may be imposing additional costs on all home loan borrowers, and that current structures are at times highly likely to motivate brokers (and possibly lenders) to act in ways other than in the consumer's interests. Unlike in wealth management (a similar advisory business, involving serious financial cost), mortgage brokers are not presently obliged by law to act in the best interest of the customer. And as we have seen with wealth management, a shift in that law may not be sufficient — CEO or board-level interest in its application is needed. The best place to start is simpler and open remuneration structures aligned as far as practical with customers' best interests.

Conflicts in broker remuneration

Inquiry participants put forward a range of views as to why trail commissions are paid and what their effect is on broker behaviour. These claimed purposes included providing an incentive for brokers to achieve good outcomes for their customers; influencing the level of refinancing and reduce 'churn'; aligning the interests of the broker with those of the lender; and remunerating brokers for providing ongoing services to clients.

We remain unconvinced that trail commissions serve any such purposes. The evidence is not there, certainly not from the banks that pay the commissions nor from the brokers' associations. It is most likely that a traditional form of remuneration common in the 1990s, when brokers emerged as a competitive force, has simply persisted long after it has been found detrimental to consumers in other financial product markets.

Despite industry-led initiatives to reform broker remuneration structures, it is apparent that little change is occurring and the principal commission structures continue to create conflicting incentives for brokers.

At its simplest, brokers have a strong incentive — regardless of what may be in their customer's best interest — to give preference in their loan recommendations to lenders that pay higher commissions. This may be uncommon, but there is no obligation for transparency of the payment to prove it.

Remuneration structures must also motivate at least some brokers to prefer advising new customers (with a new stream of trail commissions and potential referrals), particularly during the clawback period for an existing loan. Compounding this, many brokers and the Combined Industry Forum (where changes to remuneration structures are being debated by lenders and brokers) agree that brokers prefer to negotiate with a customer's existing lender before considering refinancing with another lender. This preference for loyalty is demonstrably often not in a customer's interest. And without any ability to withhold payment as an incentive to receive competitive offers, a consumer is actually in a poorer position to receive quality on-going advice as long as trail commission persist.

To the extent that brokers' business models rely on them maintaining ongoing (if infrequent) interaction with customers, they are likely to provide on-going advice irrespective of commissions. We see no case for paying for something (that is, through trail commissions) that is going to happen anyway.

Fewer conflicting incentives likely if commissions are upfront only

The current structures of mortgage broker remuneration appear to have become entrenched more because lenders are reluctant to be a first mover in negotiating alternative approaches than because they are delivering desirable market outcomes. Evidence to the Royal Commission indicated as much.

Fixed fees paid by customers rather than commission structures have been proposed, and would eliminate conflicts, but the cost to competition would be high. Consumers would desert brokers, and smaller lenders (and regional communities with few or no bank branches) would suffer much more than larger lenders, if customers were required to pay for broker advice. But change *is* required — to the role of the lender in being the paymaster — to reduce the scope for damage from conflicted advice.

Thus, while we propose that up-front commissions remain paid by lenders, we consider that going forward, trail commissions must be abolished — as they have already been in other parts of the financial system.

We accept that up-front commissions may rise as a consequence of such action. Broking businesses would need to remain commercially viable.

Industry agreement to abolish volume-based commissions (commissions based on the volume of loans written by an aggregator) must be implemented by all lenders without further delay. The absence of evidence that this is occurring affects industry credibility.

Current industry practice of restricting commission clawback arrangements to 18 months to two years should be imposed by ASIC in an enforceable Code across all lenders and include a ban on commission clawback being passed on to borrowers. Lengthy clawback periods act against consumer interests, inducing a costly form of loyalty.

In the absence of shifting broker remuneration from lenders to customers, which as we note above would diminish competition emanating from brokers, a formal best interest obligation is required as an offset to conflict, and it should be comprehensive.

A best interest obligation in the home loans market

A best interest obligation on all who provide home loans or home loan services

With lenders owning a stake in mortgage aggregators and conflicted broker remuneration structures, the interests of providers in the home loan market are not often aligned with those of the customer. It is the bank as paymaster that triggers conflicts. So a best interest obligation must cover ADIs, as well as brokers.

Removing trail commissions and restricting commission clawback will be important to reducing conflicts around remuneration. But placing remaining payment arrangements within a broader legal structure that realigns remaining incentives towards customers is needed to offset any scope for conflict.

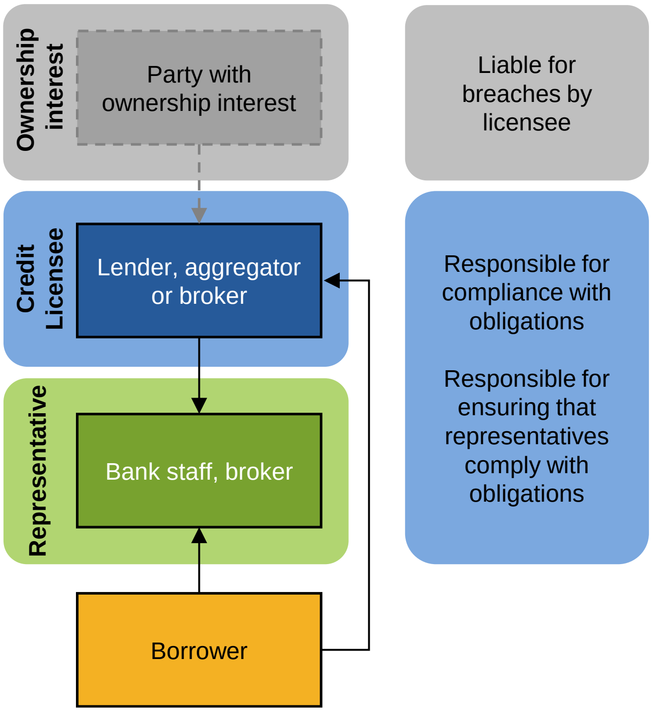
The Commission recommends the introduction of a best interest obligation for all providers in the home loans market — whether as a lender or mortgage broker — who interact directly with consumers seeking a home loan. The proposed obligation is intended to build on the existing regulatory framework in the *National Consumer Credit Protection Act 2009* (Cth), which governs the licensing and conduct regime that applies to providers in the credit market.

The new best interest obligation should comprise several distinct but complementary components:

- a duty to act in the best interest of the client
- a requirement that any resulting recommendations must be appropriate to the client, having regard to the duty to act in the best interest of the client
- a duty to prioritise the interests of the client, in the event of a conflict
- a duty to ensure that certain information is disclosed to the client.

The obligation should apply to credit licensees who provide home loans or home loan services, such as firms (aggregators) with mortgage brokers operating under their credit licence. Credit licensees should also be responsible for ensuring that their representatives comply with the obligations. The Commission also recommends that legal responsibility be extended to lenders who have an ownership interest in firms that hold a credit licence (figure 7).

Figure 7 **The best interest obligation**



Principal Integrity Officer for all banks

Principal Integrity Officer to ensure reward structures do not conflict with consumer interests

As noted above, commission-based remuneration structures create conflicts that may limit competition and mean that at times the money flow is at odds with acting in a consumer's best interest. These conflicts are particularly apparent where banks, as the creators of a financial product, are integrated with other entities that market, sell or advise on these same products.

It will not suffice to put in place standards that collectively reflect the rules of good practice, if they are out-of-step with where the entities' leadership and management consider their interests to lie. To this end, the parties best placed to directly manage these risks — senior management and boards of directors — must also be obligated to their consumers, to ensure that transparency around commissions' impact on incentives is not an afterthought.

APRA should impose on all ADIs, as a condition of their banking licence, the appointment of a Principal Integrity Officer to act as the source of both internal and external accountability for payments that could compromise consumer best interests. For this Inquiry, payments related to finding or placing mortgage products (including referral fees) have been the primary focus. However, reporting obligations *should* equally apply to other potentially conflicted payments (those that may adversely affect, or be seen to affect, the delivery of a service in a customer's best interest) — such as in financial advice and wealth management.

The Principal Integrity Officer role, as we envision, would: (i) minimise risks of negative customer outcomes from remuneration structures, including conflict with the requirement to act in the customer's best interest; and (ii) constantly re-evaluate the impact of integrated supply chains on fulfilling customer best interests. The Officer would act, in the first instance, via direct reporting to ensure a board is well-informed on the subject, but (as a fail-safe device) have an obligation to report to ASIC where advice is ignored.

Many banks claim to put the customer first. A formal, accountable reporting line to both board and regulator would put substance to this marketing. There will be a cost, but savings for banks may be inherent in other aspects of our remuneration reform. Design details of this notable addition to accountability amongst ADIs should be determined through a consultation process.

Shedding light on opaque practices that harm consumers

Knowing how your home loan rate stacks up

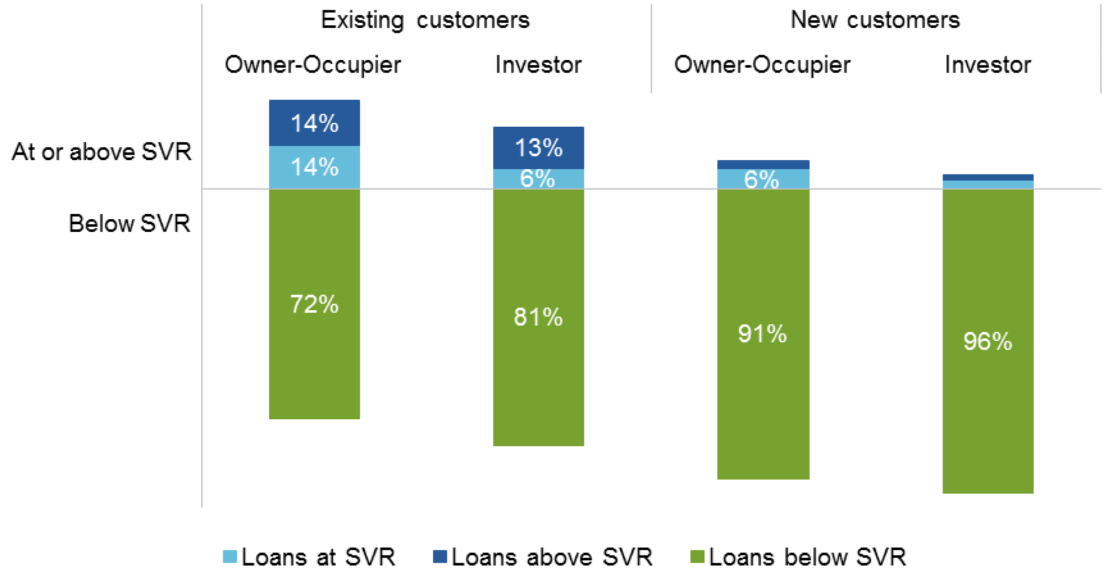
The absence of public data on *actual* prices is a distinguishing feature of Australia's banking industry that is not usually sustainable in competitive markets.

For example, the standard variable home loan interest rate advertised by ADIs bears no resemblance to the actual interest rates offered to potential borrowers: the vast majority of consumers pay less than this rate (figure 8).

Actual home loan interest rates and the discounts offered on the standard variable rate are generally not publicly available to consumers and the interest rate offered to a borrower is only revealed once they are well into the application process. Home loan packages that bundle home loans with other financial and credit products, such as offset accounts and credit cards, further obscure the actual value and comparability of individual components.

This opaque pricing is a significant factor in keeping consumers unsure of their position and more dependent on advice — some more professional than others. And brokers are often also not able to offer a full range of products. Even where they are able to present a wide variety of options to consumers, in the case of mortgage brokers and aggregators, they currently remain under no legal or contractual obligation to act in the customer's best interest.

Figure 8 **Most people do not pay the standard variable rate (SVR)**
Share of the number of home loans in 2016-17



A new home loan interest rate tool so borrowers can compare with actual rates paid by others

Shining a light on home loan interest rates would better allow mortgagees to see how their rate compares with other *actual* rates in the market for equivalent borrowers. Current comparators used by banks and brokers are not representative of rates actually paid. This is an unusual market indeed, when consumers are conditioned to expect a discount (of an uncertain size) from a published comparison rate, but that rate is *not* usually the market price for that borrower.

With access to digital data, *actual* home loan interest rates recently negotiated can and should be continuously collected by APRA, and made accessible to consumers via an online calculator, by ASIC (with an elapsed time of no more than 6 weeks). Consumers would be able to see the market median interest rate offered to all home loan borrowers in similar circumstances to them. The specific loan and borrower characteristics that are included in the online calculator should be developed through consultation and consumer testing.

Concerns about abuse of actual price information for price signalling are real, but capacity to do this already exists today via the broker channel. Moreover, use of a single median price across lenders limits scope for gaming of the pricing material supplied by individual lenders.

LMI — refunds or periodic payments

Lenders mortgage insurance (LMI) is a form of insurance for lenders that some borrowers, who are considered to be higher risk, are required by lenders to pay for (on a take it or leave it basis) in order to get a home loan.

Although it is seen as a benefit to first-home owners, data shows its greatest application is to higher income home-buyers.

Some lenders receive non-claim payments (including rebates for low claims) from LMI insurers and, in aggregate, these are not fully passed on to borrowers. Instead, the overall market price of LMI is inflated by the existence of these non-claim payments.

We see merit in intervention by ASIC to ensure that the interests of borrowers are adequately safeguarded in the LMI market. In particular, the Commission recommends that all lenders be required to offer borrowers the option of:

(i) paying for LMI up-front, with the 'unused' portion refundable in the event that they switch to a new home loan provider, and the refund schedule provided at the start of the loan, or

(ii) paying for LMI periodically (as in fact occurs for most other types of insurance), with no refund schedule necessary.

Clarifying and expanding what your financial adviser can do for you

To ensure consumers are able to clearly distinguish between general promotional effort related to products and actual personal advice, use of the term 'advice' should be limited to effort that is undertaken on a client's behalf by a professional adviser. Currently, the terminology of advice requires consumers to intuitively understand that general advice is like marketing; and personal advice is actually tailored to their situation and carries with it some protection against misuse.

Rebadging of existing 'general advice' products to implement this will involve some cost to the industry, but we would expect that some documentation is electronic, most would be updated regularly and the marginal costs of this change would not be substantial. The important shift is to training in the use of this term (and the culture that accompanies it).

While financial advisers cannot advise consumers on specific credit products, they are permitted to provide general credit advice. Where financial advisers do provide specific product advice on credit products, they must be licensed as an adviser (under the Corporations Act) as well as hold an Australian credit licence (under *National Consumer Credit Protection Act 2009* (Cth)) or be authorised representatives under both regimes. Currently, only 4% of Australian financial services licensees also hold a credit licence, and around 10% of representatives are authorised to provide both financial advice and credit assistance.

Allowing financial advisers to compete with mortgage brokers in offering personal advice on home loans would both expand sources of competition in home loan distribution and provide more holistic personal financial advice services to consumers. But there are impediments that are likely to limit the effectiveness of this proposal in the immediate future. These impediments include: the current conduct standards in the financial advice sector; the different means by which financial advisers and mortgage brokers are remunerated; and the level and nature of training and experience necessary to advise on both credit and investment products. ASIC should assess the feasibility of financial advisers providing advice on home loans and other credit products.

Addressing poor outcomes from financial add-on products

Add-on insurance is insurance that is sold alongside (and in relation to) another product. Examples include consumer credit insurance (sold alongside credit cards and loans), guaranteed asset protection insurance (sold alongside car loans) and lenders mortgage insurance (sold with higher risk home loans to protect the lender in the event of loan default). Add-on insurance is generally not a financial product that consumers actively seek, but is typically sold to them in addition to another purchase. The nature and context of the sale can mean that consumers are unable to exercise their normal competitive pressure on prices and quality.

On average, consumers receive back in claims only a small share of what they pay in premiums — about 9 cents in every dollar for add-on insurance sold by car dealers and 21 cents in every dollar for consumer credit insurance. This is far below the comparable figures for car insurance (83-98 cents) and home insurance (42-71 cents).

ASIC has exposed very poor consumer outcomes in some add-on insurance markets that include: insurers competing for intermediaries (and driving up premiums paid by consumers); policies where claims are less than or similar to the premium paid; policies that have exclusions broad enough to rule out most potential claims; and policies that offer cover that duplicates other already existing protections (such as warranties). Reforms in this area have proceeded at a glacial pace.

ASIC should proceed with its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships. Even with this, however, the Government should look to extend the model to all add-on insurance products. There should be a clear break period between such sales and an extended cooling off period.

The exemption of retailers— such as vehicle and white goods retailers — that offer finance to customers, from compliance with the *National Consumer Credit Protection Act 2009* (Cth) was to be reviewed by Treasury within 12 months of its introduction in 2009. We see little justification for maintaining such an exemption nine years beyond its introduction and consider that consumers should be protected by the National Consumer Credit Protection Act when taking up finance from retailers. But we have not been able to examine this issue in detail in this Inquiry. Accordingly, Treasury should complete and publish its 2013 review into the current exemption of retailers from the *National Consumer Credit Protection Act 2009* (Cth), with a view to removing or reforming the exemption unless there are compelling justifications for retaining it.

Insurance premium transparency

In contrast to many banking products, consumers are reminded annually of their option to renew general insurance policies. This provides a ready opportunity for getting information to consumers that would prompt consumer re-evaluation of their product decisions and improve competitive outcomes in insurance markets. In particular, we recommend that insurance renewal notices should transparently include the previous year's premium and percentage change to the new premium.

Further supporting greater clarity around insurance products on offer and removing the illusion of competition where none exists in reality, insurers should provide an up-to-date list of the brands they underwrite to ASIC, for publication on the regulator's website.

Action on the payment system is needed before incumbent positions become more entrenched

The New Payments Platform — hotbed for innovation or tool of incumbents?

The payment system is one area where innovation, and new entrants, have had an impact on market dynamics. Australians now have more payment options than ever before, and technology continues to evolve at a rapid pace. Regulation has not always kept pace with the rate of change, and this can have negative consequences for competition in future.

The New Payments Platform (NPP) requires an access regime. This is a rare opportunity to set up regulatory arrangements that will support substantial competition in services that all Australians use every single day.

The NPP, which became operational in early 2018, is set to replace the current technology through which over $1 trillion moves between banks each month. It was set up, and is mutually owned, by 13 initial shareholder participants (including the major banks and the RBA). Regulators should act now to facilitate fair access to the NPP in its early days — which will likely determine whether the platform will become a hotbed for innovation and competition, or yet another payment system subject to the market power of incumbents.

The NPP is expected to reduce *technical* barriers for new financial institutions to enter the payments system, and enable existing institutions to provide more efficient services through real time transfers of funds. It provides a rich set of payment data, which could be used by fintechs and incumbents alike to develop new applications.

Institutions that are not currently connected to the NPP can access it either through one of its existing participants or directly, by application to the NPP's governing body — New Payments Platform Australia Limited (NPPA). It is, however, up to the board of the NPPA (which includes representatives of 7 banks) to determine whether or not to accept an applicant.

In effect, this access model requires new competitors to be accepted by the initial participants, which could reasonably be expected to involve conflicts of interest. A recent survey of Australian fintechs indicated that over 80% were unconvinced about the ease of access to the NPP and believed that there should be more transparent access points for fintechs to connect. The NPP is a significant piece of national infrastructure and more transparency and rigour around the process for access is needed to avoid conflicts of interest that would potentially restrict competition.

The NPPA considers that having the RBA on its board will be a sufficient safeguard to stop the eligibility criteria disadvantaging prospective entrants. The RBA, in turn, is taking a wait-and-see approach to NPP access regulation. But there are risks from a passive approach at the time a new market is created, as it can cement incumbency.

Accordingly, the RBA should establish a formal access regime for the NPP. As part of this regime, the RBA should: broaden access to the NPP for specialist payment providers, without the need to become an ADI; review the fees set by participants of the NPP and transaction fees set by NPPA; and require all transacting participant entities that use an overlay service to share de-identified transaction-level data with the overlay service provider.

To ensure positive consumer outcomes are maintained as innovative products and services expand in the payment system, subscription to the ePayments Code (which sets out basic rules for who pays for unauthorised transactions and establishes a regime for recovering unauthorised payments) should be made mandatory for any organisation that sends or receives electronic payments, with more clearly defined liability provisions.

Distorted incentives in card payments

Card payments and bank transfers have grown in Australia and are dominated by Visa, MasterCard and the major banks (which enable over 80% of credit card payments). Australia has the highest level of contactless card use in the world and the fourth highest number of non-cash payments per person, with non-cash payments growing at about 10% per year.

Consumers get benefits from using cards — convenience, interest-free periods, rewards points — but do not face the full costs. Instead, the cost of a consumer's choice of payment is (in part or in full) borne by merchants, who pay interchange fees each time a consumer pays them using a card. In some cases these fees are used to fund reward points that are, in effect, a payment to the consumer for using the card. These fees are usually recouped through higher prices paid by all consumers. This means that financial institutions and card schemes have the opportunity and incentive to grow their networks by competing to subsidise the benefits to cardholders — at merchant's expense.

Rewards and other benefits may be useful to expand card networks in their infancy (and thereby enhance the value of the network for all), by increasing the incentive for individuals to use cards. With mature card scheme networks and ubiquitous use in Australia and worldwide, it reflects significant market power to suggest (as the major card schemes have) that in order for them to survive, merchants should be required to pay higher fees to cross-subsidise consumer reward programs. The case for interchange fees to fund reward programs or to redistribute benefits on a transactions basis from the merchant's bank to the customer's bank is feeble.

Regulation of bank interchange fees and surcharging has proved complex. The Payments System Board of the RBA should ban, by end-2019, all card interchange fees as a way to reduce distortions in payment choices and the flow-on costs of these distortions to merchants. Given the potential for three-party card schemes to avoid such regulation and further distort the mix of payment instruments, the ACCC should investigate whether further intervention — such as the direct regulation of merchant service fees — is necessary.

More choice for merchants in their use of the payments system

Merchants choose which payment methods to accept given the costs and benefits they face. Currently, contactless transactions using dual network cards (such as 'tap and go' facility at point of sale) are mainly processed through the generally higher-cost Visa or MasterCard networks by default, rather than through eftpos.

More control for businesses over their payment system costs

Merchants are likely to prefer that their financial institution routes payments through lower-cost network by default, but most merchants are simply not given this choice. In many overseas countries, either the merchant or the card holder is given the choice of payment pathway for dual network cards. For example, in Europe and Malaysia, merchants have first choice of the default pathway but the customer can override it.

To give merchants some control over their payments system costs, merchants should be given the capacity to select their own default route that is to be used for payments by dual network cards. The technology is readily available to offer dual payment choice in Australia and we consider this must now be mandated.

Supporting competition and reducing the costs of stability

Improving access to finance for small businesses

Reducing bank reliance on homes as security for SME lending

The ability of small and medium sized enterprises (SMEs) to access the necessary finance to establish and grow their business has been an issue for policymakers and previous reviews and inquiries, particularly since the GFC. Continued reliance on having a home as security for a business loan — in an era when home ownership in the key entrepreneurial period of life is at a low — will increasingly inhibit SME growth. Around one third of major bank SME loans, and often a higher proportion of smaller lender SME loans, are secured by a home.

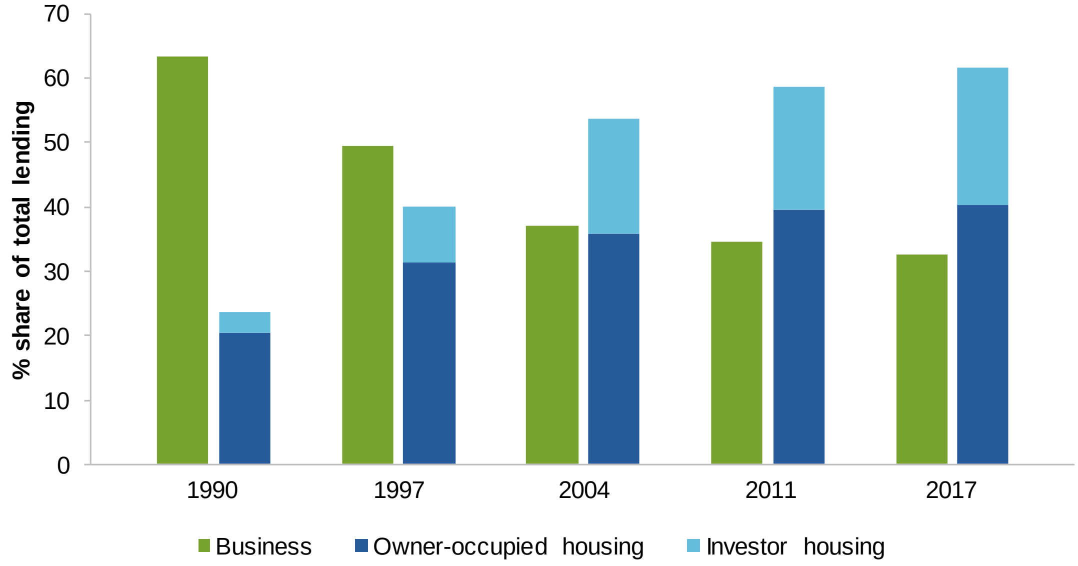
Reforms to address the ongoing issue of provision of credit to SMEs on terms that are commercially viable have the potential to significantly improve the market for SME lending. Improved access of banks to information about businesses seeking credit, particularly new businesses — for example, through Comprehensive Credit Reporting, Open Banking and business accounting software — should better inform lenders of the risk represented by SMEs seeking access to finance. But we consider the reform that would most significantly improve SME access to finance to be changes to the underlying prudential requirements for SME business lending compared with lending for residential mortgages.

For SME loans, APRA currently applies a single risk weight (of 100%) to all SME lending not secured by a residence, with no delineation allowed for the size of borrowing, the form of borrowing (term loan, line of credit or overdraft) or the risk profile of the SME borrowing the funds (box 1). This means that most lenders are generally required to hold more regulatory capital than are lenders using IRB models and more than that required under the internationally agreed Basel requirements.

As a consequence, for a SME loan that is not secured by a residence, Australia's smaller banks need to hold up to twice as much capital as the major banks — in effect, paying up to twice as much to be able to offer loans to their customers. This difference is smaller for loans secured against a residence. This approach to risk weights skews competitive opportunity away from consumer interests and provides strong incentives for both lenders and SME borrowers to secure a business loan with a residence as collateral. More generally, it creates a strong preference for home loan lending over business lending (unless secured by residential property) (figure 9).

Instead of applying a single risk weight to all SME lending not secured by a residence, APRA should provide a schedule of risk weights that takes into account alternative forms of loan security (such as commercial property) and differing loan to value ratios on this security.

Figure 9 **Lending has skewed away from business toward housing**



A more granular approach to regulatory interventions

A more granular approach is likely to be feasible in APRA's other interventions to reduce the costs on the economy of achieving stability objectives.

For example, in 2017, APRA informed ADIs that it expects them to limit the flow of new interst-only lending to 30% of their new residential mortgages. This is a further example of a blunt intervention with detrimental effects on market competition. It followed a similarly blunt intervention (in 2014) to impose a 10% benchmark on investor home loan growth.

These interventions had significant consequences across the economy. Lenders interpreted APRA's benchmarks as hard limits on lending. Competition was curtailed, as market shares had to remain static for providers to comply, and some lenders temporarily stopped offering products such as interest-only home loans. Interest rates increased on both new and existing investment loans, boosting lenders' profit on home loans. Up to half of the increase in lenders' profit was in effect paid for by taxpayers, as interest on investment loans is tax deductible. We estimated that the cost borne by taxpayers as a result of changes in home loan investor rates following APRA's intervention on interest-only loans in 2017, was up to $500 million per year (which may be partly offset by increased tax paid by the lending institutions on their profits).

The benchmark on investor loans imposed in 2014 is to be removed from August 2018, where APRA is assured by ADI boards that risk policies are in place and adhered to. However, there is nothing in the removal of the APRA benchmark to cause lenders to reduce the interest rates that they raised in order to comply with the benchmarks, and it is unlikely that competitive pressures will force them to do so. Borrowers and taxpayers will continue to pay the price.

In future, APRA should consider basing such interventions on the differences in the underlying risk of an ADI’s loan book. As much as possible, APRA should use targeted interventions to the risks it identifies (either at the institution level or groups of similar institutions), rather than imposing blanket rules across all institutions and geographic regions. The appointment of a competition champion, to assist APRA on the expected consequences of its actions, would be a valuable tool to achieve more targeted interventions and potentially have a lower impost on consumers.

Further, APRA should evaluate the effects of its prudential standards and interventions. For example, the recently introduced capital holding requirements for banks that offer warehouse funding have affected the availability of funds for small ADIs as well as non-ADI lenders. At the margin (the only area where price competition seems a reasonable probability in a highly regulated market), competition could be suppressed. APRA should monitor the impact of its changes on warehouse funding on not just those ADIs that offer warehouse funding but also on those that use it (including non-ADI lenders).

Box 1 APRA risk weights on different types of loans

Risk weights are a cornerstone of prudential standards, as they determine the amount of regulatory capital that a bank must hold against each loan it makes.

Some of APRA's standardised risk weights have been set at higher values than those recommended by the international Basel guidelines (see below table). For example, for SME loans, APRA currently applies a single risk weight (of 100%) to all SME lending not secured by a residence. In contrast, Basel III risk weights for SME lending vary from 75% (for SME retail lending up to €1 million) to 150% (for lending for land acquisition, development and constructions).

These risk weights are used by all ADIs other than the major banks, Macquarie and ING, which operate — for part (in the case of ING) or all of their credit portfolios — internal risk-based (IRB) models approved by APRA. The comparatively higher risk weights mean that most lenders are generally required to hold more regulatory capital than are lenders using IRB models.

From a prudential perspective, changing weights to more closely reflect the inherent risk of different types of loans would help prevent excessive provisioning of regulatory capital for low risk assets and under-provisioning for riskier assets. Thus, it would contribute to a more efficient banking system. From a competition perspective, increased granularity for risk weights would reduce the gap between IRB and non-IRB banks, as well as help achieve better competitive outcomes through lower costs for safer, low LVR loans.

APRA is consulting on changes to the standard risk weights, to allow for more targeted risk signals. The new proposed risk weights are lower for loans that pose less risk to the lender, such as owner occupier loans with low loan-to-valuation ratios, but increased for higher-risk lending.

Reviews of prudential standards take a considerable amount of time — it will be three years until the new framework APRA is working on is finalised and implemented. In a market that can change as dramatically and as quickly as banking, regulatory responses should be much more timely. Risk weights should be reviewed regularly, particularly given the increasing amount of data collected and generated by lenders and borrowers (for example, through comprehensive credit reporting).

How Australia's risk weights compare with Basel

Type of lending	*Basel II Standard*	*Australia (based on Basel II)*	*Basel III Standard*	*Australia (proposed – based on Basel III)*	*Australia IRB*
Home loans[a]	35%	35 - 75%	20 - 70%	20 - 85%	Avg 26%
e.g. Low risk mortgage[b]	35%	35%	20%	20%	
e.g. High risk mortgage[c]	35%	50%	50%	75%	
SME lending not secured by property	75 - 100%	100%	75 - 150%	85%	Avg 48 - 55%
Lending for/secured by commercial real estate	100%[d]		80 – 100% [e] 130% [f]		

[a] After consideration of any lenders mortgage insurance. Assumes repayment is not materially dependent on cash flows from property. [b] 50% LVR, owner occupier, principle and interest. [c] 95% LVR, investor, interest only. [d] Lending on office or multi-purpose/ multi-tenanted commercial premises can receive a risk rating of 50% where the value of the loan does not exceed 60% of the mortgage value of the property [e] LVR ≤ 80% [f] LVR > 80%, where repayment is materially dependent on the cash flows generated by the property.

Findings and recommendations

The state of competition

FINDING 2.1 KEY FEATURES OF WORKABLE COMPETITION IN THE FINANCIAL SYSTEM

The key features of *workable competition in Australia's financial system* at which we can aim, include:

- a high awareness of changes in market opportunities along with low costs for consumers when switching to preferred products
- active support for consumers by public advice or private advisers to conveniently make informed decisions in their best interests
- an Open Banking regime that gives consumers perpetual access to their data, with the capacity to see that data safely moved from one provider to another
- minimal limits to either entry by new providers or expansion or exit of existing providers, in regulated product markets (subject to other regulatory objectives such as prudential outcomes)
- regulators who anticipate that financial products and the ways of delivering them will change with technology and consumer preferences, and be willing and able to change regulation as required
- effective and timely scrutiny of the adverse use of market power, including as a response to regulator interventions.

FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST

Competition and stability are both important to the Australian financial system.

Since the global financial crisis there has been a focus on requiring prudentially regulated institutions to be unquestionably strong. It is important to ensure that the essential role of competition in economic growth is not eroded by having stability as the default regulatory position, to the exclusion of competition. Competition can support stability, checking irresponsible behaviour of providers and improving outcomes for consumers, and must be allowed to flourish.

FINDING 3.1 STATE OF COMPETITION IN THE BANKING SYSTEM

Price competition in the banking system is limited. Although institutions claim that they compete in loan markets by discounting, such behaviour is not indicative of a competitive market when price obfuscation is common and discounts are specific to groups of customers.

Competition on product features and service is more evident. But the large number of marginally different products appears more reflective of a capacity for price discrimination than of competition.

FINDING 3.2 THE STRUCTURE OF THE BANKING SYSTEM

Australia's banking sector is an established oligopoly with a long tail of smaller providers.

The four major banks as a group hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is substantially supported by regulatory settings, which contribute to the major banks' structural advantages.

As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability — with minimal loss of market share.

The smaller banks and non-bank financial institutions typically follow the pricing trend set by the major banks, and are not a significant competitive constraint on the major banks' market power.

Adding cost to the larger banks without altering their market power does not lift competition, harms consumers and is counter-productive. Policy measures aimed at addressing either conflicts of interest or regulatory interventions that disregard competition, can mitigate adverse outcomes for consumers even if the current industry structure remains largely intact.

FINDING 6.1 BETTER RATINGS AND COST OF FUNDS FOR 'TOO BIG TO FAIL' BANKS

The major banks in Australia benefit from a 'too big to fail' status reflecting an expectation of government intervention if one or more of these banks were in financial difficulties. This status lowers the cost of funds for these banks.

By incorporating perceived government support in their relative ratings of Australia's banks, rating agencies further embed the major banks' 'too big to fail' status.

FINDING 8.1 COST OF FUNDS FOR DIFFERENT SIZE BANKS

Larger banks benefit from lower costs of funding, compared with smaller institutions. Size, scope and incumbency have enabled them to increase their share of the deposit market, retain better access to offshore funding markets and raise funds at relatively cheaper rates due to their higher credit ratings, which in part reflect an expectation of government support.

Risk weights determined by the prudential framework have a substantial impact on the cost of funds. The major banks have invested in approved internal risk management models, gaining a further cost advantage from being allowed to use risk weights that are generally lower than APRA's standard requirements.

Cost interventions (such as changes to risk weights) have been presented as targeting both stability and competition. While such interventions may have achieved stability objectives, they have had adverse consequences for competition. Interventions that raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and will harm consumers.

FINDING 8.2 NEW WAREHOUSING RULES COSTLY FOR NON-ADIS

Prudential regulations (Prudential Standard APS 120) affecting warehousing activities (temporary lines of credit provided by larger banks to other lenders) that came into effect on 1 January 2018 take a one-size-fits-all approach to risk ratings for smaller authorised deposit-taking institutions (ADIs) and non-ADIs. These have increased the costs of warehousing and reduced the competitiveness of those (generally small) institutions that rely on warehouse funding.

RECOMMENDATION 8.1 COMPETITION IMPACTS OF APS120 SHOULD BE ASSESSED

Consistent with recommendation 19.3, APRA should conduct a post-implementation review on how the changes in Prudential Standard APS 120 have affected the costs of funds and competitiveness of non-authorised deposit-taking institutions.

New entrants in banking

FINDING 4.1 A CONSOLIDATION IN BANKING

There has been substantial consolidation in Australia's banking system. From 2005 to 2017, the number of organisations with a banking licence fell by almost 40%. This was largely a result of mergers between institutions, rather than exits.

FINDING 4.2 FOREIGN BANKS TEND TO OPERATE IN SELECT MARKETS

Foreign banks have shown that they are willing to enter Australia's banking system — between 2007 and 2018, the vast majority of new entrants to the banking system were foreign bank branches.

The regulatory framework incentivises foreign banks to enter and compete in the wholesale banking sector, rather than compete for household deposits. While they are important to innovation and to price competition in certain market segments, foreign banks remain focused on specific market segments and are not likely to prove a competitive threat in the broader retail banking sector.

FINDING 4.3 MOST FINTECHS ARE FOCUSING ON LESS-REGULATED SERVICES

Australia's fintech sector has grown substantially in recent years and offers a range of financial services.

However, few fintechs consider themselves to be challenger banks. The vast majority are focused on providing services in areas of the financial system with less onerous prudential regulation, such as small-scale funds management and lending, and payments systems.

Global technology companies, said to be the potential disruptors, are yet to make a mark in banking and the broader financial system in Australia.

FINDING 4.4 FINTECH COLLABORATION AND COMPETITION

Fintechs are not, on present indications, likely to have the kind of competitive disruptive effect that would alter the market power of major banks in the foreseeable future.

In the long term, lowering barriers to entry and growth, including greater access to consumer data, may lead fintechs to favour competition against incumbents over collaboration.

We must look further afield for substantial offsets to current market power.

RECOMMENDATION 4.1 EXPANDING ASIC'S REGULATORY SANDBOX

The Australian Government, in consultation with ASIC, should expand the scope of products eligible for testing under ASIC's regulatory sandbox, beyond the proposed enhanced regulatory sandbox, to include prudentially regulated fintechs that want to hold household deposits and issue or provide other financial products or services.

At the same time, ASIC should take a more hands-on approach to approving and supporting fintechs in testing their products or services, particularly to help with judgments on whether and how products may harm consumers.

ASIC should also consider requests from existing institutions to access the sandbox on a case-by-case basis.

An ongoing program of regulatory improvement in support of the sandbox should be a standing item for the Commonwealth Treasury's legislative program.

The role of integration

FINDING 9.1 COMPETITION ISSUES NOT CLEARLY CAUSED BY INTEGRATION

The Productivity Commission has not found any competition issues in either mortgage or wealth management markets that are clearly associated with integration. Where poor consumer outcomes arise in these markets, these outcomes may be compounded at times by integration, but are more likely associated with poor transparency and adverse remuneration incentives that arise even absent integration.

FINDING 9.2 FORCED SEPARATION IS NOT A PANACEA

Forced structural separation is not likely to prove an effective regulatory response to competition concerns in the financial system, specifically not in either home loan or wealth management markets.

RECOMMENDATION 9.1 UNDERSTANDING THE EFFECTS OF INTEGRATION

The ACCC should undertake 5-yearly market studies on the effect of vertical and horizontal integration on competition in the financial system. The first of these studies should commence in 2019 and include establishing a robust evidence base of integration activity in the financial system.

Consumers

FINDING 5.1 CONSUMERS' CAPACITY TO PUT COMPETITIVE PRESSURE ON PROVIDERS IS OFTEN LIMITED

For many financial products, consumer responses to variations in price and service are limited. Consumers lack meaningful transparent information and face switching barriers; and they perceive insufficient ongoing difference between providers and product offerings to make the process worthwhile.

FINDING 5.2 VARYING PRODUCT USAGE RATHER THAN PRODUCT HOLDINGS

Multiple account holdings (such as transaction accounts and credit cards) allow consumers to change their product usage but not switch their product holdings. Whether this translates to demand-side pressure depends on the extent to which financial service providers are responsive to the volume of business that they receive, or just the number of customer accounts that they have.

Where multiple products that are very similar can be held at a relatively low cost, a switching (of product holdings) and the long history of reforms aimed at this, become less important as policy objectives.

FINDING 5.3 MARKET SEGMENTATION CURTAILS CONSUMER COMPETITIVE PRESSURE

Financial service providers are able to selectively offer products, prices or terms to different customers, using the information they have about individual consumers. This curtails the ability for an active subset of consumers to drive increased competition in the broader market.

RECOMMENDATION 5.1 DATA ACCESS TO ENABLE CONSUMER CHOICE

The Open Banking system proposed for Australia should be implemented in a manner that enables the full suite of rights for consumers to access and use digital data (as set out in the Productivity Commission Inquiry report, *Data Availability and Use*).

Mortgage brokers and home loan markets

FINDING 11.1 BROKERS ARE NOT CONSISTENTLY FINDING LOWER INTEREST RATES FOR CONSUMERS

While many consumers believe that mortgage brokers can secure them a lower interest rate, interest rates on home loans obtained through brokers are not significantly different to those obtained directly from lenders.

FINDING 11.2 BROKERS ARE A COST–EFFECTIVE WAY TO DISTRIBUTE HOME LOANS FOR LENDERS WITHOUT WIDESPREAD BRANCH NETWORKS

For smaller lenders without national branch networks, brokers tend to be a more cost-effective distribution channel than branches, since branches involve a significant investment. Competition is thus assisted by the presence of brokers.

Larger lenders with established branch networks generally find brokers less cost-effective than existing branches.

FINDING 11.3 TRAIL COMMISSIONS ARE NOT CONSISTENT WITH BORROWERS' INTERESTS

There is little if any evidence to substantiate the claim that trail commissions are a payment for the ongoing provision of services to borrowers.

In practice, trail commissions have the effect of aligning the broker's interests with those of the lender, rather than those of the borrower.

RECOMMENDATION 11.1 BROKER REPORTING THAT ACCORDS WITH IT BEING THE DOMINANT HOME LOAN DISTRIBUTION CHANNEL

As part of the process of issuing credit licences, ASIC should provide clear definitions for, and collect information from licensees about whether they operate as mortgage aggregators, mortgage broker businesses or individual mortgage brokers. This information should be collected in a way that can be reliably used for analyses of the mortgage broking industry.

Aggregators should be required to report to ASIC annually on the number of individual brokers operating under them, whether as credit representatives of the aggregator, credit representatives of another credit licensee, credit licence holders or direct employees of a broker business.

RECOMMENDATION 11.2 REFORMING MORTGAGE BROKER COMMISSION STRUCTURES

An enforceable Code applying to all mortgage lenders should be created and imposed by ASIC, to implement the following reforms to broker remuneration structures:

- ban the payment of trail commissions in mortgage broking for all loans originated after end-2018
- require upfront commissions to aggregators and brokers to be paid based on the funds limit drawn down by customers, net of offset, instead of the limit of the loan facility
- ban the payment of volume-based commissions, campaign-based commissions and volume-based payments
- limit to two years the period over which commissions can be clawed back from aggregators and brokers.

RECOMMENDATION 11.3 REFORMING COMMISSION CLAWBACK ARRANGEMENTS

The Australian Government should extend the ban on early exit fees to explicitly prohibit commission clawbacks being passed on to borrowers. ASIC's powers should be expanded to allow it to enforce the ban.

RECOMMENDATION 11.4 BEST INTEREST OBLIGATION FOR CREDIT LICENSEES THAT FACILITATE HOME LOANS

The Australian Government should amend the *National Consumer Credit Protection Act 2009* (Cth) to impose best interest obligations on licensees that provide credit or credit services in relation to home loans.

These best interest obligations should comprise:

- a duty to act in the best interest of the client
- a requirement that any resulting recommendations must be appropriate to the client, having regard to the duty to act in the best interest of the client
- a duty to prioritise the interests of the client, in the event of a conflict
- a duty to ensure that certain information is disclosed to the client.

Where the lenders have an ownership interest in firms that provide the credit assistance services, those lenders should also have a legal responsibility to ensure that the licensee discharges its best interest obligations.

RECOMMENDATION 9.2 A PRINCIPAL INTEGRITY OFFICER

The Australian Government should mandate the appointment of a Principal Integrity Officer (PIO) in parent financial entities — authorised deposit-taking institutions in the first instance, but with potential extension to other Australian Credit Licensees and Australian Financial Service Licensees. The PIO should have independent status within the entity and would have a direct reporting line to its board.

Once created, the position must not be vacant for more than a minimal period defined in legislation.

The PIO should have a statutory duty to advise the entity's board on performance related to remuneration and practices that may be inconsistent with serving a customer's best interests, including breaches of commission or other remuneration benchmarks and regulations. The PIO should also review internal business practices as they develop over time that may be inconsistent with the entity's obligation to act in the customer's best interests.

The PIO would be required to report independently to ASIC on unsatisfactory responses to its reports, including persistent failure of its board to observe standards supporting consumer best interest obligations. The PIO should be protected from adverse action by statute where they do so report.

Details of the PIO, related legislative changes and penalties, should be determined through a consultation process starting by end-2018.

RECOMMENDATION 12.1 INTEREST RATE TRANSPARENCY FOR HOME LOANS

APRA should continuously collect data from mortgage lenders (authorised deposit-taking institutions (ADIs) only) on interest rates of new residential home loans by borrower and loan characteristics. Consideration should be given to adding non-ADIs to the data set, once the collection process from ADIs has become streamlined.

Using this data, ASIC should develop an online calculator that reports, with an elapsed time of no more than 6 weeks, median interest rates for loans issued according to different combinations of loan and borrower characteristics.

The underlying data should be published in a way that is accessible to third parties such as web application developers. At a minimum, data should be published in a machine-readable format.

RECOMMENDATION 13.1 LENDERS MORTGAGE INSURERS SHOULD DISCLOSE INFORMATION ABOUT PAYMENTS TO LENDERS

APRA should update its disclosure requirements for lenders mortgage insurers to require them to disclose the amount and purpose of all payments made to lenders.

RECOMMENDATION 13.2 OFFERING BORROWERS MORE CHOICE FOR LENDERS MORTGAGE INSURANCE

ASIC should require all lenders to provide those borrowers that are levied with lenders mortgage insurance (LMI) with the option of being levied once at the commencement of their home loan (whether paid as a lump sum or as deferred payments) or being levied annually over the first 6 years of their loan, with transparency around the comparison of these options.

Where LMI is levied at the commencement of the home loan, all lenders should be required to set a schedule of refunds on the cost of LMI when borrowers choose to refinance or pay out their loan within 6 years of the loan being originated. The refund schedule should be made available to the borrower before any fee or charge is levied.

General insurance

FINDING 14.1 MARKET POWER IN GENERAL INSURANCE PROVISION

General insurance markets are concentrated. In the home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets, the largest four firms (which are not always the same four) hold market shares in excess of 70%. This concentration has increased slightly in recent years, mostly as a result of consolidation activity.

The domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets are particularly concentrated, and while the domestic home insurance market is less concentrated, the two largest firms still account for more than half the market.

But because many insurers supply their products under multiple brands, consumers may see more an illusion of robust competition than a reality.

RECOMMENDATION 14.1 COMPARATIVE PRICING INFORMATION ON INSURANCE RENEWAL NOTICES

Renewal notices for general insurance products should transparently include the previous year's premium and the percentage change to the new premium. This policy should commence by the end of 2019 and be enforced by ASIC.

RECOMMENDATION 14.2 TRANSPARENCY ON INSURANCE UNDERWRITING

In addition to specifying which insurer underwrites their products, each insurance brand should specify on their website any other brands that are underwritten by the same insurer, for that particular form of insurance.

Insurers should provide an up-to-date list of the brands they underwrite to ASIC. ASIC should transparently publish this information as a list on its website.

RECOMMENDATION 14.3 PHASE OUT DISTORTIONARY INSURANCE TAXES

Consistent with the Productivity Commission's 2014 *Natural Disaster Funding Inquiry* (recommendation 4.8), state and territory taxes and levies on general insurance should be phased out.

RECOMMENDATION 15.1 DEFERRED SALES MODEL FOR ADD-ON INSURANCE

ASIC should proceed as soon as possible with its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships.

The deferral period should be a minimum of 7 days from when the consumer applies for or purchases the primary product.

Following implementation, the Australian Government should establish a Treasury-led working group with the objective of comprehensively extending the deferred sales model to all other add-on insurance products, with the model set in legislation and ASIC empowered to offer exceptions on a case-by-case basis.

RECOMMENDATION 15.2 REVIEW OF NCCP ACT EXEMPTIONS

The Treasury should complete its 2013 review into the current exemption of retailers from the *National Consumer Credit Protection Act 2009* (Cth), with a view to removing or reforming the exemption. The report should be made publicly available on completion.

Financial advice

RECOMMENDATION 10.1 ASIC TO ASSESS A NEW LICENCE TO ALLOW FINANCIAL ADVISERS TO ADVISE ON HOME LOANS

ASIC should assess the feasibility of financial advisers providing advice on home loans and other credit products, via a new Australian Financial Services Licence that would not require a separate Australian Credit Licence to be obtained.

This assessment should examine the costs and benefits of a new licence, the consequences of various remuneration models and the applicability of a Principal Integrity Officer.

RECOMMENDATION 10.2 RENAME GENERAL ADVICE TO IMPROVE CONSUMER UNDERSTANDING

General advice, as defined in the *Corporations Act 2001* (Cth), is a misleading term and should be renamed. Any replacement must ensure that the term 'advice' can only be used in association with 'personal advice' — that is, advice that takes into consideration personal circumstances.

Consumer testing of alternative terminology is required to ensure that misinterpretation and excessive reliance on this type of information is minimised. Including time for consumer testing and a transition period to enable industry training and adjustment, a new term should be in effect by mid-2020.

RECOMMENDATION 10.3 GREATER TRANSPARENCY OF PRODUCTS ON THE APPROVED PRODUCT LIST

Australian Financial Service Licensees should disclose to ASIC (for each broad class of financial product):

- the number of products on their approved product list (APL)
- the proportion of in-house products on their APL
- the proportion of products recommended that are in-house
- the proportion of products recommended that are off-APL

ASIC should publish this information annually.

ASIC should also conduct selected audits of the information received to facilitate assessment of the effectiveness of advisers in meeting clients' best interests.

Payments system

RECOMMENDATION 17.1 BAN CARD INTERCHANGE FEES

The Payments System Board should introduce a ban on card payment interchange fees by the end of 2019. Any other fees should be made transparent and published.

RECOMMENDATION 17.2 ANALYSIS AND ASSESSMENT OF THREE-PARTY SCHEMES

The ACCC, with input from the Payments System Board, should investigate:

- whether current or recommended interchange fee regulation favours three-party card schemes and, if such a distortion exists, whether it is significant enough to require further regulatory intervention; and
- if further regulatory intervention is desirable, the nature of such intervention, including, but not limited to, the possibility of regulating merchant service fees as an adjunct to the interchange fee ban.

This investigation should be completed by no later than mid-2019.

RECOMMENDATION 17.3 MERCHANT CHOICE ROUTING FOR DUAL-NETWORK CARDS

The Payments System Board should set a regulatory standard that gives merchants the ability to choose the default network to route transactions for dual-network cards. As the technology is readily available, this reform should be in force by 1 January 2019 at the latest.

RECOMMENDATION 17.4 REVIEW TRANSPARENCY OF FEES ON FOREIGN TRANSACTIONS

By end-2019, the ACCC, in consultation with ASIC, should investigate what additional disclosure methods could be used to improve consumer understanding and comparison of fees for foreign transactions levied by authorised deposit-taking institutions and other payment providers.

This should include determining the feasibility of using benchmark exchange rates to improve transparency of international money transfers, as well as measures to improve transparency for fees on overseas purchases.

RECOMMENDATION 17.5 REVIEW REGULATION OF PURCHASED PAYMENT FACILITIES

The Council of Financial Regulators should review the current regulation of Purchased Payment Facilities (PPFs).

The review should develop an approach to simplify the regime, develop clear thresholds for regulatory responsibility and reduce barriers to growth in this sector. The review should consult on and design a tiered regulatory structure for PPFs, including one tier that does not attract prudential regulation.

The review should be completed by end-2018 at the latest and provide a path forward for regulators by mid-2019.

RECOMMENDATION 17.6 UPDATING AND MANDATING THE EPAYMENTS CODE

The Australian Government should give ASIC the power, by end-2018, to make the ePayments Code mandatory for any organisation that sends or receives electronic payments.

ASIC should review the ePayments Code and update it to reflect changes in technology, innovative business models and developments in Open Banking. ASIC should more clearly define the liability provisions for unauthorised transactions when third parties are involved, including participation in financial dispute resolution schemes.

ASIC should update the ePayments Code by end-2019 and commit to 3-yearly reviews.

RECOMMENDATION 17.7 ACCESS REGIME FOR THE NEW PAYMENTS PLATFORM

As a significant piece of national infrastructure for which the competition benefits hinge on widespread access of both financial system providers and consumers, the New Payments Platform (NPP) should be subject to an access regime imposed by the Payments System Board (PSB). As part of the regime, the PSB should:

- allow specialist payment providers that hold an Exchange Settlement Account to connect to the NPP without the need to be an authorised deposit-taking institution
- review the fees set by NPP institutions and transaction fees set by New Payments Platform Australia Limited
- require all NPP institutions that use an overlay service to share de-identified transaction-level data with the overlay service provider. The PSB should consult the ACCC on the final design of the data sharing obligations, having regard to impending Open Banking reforms.

RECOMMENDATION 17.8 IMPROVING FUNCTIONALITY OF THE NEW PAYMENTS PLATFORM

The ACCC, in consultation with the Payments System Board, should investigate different ways that New Payments Platform Australia Limited and its participating financial institutions can improve the functionality of the New Payments Platform (NPP) to promote competition within the NPP and across the payments system more broadly.

This includes investigating the feasibility of additional functionality for PayID to give customers the ability to both send and receive recurring bank transfers, direct debits and card payments.

The investigation should be completed by mid-2019, with a view to implementing additional functionality by end-2019.

Regulators

FINDING 6.2 THE FOUR PILLARS POLICY IS REDUNDANT

The Four Pillars policy is a redundant convention.

There are sufficient provisions within the *Competition and Consumer Act 2010* (Cth), the *Banking Act 1959* (Cth) and the *Financial Sector (Shareholdings) Act 1998* (Cth) that give the government or the designated regulators power to intervene to ensure competition, prudential outcomes and the broader public interest are protected.

There is no evidence that the Four Pillars policy has enhanced competition; and far more reasons to conclude that it may have dissuaded it by embedding a fixed market structure.

RECOMMENDATION 18.1 STATEMENTS OF EXPECTATIONS FOR REGULATORS

Updated Statements of Expectations for regulators, as agreed in the response by the Australian Government to the Murray Financial System Inquiry, should be published as a matter of priority. They should be written in clear language and updated at regular intervals thereafter.

Regulators should publish Statements of Intent within three months of receiving the Statements of Expectations.

In their annual reports, the financial regulators should provide information on the actions they have taken in line with their Statements of Intent and outcomes on performance measures.

RECOMMENDATION 18.2 ASIC TO PUBLISH DATA

The financial regulators already collect large amounts of data, which is a valuable public resource. Subject to privacy requirements, much more such data should be made publicly available.

As a first step towards improving the availability of data, ASIC should publish a list of the datasets collected and used in its research projects and reports and release any non-sensitive datasets.

FINDING 7.1 COST OF APRA INTERVENTIONS IN THE HOME LOAN MARKET

APRA's actions to slow interest-only lending on residential property in early 2017 resulted in banks imposing higher interest rates on both new and existing residential investment loans, despite the regulatory objective being to slow only new lending.

This led to a windfall gain for the banking sector.

Up to half of this gain is in effect being paid for by taxpayers, as interest on investment loans is tax deductible. The Commission estimates that the cost borne by taxpayers as a result of APRA's intervention was up to $500 million a year, depending on various tax permutations.

Competition between lenders was restricted, and there was limited competitive variation in lenders' responses to the regulatory intervention.

FINDING 18.1 APRA NOT WELL PLACED TO CONSIDER COMPETITION EFFECTS

APRA is not well placed to balance the cost to competitive behaviour in its regulatory actions. Although the legislation that requires APRA to give weight to competition is valuable, its remit quite reasonably must favour system stability — even where its actions could impose a significant cost to competition.

The capacity to generate timely and trusted debate among relevant regulators on the question of whether the public interest is served by restricting competition is a desirable addition to the regulatory structure. This is particularly the case given our finding that key financial markets are characterised by large institutions that hold substantial market power. The Council of Financial Regulators is a valuable forum with the scope and leadership in which to deliver this debate.

In the absence of such a debate, consideration of competitive effects will inevitably continue to be subordinate to stability.

RECOMMENDATION 19.1 COMPETITION CHAMPION FOR THE FINANCIAL SYSTEM

To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, the ACCC should be given a mandate by the Australian Government to champion competition in the financial system, including in decisions taken by regulators that have or may have the outcome of restricting competition.

To minimise cost and disruption, this role should be implemented in substantial part through the Council of Financial Regulators (CFR) by making the ACCC a permanent member of the CFR.

There should be no change under this recommendation to the current legislated responsibilities of the regulators. Rather, the Australian Government should include in its Statement of Expectations for each of the financial regulator members of the CFR that the ACCC should be given the opportunity as a member of the CFR to advise the Council on regulator actions that may have material effects on competition, before they are implemented.

The functions of the ACCC within the CFR would be:

- preparing transparent analysis of competition impacts of material market interventions by financial market regulators
- publishing a bi-annual financial system competition report which would be the competition equivalent of the RBA's Financial Stability Review.

RECOMMENDATION 19.2 TRANSPARENCY OF REGULATORY DECISION MAKING

The Council of Financial Regulators (CFR) should apply the ACCC analysis in a discussion amongst members on interventions that may have a material impact on competition in a product market.

The ACCC assessment of competition impacts should be published in a simple form and timely manner as part of a new commitment to publish Minutes of CFR meetings.

RECOMMENDATION 19.3 ROBUST AND TRANSPARENT ANALYSIS OF MACROPRUDENTIAL POLICIES

APRA should conduct and publish annually quantitative post-implementation evaluations of its material prudential interventions, including costs and benefits to market participants and the effects on competition.

RECOMMENDATION 16.1 STANDARDISED RISK WEIGHTINGS FOR SMALL BUSINESS LENDING

Instead of applying a single risk weight to all small and medium business lending not secured by a residence, APRA should provide for a broader schedule of risk weights in its Australian Prudential Standard (APS 112).

It should take into account the different risk profile and the type of lending (such as the value of the loans made to an individual business and alternative forms of loan security including commercial property and differing loan to value ratios on this security) to better reflect the Basel Committee's standardised risk weightings.

In light of apparent major improvements in the collection and use of data (including via the New Payments Platform), APRA should also consider proposals by authorised deposit-taking institutions (ADIs) for variations from the standardised risk assessment for small and medium enterprise lending, based on the ADI improving its data and risk management systems. International best practice should be closely considered as APRA reviews proposals from ADIs.

1 An Inquiry focused on competition

Key points

- The financial system is a vital part of the Australian economy because of its size and the key role it plays in enabling and supporting transactions by individuals, households, businesses and government.
- Effective competition in the financial system should drive innovation in product offerings, improvements in product quality and variety, greater efficiency and lower prices, for the benefit of business and consumers.
- The financial system should be stable. But equally, it should ensure that those for whom it exists — the businesses investing in the Australian economy and the individuals whose consumption drives the majority of economic activity — receive good service at transparent prices, and can have confidence that unquestionably strong institutions are not simply exploiting the market power they might have.
- Regulators largely have the tools to support a competitive market place but their focus is tilted towards the stability of the system, with regulatory regimes that are indifferent to, or actively discourage, innovation and competition.
- We examined a range of financial products and services to build a picture of how competition is operating in different parts of the financial sector. Not all markets are covered in the same depth. Where we looked has been substantially the result of advice from market participants and regulators.
- Inquiry participants have identified a range of issues, not all of which were focused on competition. Only where we could see competition being impeded, and where public policy offered a plausible solution, has the Commission proposed reforms.
- There have been, and continue to be, many reviews into parts of the financial system. Frustrating as it must be for the industry's leaders to explain their position repeatedly, these reviews indicate a depth of community concern about the financial sector and its conduct. The government and agencies should, in turn, remind themselves of the plethora of reform options from these reviews that *they have already accepted* but not implemented.
- Wherever possible with other reviews, and with a sceptical eye to the credibility of commitments that have been made, the Commission has assessed the work under way or recently completed and drawn on it in proposing reforms.
- Although banks and insurers cooperated in providing us with confidential information about their operations, the responses of some were glacial in their pace and we were surprised and sceptical in some cases at the gaps in the information held — for example, on the profitability of key product groups, the relative costs of product distribution through different channels or the nature of agreements between companies that work closely together. Institutions that are licensed to provide an essential service should expect to be required to provide such information and cannot hope to earn the confidence of the public if key data is not readily available.

1.1 Why this Inquiry?

This Inquiry comes at a time when there are widespread questions about the extent to which financial institutions such as the major banks, insurers and advisers are operating to the benefit of their customers.

We recognise that the Australian banks largely withstood the global financial crisis and that this was a result of their financial strength, their conservative mix of exposures, the overarching regulatory environment and the significant support provided by the Government.

But there have still been significant losses for Australians with numerous scandals and allegations over the past decade, including in relation to poor financial advice, the maladministration of life insurance claims, and market manipulation (HoRSCE 2016e). The Prime Minister recognised these issues in his speech at Westpac's 199th anniversary event in April 2016:

> The truth is that despite the public support offered at their time of need, our bankers have not always treated their customers as they should.
>
> Some, regrettably as we know, have taken advantage of fellow Australians and the savings they've spent a lifetime accumulating, seeking only dignity and independence in their retirement. (Turnbull 2016)

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established in December 2017 (Morrison, S. (Treasurer) 2017f) and has been examining many of these issues of conduct.

Many people have concerns about the level of profits earned by the major players in the financial system and the apparent tendency for prices to rise quickly and fall slowly. Growth in banks' profits seems to rely on increasing household debt, either through credit card interest and charges or through the demand for increasingly large mortgages as house prices rise.

It also seems that existing customers are exploited while banks and insurers focus on growing their market share by offering better deals to new customers. There is at a minimum, the perception of provider conflicts of interest that augment the perception that consumers can, and are, being readily exploited.

Small businesses report that they do not have access to finance when they need it or that the terms limit the commercial viability of their investment plans.

This Inquiry, therefore, sits against the backdrop that, while the financial system has withstood some severe economic headwinds, the public perception is that it has not been serving the Australian people as well as it should. We accept that this perception exists. However, as is expected in a Productivity Commission inquiry, we have focused on rigorous analysis rather than isolated or unsubstantiated anecdotes when making our recommendations. In accordance with the terms of reference, this Inquiry looks at the financial system through the prism of competition and, in line with our usual practice, on the basis of what the available data can tell us.

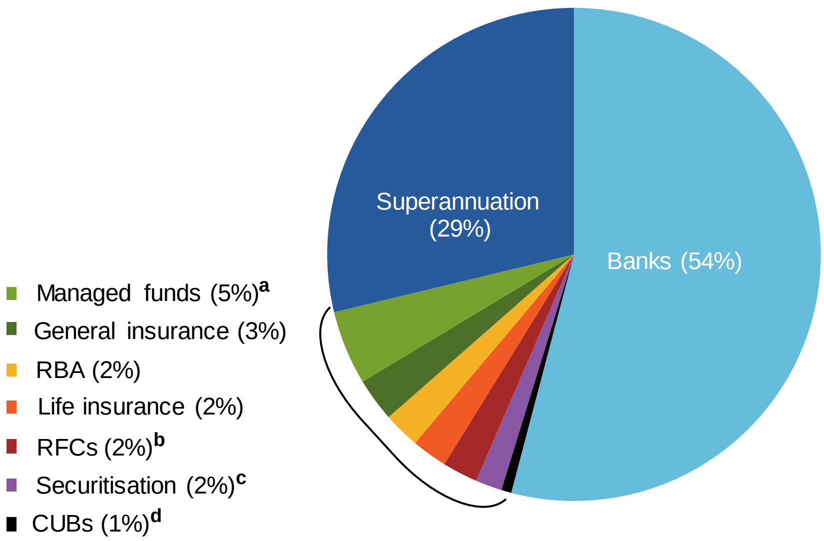
1.2 Australia's financial system

The financial system is a large, strong and growing part of the Australian economy. As at 31 December 2017, banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies and the superannuation industry held a combined $7.6 trillion in assets (RBA 2018a). Figure 1.1 shows the relative size of the different segments of the financial system.

The system as a whole contributed $149 billion to the Australian economy in 2016-17 (or almost 9% of annual GDP) (ABS 2017b). It employs nearly 437 000 people (3.5% of the workforce) (ABS 2018d). The Australian financial system accounts for a larger proportion of the total value added in the economy than the financial systems of most other advanced economies (OECD 2018).

Figure 1.1 **Size of the financial system, by segment**

Total assets as at December 2017



[a] Includes public unit trusts, cash management trusts, common funds and friendly societies. [b] Registered Financial Corporations whose assets exceed $50 million, including money market corporations, finance companies and general financiers. [c] Special purpose vehicles set up to securitise selected assets, including residential mortgages. [d] Credit unions and building societies.

Source: RBA (2018a)

The Australian financial system has grown in importance over the past 40 years (more than doubling as a proportion of the economy since 1978) (ABS 2017b). This growth has come from a substantial increase in household borrowing since financial liberalisation in the 1980s; the growth in the superannuation savings pool; and the very rapid growth in activity in financial markets (with much higher trading volumes on the equity and foreign exchange markets, driven by tax changes, privatisations and the floating of the Australian currency) (Maddock 2014).

Given the size of Australia's financial system, both in absolute terms and as a share of the economy, it is critical to ensure that it is operating as efficiently (and to the benefit of the community) as possible.

The financial system provides key functions directly for businesses and households and more generally in support of the operation of the real economy. These functions include the channelling of savings into investments, the operation of payment systems, and helping to manage financial risks. Linkages between financial system players (for example, through inter-bank markets and payment systems) are vital to the functioning of the system. The biggest financial decisions Australians make in life — buying a home, setting up a business or providing for their retirement — are all supported by the financial system (Australian Government 2015, p. 1).

Concerns about the level of competition in financial services

There are reasons to be concerned about the levels of competition in Australian financial services. Although the Murray Financial System Inquiry (Murray FSI) concluded that the level of competition was 'generally adequate', it suggested that:

> … the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future. (Murray et al. 2014a, p. xvi)

The ACCC observed a number of indicators concluding that:

> … the current oligopoly structure of the banking system is not vigorously competitive and has not been for some time (ACCC, sub. 17, p1).

These indicators included:

- concentrated market structure, with the largest players maintaining significant market shares over a considerable time
- the largest players maintaining high margins and high overall profits by international standards, without attracting significant new entry or expansion by smaller players
- the large banks being relatively quick to pass through RBA interest rate increases to mortgage customers, but slow to pass through rate reductions
- a high degree of symmetry in the product and service offerings of the large banks, with little evidence of strong rivalry to be the first to roll out new products and services to meet customer needs and wants
- low levels of customer switching. (ACCC, sub. 17)

While the ACCC focused on banking, many of the same indicators are also evident in other parts of the financial system, such as in general insurance.

In the course of this Inquiry, participants have identified a number of issues that indicate problems with either the extent of competition in various parts of the financial system or outcomes for the community. These include:

- questions about the extent to which regulatory capital requirements have affected the costs of lending for banks of different sizes, and questions about how banks have responded to regulatory initiatives and restrictions, including a perception that they have taken advantage of some regulatory changes to increase interest rates on loans at the expense of consumers
- concern that an 'implicit guarantee' of government support to the larger banks (as institutions that are considered 'too big to fail') gives them an advantage in attracting customers and in securing funds from international markets
- the extent to which large players in the financial system have integrated functions across the supply chain for some products and the impact that this may be having on market outcomes.
- the persistent absence of clear and useful information for consumers, making it harder for them to compare providers on prices or key product features.

Subsequent chapters within this report provide analysis of these issues.

Financial system policy developments in recent years

Australia has had a number of landmark financial system inquiries (FSIs) over the past 40 years:

- The Campbell FSI, which reported in 1981 and led to the floating of the Australian dollar and the deregulation of the financial sector
- The Wallis FSI, which reported in 1997 and established the current 'twin peaks' model, under which APRA and ASIC share responsibility for financial system regulation. The inquiry also led to the establishment of the Payments System Board.
- The Murray FSI, which reported in 2014 on ways to foster an efficient, competitive and flexible financial system. The Government accepted the majority of the Murray FSI recommendations, and has been working to implement them (Treasury, sub. DR 126). The Government response to the Murray FSI formed part of the Government's broader agenda for financial system reform. This agenda seeks to improve the resilience of and stimulate innovation in the financial system, improve the efficiency of the superannuation system, support consumers being treated fairly and strengthen regulator capability and accountability (Australian Government 2015).

The Murray FSI found that policy settings in the Australian financial system did not focus on the benefits of competition and innovation.

> … there is currently no process for regularly assessing the state of competition in the financial system, as there is for assessing stability in the form of the Financial Stability Review. This creates the risk that broader competition issues will 'fall between the cracks' as regulators focus on their specific mandates for stability or consumer protection. For example, no regulator has direct responsibility for removing barriers to consumers switching products. (Murray et al. 2014a, pp. 254–256)

The Murray FSI made a number of specific recommendations to remove impediments to the development of competition. These included recommendations to narrow the differences in risk weights in mortgage lending; consider a competitive mechanism to allocate members to more efficient superannuation funds; and ensure that regulators were more sensitive to the effects of their decisions on competition, international competitiveness and the free flow of capital (Murray et al. 2014a).

Despite the Government accepting most of the Murray recommendations to strengthen the focus on competition in Australia's financial system, it remains (as discussed later in this report) without a champion amongst the existing regulators. The Murray FSI did not recommend that any of the existing regulators — or the Treasury — should take on such a role. Financial system competition is the neglected cousin to financial system stability.

Following the Draft Report, the Treasury has claimed the role of competition champion, particularly within the Council of Financial Regulators:

> … Treasury sees itself as having a particular responsibility for raising competition issues and testing whether appropriate trade-offs are made, when necessary, between financial stability objectives and competition and efficiency. (Treasury, sub. DR 126, p. 12)

Other ongoing reviews

There has been ongoing intensive scrutiny of the financial services system by committees of Parliament, including the regular hearings and reports of the House of Representatives Standing Committee on Economics as part of its review of the four major banks.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is covering a wider range of issues. We have not sought to cover the same ground, but we have followed the public hearings and reviewed the published background material. By the same token, the terms of reference of the Royal Commission allow it to exclude areas which are being, or will be, considered by other inquiries, investigations or proceedings (Australian Government 2017f).

The range of current reviews relating to competition in the financial system is illustrated in table 1.1. A summary of the current regulatory arrangements is provided in appendix B.

Table 1.1 **Financial system reviews – under way and completed**

At June 2018

Encouraging competition	Protecting consumers	Maintaining a sound system
• Inquiry into competitiveness and efficiency of Australia's superannuation system (PC) – Ongoing. Draft Report issued in May 2018 • Inquiry into the supply of residential insurance in Northern Australia (ACCC) – Ongoing. Interim report due by 30 November 2018	• Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry – Ongoing. Interim report due by 30 September 2018 • Development of design and distribution obligations and product intervention power (Treasury) – Ongoing • Review of interest only home loans (ASIC) – Ongoing • Review of mortgage broker remuneration (ASIC) – Ongoing • Review of financial advice (ASIC) – Ongoing • Residential mortgage products price inquiry (ACCC) – Ongoing. Interim report published in March 2018. Final report due after 30 June 2018 • Review of the four major banks (House of Representatives Standing Committee on Economics) – Ongoing. Third report tabled December 2017. Next hearings in October 2018 • Inquiry into consumer protection in the banking, insurance and financial sector (Senate Economics References Committee) – Ongoing. Due to report by 26 June 2018	• Review of bank capital requirements, including implementation of Basel III (APRA) – Ongoing. Revised prudential requirements will commence in January 2021 • Review of prudential requirements for superannuation funds (APRA) – Ongoing. Final requirements will be released in mid-2018 and come into effect in January 2019 **Under way**
• Inquiry into competition in the Australian financial system (PC) • Review into the operation of the open banking regime (Scott Farrell) – Report published February 2018. Government announced agreement to recommendations in May 2018 • Review of the restrictions on the use of the term 'bank' (Treasury) – Legislation received Royal Assent in March 2018 • Review of the rules for ASIC's regulatory sandbox (Treasury) – Legislation currently in Parliament • Asia Region Funds Passport (Treasury) – Legislation currently in Parliament • Licensing new entrants to the banking sector (APRA) – new restricted ADI framework implemented in May 2018	• Review of the external dispute resolution framework (Ramsay et al, Treasury) – Legislation received Royal Assent in March 2018 • Banking Executive Accountability Regime (Treasury) – Legislation received Royal Assent in February 2018 and comes into force for large ADIs in July 2018 • Review of ASIC's enforcement regime (Treasury) – Final report and Government response published April 2018 • Inquiry into the life insurance industry (Parliamentary Joint Committee on Corporations and Financial Services) – Report tabled in March 2018	**Completed**

Source: Productivity Commission analysis

1.3 The Commission's approach to the Inquiry

The Murray FSI recommended that the Government should commission periodic external reviews of the state of competition in the financial system every three years (Murray et al. 2014a). In agreeing to this recommendation, the Government committed to tasking the Productivity Commission to 'review the state of competition in the financial system by the end of 2017', with subsequent periodic reviews to be 'undertaken as appropriate' (Australian Government 2015). The Commission received the terms of reference from the Treasurer for this Inquiry in May 2017.

This Inquiry complements other work by the Commission:

- the completed inquiry into *Data Availability and Use* (PC 2017c), and
- the concurrent inquiry into *Superannuation: Assessing Efficiency and Competitiveness*, for which a Draft Report was published in May 2018 (PC 2018).

The Commission altered its processes somewhat to ensure it minimised the scope for duplicating other work either under way or recently considered in the finance system. In undertaking this Inquiry, we have taken stock of the actions planned, even if they have yet to be formally implemented, and have pointed out where we think progress has been slower than ideal.

Early roundtable public hearings were held at the end of June 2017 with regulators, regional banks and consumer groups to garner their views on the key competition-related issues in Australia's financial system. A short consultation paper was published in early July 2017 to detail the scope of the terms of reference and assist participants in preparing submissions to the Inquiry. A very diverse initial round of fact-finding meetings were held with representatives from financial product markets, consumer groups, regulators and academics.

As a result, a targeted market-specific analysis focused on competition was adopted. We have not attempted to address issues that are not intrinsically linked to competition in the financial system — many of these issues are in any case being covered by other current reviews.

In line with its usual approach, the Commission has analysed a wide variety of material during the course of the Inquiry, including evidence presented in the course of other reviews, public submissions, our own roundtable hearings and public hearings and confidential briefings, both before and after the publication of the Draft Report. The Commission has also obtained data from a number of financial institutions and industry associations, as well as from the regulators.

In analysing evidence and drawing conclusions on reform options, the Commission has, in accordance with its Act, taken a community-wide perspective. That is, reform options are those that, in the Commission's assessment, would be likely to provide long term net benefits to the community as a whole (including consumers, shareholders and businesses) rather than to one side of a market or sector, and recognise the necessary trade-offs.

Managing risks from the financial system

Given its importance, the financial system can pose risks to the rest of the economy if things go wrong. These risks are of two types — macroeconomic (or systemic) risks and microeconomic (or idiosyncratic) risks (Freixas and Rochet 2008).

The financial system can produce macroeconomic risks through its ability to create or amplify economic shocks. This ability arises because of the complexity of the financial system and its interconnectedness with the rest of the economy. As the OECD put it:

> The loss of confidence in one major financial institution in a financial crisis can snowball into a loss of confidence in the entire market because the inability of one bank to meet its obligations can drive other, otherwise healthy, banks into insolvency. (OECD 2009, p. 7)

If risks in one part of the financial system become systemic, then not only may the whole financial sector be endangered, but the effectiveness of monetary policy may be undermined, and economic downturns exacerbated. This, in turn, can slow economic growth, raise unemployment and business failures and put pressure on social security payments and fiscal policy.

The Treasury emphasised the cost of financial crises:

> Financial crises — whether emanating from directly within the financial system or a result of external shocks — tend to be deeper, and the recovery more protracted than other types of economic crises. In that regard, a financial crisis can have major costs for both the financial system and the wider economy. Key impacts of a financial crisis include large falls in GDP, significant increases in unemployment and substantial direct fiscal costs as well as social costs. (Treasury, sub. DR 126, p. 4)

In terms of microeconomic risks, the financial system can cause significant harm to consumers (both individuals and businesses). The combination of a complex system and incentives faced by product providers can create an environment in which uninformed or ill-advised consumers become vulnerable to dishonest, predatory or simply 'sharp' business practices (which are technically legal but ethically dubious), or consumers may suffer the adverse outcomes of providers exercising considerable market power.

In all these circumstances, the complex nature of financial products makes it harder for consumers to make informed choices or detect propositions that are not in their long term interests.

In order to manage both the macroeconomic and microeconomic risks, the sector is highly regulated.

- Prudential regulation focuses on ensuring that individual financial institutions are able to withstand external shocks and can continue to meet their obligations to depositors or the insured. This supports the resilience of the system as a whole.

- Conduct regulation focuses on reducing the risk that consumers will be harmed through their interactions with the financial system, and provides for remedies in cases of misconduct.

The cost of this regulation to banks and other suppliers of financial services is large, and submissions from the industry suggest that the costs have grown noticeably since the global financial crisis. Based on figures provided by ADIs, the annual expenditure on APRA and ASIC reporting and compliance increased by nearly 60% between 2008 and 2016.

But regulatory requirements can provide strength and stability to the system. A stable financial system means that financial intermediaries, markets and the market infrastructure can offer reliable payment systems and security for deposits, facilitate the smooth flow of funds between savers and investors and handle distressed financial institutions in a way that maintains public confidence in the system as a whole.

According to the RBA, the Australian financial system remains resilient and its ability to withstand adverse shocks continues to be strengthened (RBA 2018e).

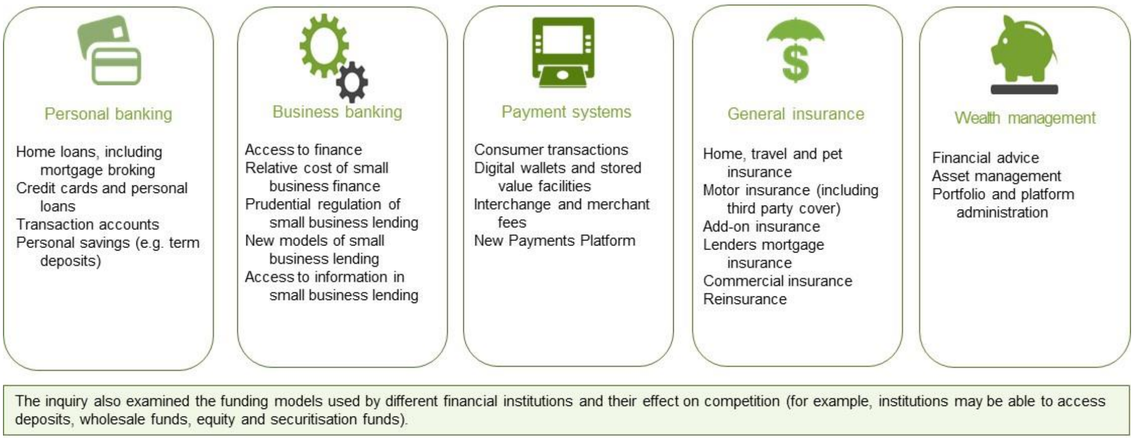
The question for this Inquiry is whether the undoubted benefits of a strong and stable financial system are being captured primarily by the incumbent firms and their shareholders, or whether competitive rivalry could enable these benefits to be shared with consumers.

Markets covered by the Inquiry

The potential scope of the financial services and entities to be covered by the Inquiry was very broad. We focused on a selection of services and activities, set out in figure 1.2.

Most aspects of retail banking and general insurance were covered in depth in this Inquiry.

Figure 1.2 **Financial system services and activities examined**



However, life insurance was not considered in this Inquiry, given that more than 70% of life insurance is provided through superannuation, and the Commission is undertaking a separate review of the competitiveness and efficiency of Australia's superannuation system. In addition, health insurance was not considered as part of this Inquiry, as an examination of Australia's private health insurance system would have required consideration of issues that extend well beyond the financial system.

Structure of the Inquiry report

From our early consultations and analysis, it became apparent that a number of key areas raised particular issues pertinent to competition. In order to give them adequate attention in the time available for the Inquiry, we focused on these key areas for in-depth analysis, with a view to determining specific reform options that would improve competition in these areas.

Specifically, we looked at the provision of financial services and the interaction of market participants, issues facing the consumers of financial services and the functions and activities of the regulators.

In moving from the Inquiry Draft Report, we undertook expanded analysis of the residential home loan market (including the role of brokers and the use of lenders mortgage insurance), financial advice, and some aspects of the payments system, where responses to the Draft Report — both in written submissions and at the public hearings — indicated that the issues required more attention.

The report chapters are supported by four appendixes that outline the Inquiry process and provide detailed descriptions of different segments of the Australian financial system.

2 Examining competition in the financial system

Key points

- There is no prospect that Australia's basic financial markets will be fully competitive. Regulator commitment to our larger institutions being unquestionably strong and immune from serious market sanction is a significant factor that cannot be avoided.
- Key features of workable competition in Australia's financial system at which we can aim are:
  - a ready scope for consumers to assess how prices or features vary with product differentiation and be able to act on that assessment
  - as few as possible limits to entry by new financial system providers (but still consistent with other regulatory objectives such as reducing systemic risk)
  - regulators both open-minded towards innovative risk management improvements and new financial products/services; and as sceptical of incumbents as of new entrants
  - effective scrutiny of the adverse use of market power by any participant or set of participants, including as a response to regulator interventions
  - information flows sufficient to make informed decisions regarding aspects such as credit worthiness, risk or product choice.
- The Commission's framework for assessing competition in this Inquiry involves defining the main markets within the financial system, and looking at each with regard to the provider and consumer sides of the market, and from government and regulator perspectives.
- For each of these markets we have considered three key questions:
  - Are consumers able to put material competitive pressure on financial system providers? If not, why not?
  - Is the extent of rivalry in each financial system product market resulting in innovation and efficiencies that improve community outcomes?
  - Are government and regulator focuses and actions improving or detracting from competition in the Australian financial system?
- Indicators of poor levels of supply-side competition in the Australian financial system would include: the ability to maintain persistently high market shares and profit levels over time; the existence of impediments to new entrants; and the absence of services that are evident in similar markets overseas.
- Indicators of poor levels of demand-side competition in the Australian financial system include: low financial literacy and poor engagement of consumers; a strong imbalance of information between consumers and providers; and evidence of an inability or unwillingness to switch products or providers.

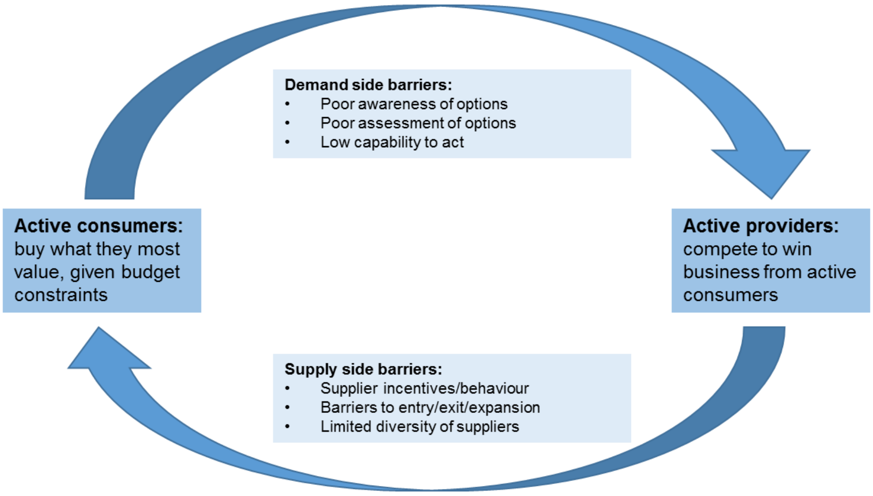
2.1 Competition in the financial system — what it looks like and why it matters

Why competition matters

Competition has been demonstrated repeatedly, in both Australian and abroad, to generate strong incentives for providers of services and goods to act efficiently and, at the same time seek to meet the constantly-changing needs of consumers.

At their best, competitive markets adequately meet society's needs with little government intervention. When both sides of a market function well, a virtuous circle is created between consumers and competition (figure 2.1).

Figure 2.1 **The 'virtuous circle' of competition**
Including the potential barriers



Source: Adapted from Fletcher (2011)

Australia's financial system plays a pivotal role in providing funding and liquidity for the economy, allowing effective management of financial risks, delivering payment services and facilitating price discovery.

Unlike in many markets, there is not always a clear distinction in financial system markets between 'consumers' and 'providers'. Some providers of financial products are also consumers of related wholesale products or services that are supplied by their competitors. Smaller banks, for example, may get wholesale funds or payment services through larger banks; insurance providers may be consumers of reinsurance. Financial services firms may also act as intermediaries, for example by bringing together depositors and borrowers, or by facilitating payments between merchants and their customers.

The Murray Financial System Inquiry (FSI) highlighted the role competition plays in improving the price, quality and/or range of financial products, services and markets.

> Competition is a process of rivalry between individuals or firms in the sale and purchase of goods and services. It is the cornerstone of a well-functioning financial system, driving efficient outcomes for price, quality and innovation. Competition is desirable because it generally leads to better consumer outcomes. (Murray et al. 2014b, pp. 2–3)

More specifically, competition in financial markets could put a strong discipline on businesses to lower resource costs associated with the delivery of products and services, engender faster innovation and deployment of new technology, deliver more choices for consumers at lower prices, and with better information to allow informed choices (Harper et al. 2014; RBA, sub. 29).

By allowing more efficient firms to enter financial product markets and gain market share, at the expense of firms that are less efficient or less focused on consumer needs, competition can lead to community-wide improvements.

The effects of stronger competition in the financial system would be felt well beyond financial markets and into other parts of the economy. Increased competition can benefit the economy as a whole via improvements to productivity and economic growth, as noted by the OECD:

> Competition among businesses can deliver improvements in production efficiency and bring newer and better products to consumers through innovation, leading to gains in economic growth and consumer welfare. … When customers can choose between different providers, they benefit and so does the economy as a whole. Their ability to choose forces firms to compete with one another. Choice for customers is a good thing in itself, but competition between firms also leads to increased productivity and economic growth. (OECD 2016b, pp. 24, 28)

The Murray FSI (Murray et al. 2014b) noted that the efficiency with which Australia's financial system allocates funding and risk in the economy affects Australia's economic growth and long-term living standards. That is, because the financial system has important flow-through effects to the rest of the economy, the positive impacts of competition within Australia's financial system are magnified throughout the economy. Likewise, negative impacts from lack of competition can also impact on the broader economy.

The stability of the financial system is important in maintaining the confidence of the international community in the Australian economy and of Australia's consumers in the security of their financial system, including the payments system. Australia has long been, and will continue to be in the future, dependent on net capital inflows.

Nevertheless, as the Chairman of APRA has stated, there are times when the regulator consciously and unapologetically seeks to constrain competitive behaviour.

> The measures that we have put in place in recent years have been designed, unapologetically, to temper competition playing out through weak credit underwriting standards. (Byres 2017a)

The relationship between stability and competition is considered below.

What would more competition in the Australian financial system look like?

Few, if any, markets are perfectly competitive and the key product markets within the Australian financial system are certainly not. Given the extent to which the Australian financial system is regulated to maintain system stability and improve community outcomes, most markets in it *will never be* perfectly competitive. Regulators will restrict rivalry that they perceive as creating serious risk. Market sanction in the form of takeover of any large poorly-performing entities will be managed by regulators, not driven by rivalry. Entry will remain restricted, even if barriers are lowered. 'Too big to fail' perceptions will persist regardless of arguments to the contrary; or the imposition of additional costs.

But it is still possible to achieve a level of *workable competition*[1], with market outcomes that tend more toward competitive outcomes than toward outcomes that would be likely under a monopoly structure.

We have identified a number of features of workable competition in Australia's financial system (finding 2.1), some of which are already present to varying degrees in financial product markets (as noted in the remainder of this report). Broadly, workable competition in Australia's financial system should include:

- On the provider side — Providers would be able to offer a variety of products that meet the needs of different groups of customers. Pressure from alternative providers would ensure that the differences between products on offer would be clear, with product differentiation and up-selling not able to be routinely used as a means to confuse or lock-in consumers. Prices for different products would vary, but would be driven by cost or quality rather than exploitation of groups of consumers. Even if ownership is concentrated amongst a small number of providers, market pressures would be such that little capacity persists to allow for either tacit agreements or successful collusion, including but not limited to pricing and supply decisions that affect market outcomes for either consumers or other providers.
- On the consumer side — Consumers would have access to directly usable information on their own interactions with the financial system and on alternative products on offer. Information would be presented publicly by trusted parties in a way that ensures a high awareness of changes in market opportunities. Switching costs would be low. Pricing would efficiently reflect relative risk amongst consumers, improving resource allocation.
- On the regulator side[2] — Regulators would anticipate and look for signs that financial products and ways of delivering them will change with technology and consumer preferences, be willing to change regulation as required, and be outcome-oriented. There would be continual review of impediments to entry of new financial products or providers. Scrutiny of adverse use of market power by any participant or set of

---

1 A term first used by Clark in his 1940 article, 'Toward a concept of Workable Competition' (Clark 1940).

2 The extent to which regulator actions may be improving community wellbeing other than by improving competition is not able to be assessed for the financial system given the information available to the Commission.

participants would be effective and timely. Regulatory interventions would be fully assessed for likely commercial responses and something akin to a cost-benefit analysis would precede major interventions.

Competition is not an outcome that once attained, can be ticked off as having been accomplished without ongoing monitoring and focus. This has been highlighted in both submissions and previous reviews (including PayPal, sub. 19, p. 2, ABA, sub. 11, p. 1, CHOICE, sub. 42, p. 3 (Harper et al. 2015, p. 397) and (Murray et al. 2014b, pp. 2–4).

And in view of the emphasis that regulators and the Treasury have given to competitive neutrality in their responses to the Draft Report, it is necessary too to observe that it is quite a different concept to competition (box 2.1). Markets may be competitively neutral and yet impede innovation and effective competition (evenly) across all players.

That may not be the case with Australian financial markets, but parties responsible for public policy should not emphasise their attention to neutrality as a substitute for attention to effective rivalry.

Box 2.1 Competition and competitive neutrality — two different concepts

The concept of competitive neutrality has been defined by the OECD as 'where no entity operating in an economic market is subject to undue competitive advantages or disadvantages'. (OECD 2012, p. 17)

To ensure that government businesses did not enjoy a net competitive advantage as a result of public sector ownership, the 1995 National Competition Policy reforms applied 'competitive neutrality principles' to government businesses. These were designed to ensure that competition between the private sector and competing government businesses is based on the competitive merits of the relevant business, not any distinction in ownership. Twenty years later, the concept is still relevant and the Harper Review recommended:

> Government business activities that compete with private provision, whether for-profit or not-for-profit, should comply with competitive neutrality principles to ensure they do not enjoy a net competitive advantage simply as a result of government ownership. (Harper et al. 2014)

In terms of the financial system, competitive neutrality was considered in both the 1981 Campbell committee and 1996 Wallis FSI (DR sub. 61, p. 53) and then included in APRA's mandate, which requires it to consider both competition and competitive neutrality (section 8 of the *Australian Prudential Regulation Authority Act 1998*).

In APRA's case, competitive neutrality applies between the types of institutions regulated by APRA, rather than between government and other businesses.[3]

> APRA also endeavours to maintain competitive neutrality in its prudential framework and supervisory activities by minimising unnecessary or artificial regulatory distinctions between different entities undertaking activities which exhibit similar risk profiles. (sub. 22, p. 7)

(continued next page)

[3] While historically, Australian governments directly owned a number of financial institutions (see box 2.6), today there is limited direct government participation in the Australian financial system.

Box 2.1 (continued)

Sometimes competitive neutrality is referenced in a vague and often misleading way as 'levelling the playing field'. In this course of the Inquiry, some have suggested the 'playing field' is tilted in favour of the major banks and have provided suggestions as to how the 'playing field could be levelled'. These suggestions usually involve biasing policy towards some competitors.

As the Harper review noted, competition is not designed to support particular participants in a market or to protect individual competitors, rather it should foster choice and increased responsiveness to consumers.

> [The Competition and Consumer Act] does not, and should not, seek to restrain a competitor because it is big or because its scale or scope of operations enables it to innovate and thus provide benefits for consumers …
>
> Ordinarily, competition law is not concerned with harm to individual competitors. Indeed, harm to competitors is an expected outcome of vigorous competition. Competition law is concerned with harm to competition itself — that is, the competitive process. (Harper et al. 2015, pp. 285, 307)

'Levelling the playing field' by supporting a particular participant, or group of participants could result in harm to the competitive process and indeed, to consumers. It is important to differentiate between the concepts of competition, competitive neutrality and 'levelling the playing field'. They are not synonymous, and, in the case of 'levelling the playing field' are often used to disguise explicitly anticompetitive intent.

FINDING 2.1 KEY FEATURES OF WORKABLE COMPETITION IN THE FINANCIAL SYSTEM

The key features of *workable competition in Australia's financial system* at which we can aim, include:

- a high awareness of changes in market opportunities along with low costs for consumers when switching to preferred products
- active support for consumers by public advice or private advisers to conveniently make informed decisions in their best interests
- an Open Banking regime that gives consumers perpetual access to their data, with the capacity to see that data safely moved from one provider to another
- minimal limits to either entry by new providers or expansion or exit of existing providers, in regulated product markets (subject to other regulatory objectives such as prudential outcomes)
- regulators who anticipate that financial products and the ways of delivering them will change with technology and consumer preferences, and be willing and able to change regulation as required
- effective and timely scrutiny of the adverse use of market power, including as a response to regulator interventions.

Competition in light of the need for financial system stability

Markets in which there are fundamental underlying public interest goals that must be satisfied will necessarily produce product and price outcomes that differ from what a (theoretical) competitive market would be able to deliver. There is very little activity in Australia's financial system that is not guided by regulatory requirements or comes under regulatory scrutiny.

These regulatory requirements and underlying government policies are examined in depth in later chapters, including the implications of: government policies such as the Four Pillars policy and implicit support for institutions considered 'too big to fail' (chapter 6); prudential settings on outcomes in retail banking markets (chapters 7, 8 and 12); conditions around the entry of new entities into parts of banking and payments systems (chapters 4 and 17); international obligations on Australia's financial institutions (chapter 6); and requirements on providers to improve opportunities and outcomes for consumers in both banking and insurance (appendix B and chapter 15).

As discussed in depth in chapter 18, Australia's financial system regulators have been comparatively successful at ensuring prudential and other regulatory settings have delivered a stable and 'unquestionably strong' financial system, with banks' capital positions improving in the years following the global financial crisis (GFC) (IMF 2012), and capital requirements strengthening in recent times (APRA 2017c). A stable financial system means that financial intermediaries, markets and market infrastructure offer reliable payment systems, security for deposits, facilitate the smooth flow of funds between savers and borrowers and handle distressed financial institutions in a way that ensures public confidence in the system as a whole is not seriously undermined. The potential adverse consequences of an unstable financial system on the welfare of households and businesses and the operation of an economy were clearly apparent in those overseas countries that suffered badly during the GFC.

The analysis in this Inquiry report does not question that a stable financial system is a necessity for Australia's economy and the wellbeing of its citizens.

What is examined, and required by the Inquiry's terms of reference, is the interaction between stability and competition. The Commission would be failing the Australian community were it to avoid considering the implications for competition of policies and regulatory settings focused on stability for their inevitable impact on competition.

The interaction of stability with competition remains, a conceptual and practical challenge for Australia's regulators (chapter 18). It is primarily in markets where liquidity is at risk, that the impact of competition on stability is potentially an issue. To the extent that there are adverse outcomes from dysfunctional competition in some product areas (for example, through inappropriate incentives or asymmetric information in the provision of loan products) and these create issues for system wide stability, a broad consideration of the interaction of competition and stability is warranted.

Competition can support stability, for example, through preventing excessive concentration in the financial system that would otherwise lead to dependency on a very small number of providers. Anti-competitive behaviour does nothing for system stability and can potentially undermine it. A financial system that contains only one or two large dominant providers (that are too big to fail and hence implicitly underwritten by the relevant government) could be very stable at least in the short term. However, such providers would have strong incentives to engage in adverse behaviour, knowing that any upside would be captured by shareholders while losses would be protected by government intervention or could be readily recovered by exercise of market power. Competition can and should reduce the reliance of the financial system on any single provider and thus is itself a method to reduce the incentives for excessive risk taking by financial providers.

Competition can also deliver more consumer-oriented products and lower interest rates in the economy, reducing the risk of borrower default. The ACCC noted that:

> We recognise that there is an important role for government to safeguard the stability of the banking system. However, competition policy should not be viewed as a threat to this objective. Indeed, increased competition in concentrated retail banking markets could help make those markets more robust and effective over time, and less prone to poor performance and failure … (ACCC, sub. 17, p. 1)

On the other hand, regulators can fear that strong competition could erode standards of prudent conduct and lead banks to take more risks in lending activity in order to maintain their profitability — at a cost to system-wide stability. Indeed, as discussed in chapter 6 Australians' financial system regulators consider just that situation to have been evident in the home loan market in 2014.

The fear of unfettered competition can be exaggerated. While it is true that *unmonitored* competition can result in risky ventures, desirable growth in employment and national welfare is necessarily fuelled by risk-taking. We cannot simply always prefer stability, without acknowledging a significant cost to economic activity from such a default position.

If every regulatory decision must have the same objective – always adding to an institution being unquestionably strong – innovations in risk management will be ignored heaping cost on to consumers. As the Draft Report made clear, regulators, their regulatory powers and how they are put into effect is a substantial source of market power amongst ADIs, while maintaining system resilience. Failing to recognise this is a serious risk to competition.

At the other extreme, a market composed of a plethora of small banks may be competitive, but is unlikely to have the reserves to cope with sudden serious adverse circumstances. Australia, with an oligopolistic banking system, is not at either extreme and so can (and should) seek both stability and competition.

In its submission to the Murray FSI, the Reserve Bank of Australia (RBA) noted that 'although the literature is mixed, Australia's experience over the past two decades demonstrates that competition in the banking sector, and new entry in particular, can occur without compromising financial system stability' (RBA 2014a, p. 168).

The Commission's view is that competition and stability in the financial system can coexist; but such a coexistence is unlikely at the extremes of market structures. From the responses to the Draft Report, this is well-accepted. But what accompanies it is — from the regulators themselves and those who are the largest regulated entities — a view that the present balance is generally just fine.

The Commission is a little more sceptical. Where regulators and the largest regulated parties agree, it is reasonable to be so.

As reflected in the reforms recommended later in this Inquiry report, the balance between competition and stability has failed where: consumers have a poor ability to counter a lack of competition between providers; and regulators are insufficiently interested in analysing the costs that their actions impose — in fact, a primary regulator asserts (see chapter 19) they should not have to pay attention to such costs, and Treasury itself believes such consideration may distract the regulator in achieving their primary objective (sub. DR126). In public policy, such costs should not be ignored in any circumstances.

These issues are considered further in chapter 18.

FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST

Competition and stability are both important to the Australian financial system.

Since the global financial crisis there has been a focus on requiring prudentially regulated institutions to be unquestionably strong. It is important to ensure that the essential role of competition in economic growth is not eroded by having stability as the default regulatory position, to the exclusion of competition. Competition can support stability, checking irresponsible behaviour of providers and improving outcomes for consumers, and must be allowed to flourish.

Price discrimination and competition

In competitive markets, prices closely reflect costs and quality. Different consumer groups may face different prices for similar products, but this is driven by the different costs of serving these groups. In contrast, in markets with limited competition, providers may be able to set different prices to different groups of consumers for the same product. While there are some circumstances where this is efficient, its presence should invite a close examination of the level of competition.

In banking and insurance, price discrimination or differentiation is often based on consumers' willingness to 'shop around'. This enables providers to grow their market share by offering better deals to new customers while existing customers remain on less attractive and/or higher priced offers.

Price discrimination issues are discussed in more detail in chapter 5.

The changing nature of market interactions

A number of new technologies and innovations have emerged in recent years, which are beginning to challenge the dominant business models in some markets and change the way that individuals and businesses engage with the financial system. As noted by ASIC, technological developments have resulted in the development of new products and services to meet the needs of consumers and market participants more effectively through:

- lower costs and improved efficiency
- enabling consumers to deal directly and more seamlessly with providers
- enable businesses to deliver better value services and products to their customers. (sub. 40)

The impact of technology on competition was also highlighted in the Murray FSI.

> Over the medium term, technology will increasingly affect the level of competition in the financial system. In some ways, technology is improving competition. It enables consumers to compare and switch between products, making new business models, such as online-only banks and peer-to-peer lenders, viable. However, technology also has the potential to reduce competition. Technology is introducing new economies of scale into financial markets. For example, the use of data is becoming increasingly important in understanding risks and meeting consumer needs, giving players with large customer bases the capacity to develop competitive advantages by leveraging their pre-existing data sets. Although these developments should make the financial system more efficient, they could potentially lead to less competition in the medium to long term. (Murray et al. 2014b, pp. 2–4)

'Fintech' is often the popular focus of new technological developments in the financial system — Treasury, for example, note that:

> FinTech is all about stimulating technological innovation so that financial markets and systems can become more efficient and consumer focused. This can help drive improvements in traditional financial services and, perhaps more importantly, promote disruption through innovative new products and services, which can offer benefits to consumers and other sectors of the economy. (The Treasury 2016, p. 1)

But many of the technological changes evident are considerably more fundamental and are not confined to the very small fintech part of the system.

Online banking has become part of mainstream operations; the push for consumer control over data will undoubtedly benefit fintechs, but if implemented as envisaged by the Commission's Data Availability and Use Inquiry (PC 2017c), it will re-invigorate competition across the financial system more generally; and the new payments platform has the potential to fundamentally change the way individuals and businesses interact with each other and with the financial system (chapter 17).

Consumer preferences for how they find out about financial products, pay for goods and services, and do their banking are also evolving (chapters 5,10 and appendix C).

2.2 How we assess competition in the Australian financial system

While this Inquiry is broad ranging, it is not considering every aspect of the financial system. The best way to analyse the weaknesses and opportunities for improvement is not at the system-wide level, as this already has had a number of eyes cast over it — not least the Murray FSI. The advice from most of the seventy or so stakeholders we consulted within the early months of the Inquiry was to go to the individual market level. So our focus is on those products and product markets where there is most apparent need for a boost to competitive behaviour — which could be from the demand side (consumers) or from the supply side (banks or insurers). Some responses to the Commission's Draft Report suggested there were no additional significant markets for an Inquiry focused on competition issues to pursue. The Commission was invited to examine behaviour issues — but these were out of scope or risked us duplicating other inquiries.

For the most part, we started from the point of provision of financial products to households and businesses, and seek evidence or indication of where either the current regulatory settings are having a detrimental effect on competition, or the incentives faced by market participants are resulting in poor market outcomes. The markets that we looked at were informed by initial consultations and research, and include (see chapter 1):

- personal banking
- business banking
- funds management and financial planning
- general insurance
- the payments system.

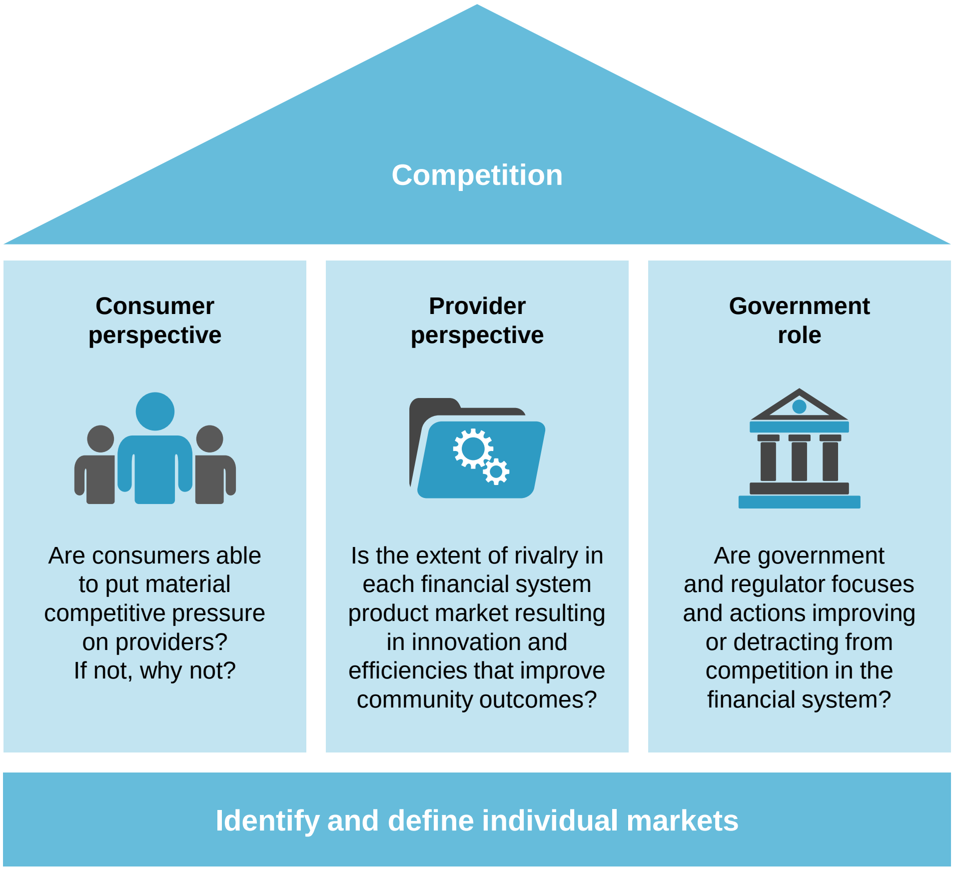
The basic principles by which we put 'boundaries' around each of these markets is discussed in the next section. For each market analysed, we considered the following aspects (figure 2.2):

- Are consumers able to put material competitive pressure on providers? If not, why not?
- Is the extent of rivalry in each financial system product market resulting in innovation and efficiencies that improve community outcomes?
- Are government and regulator focuses and actions improving or detracting from competition in the Australian financial system?

Reforms proposed are aimed at either actively promoting competition in Australia's financial system, or addressing outcomes of the existing market structure that are not beneficial to the community. Accordingly, proposed reforms are intended to:

- align with the natural preferences of market participants (be incentive-compatible)
- be adaptable to different technologies (including new technologies and be technology neutral) and
- fit within the context of ongoing reforms.

Figure 2.2 **Competition Framework**



Defining the markets within the financial system

A key challenge we faced was to identify and define the markets in which competition should be assessed.

When Australia's competition regulator, the Australian Competition and Consumer Commission (ACCC) takes action under the *Competition and Consumer Act 2010* (Cth) or conducts market studies, it defines relevant markets having regard to the availability of close substitute products and sources of supply for the good or service in question. This involves consideration of the product and geographic dimensions of the rivalry between firms.

> A market is the product and geographic space in which rivalry and competition take place … identifying relevant substitutes is key to defining a market. Substitution involves switching from one product to another in response to a change in the relative price, service or quality of two products (holding unchanged all other relevant factors, such as income, advertising or prices of third products). Market definition begins by selecting a product supplied by one or both of the merger parties in a particular geographic area and incrementally broadening the market to include the next closest substitute until all close substitutes for the initial product are included. There are

two types of substitution: demand-side substitution, which involves customer-switching; and supply-side substitution, which involves supplier-switching. (ACCC 2008a, pp. 15–16)

The extent of product substitutability and geographic dimensions of producer rivalry are more important in some product markets than others, and change over time as technology evolves. For example, whereas households once relied on their local branch for getting a home loan, now, over 50% of loans are sourced via brokers and many financial institutions operate online with few or no physical branches. Such developments expand the geographic market for home loans beyond the local region, to include all institutions that offer home loans in Australia. Similarly, while some small businesses still rely on the personal knowledge and relationships of their local branch, increasingly, those businesses that operate online rely solely on online banking (chapter 16).

In its merger guidelines, the ACCC notes two market characteristics — product bundling and vertical integration — that are particularly relevant to financial markets and add an additional consideration to competition assessment processes (box 2.2).

With regard to product bundling, for example, there is an enormous range of financial products that, on the face of it, are substitutable, but in reality, evidence little switching behaviour, either in terms of products held or use of those products (chapter 5).

There are also features unique to individual financial markets that make competition difficult to define, such as the design of regulatory intervention in setting risk weights and the peculiarity of products such as variable rate mortgages, where prices (interest rates) are changed solely at the discretion of the lender (chapter 12).[4]

For some services, the financial institutions are platforms. For example card payments, where both merchants and customers are consumers; and in personal banking where households both supply deposits and demand loans. Where these two-sided markets occur, we consider *both* product markets for each platform, for example the market for deposits and the market for loanable funds, noting linkages between the markets where relevant. This is consistent with the way the ACCC deals with two-sided markets in its merger assessments (ACCC 2017d).

With substitutability as the starting point for defining the relevant markets in the Australian financial system, a challenge we faced was to ensure that the markets are not defined either so narrowly as to miss key provider interactions or substitutes, or so broadly such that substitutes that would never be made are nevertheless assumed to be available.

4 In other developed countries, mortgage contracts are based on medium to long-term fixed interest rates. Australia, the United Kingdom and Ireland are the only countries where the mortgage has a rate set by the lender at its discretion and rates on loans are changed for all borrowers at the same time (Lea 2010).

Box 2.2 Special considerations in defining financial markets

Two issues that are particularly relevant in defining financial markets are the existence of product bundling and vertical integration.

In its merger guidelines, the ACCC notes that products or services that are bundled together may be assessed as being supplied in separate product markets or one aggregated market. In defining the relevant markets for bundled products, the ACCC considers a number of factors including:

- the split between products purchased or supplied separately, and products purchased or supplied together
- the costs involved in purchasing or supplying the product separately
- any obstacles to purchasing or supplying the product separately, and
- any assets or specialisation required to supply each product

In defining a market involving vertically integrated firms, the ACCC considers whether competition analysis is best conducted in the context of one relevant market covering multiple vertical layers of a supply chain or a series of separate markets each comprising one or more vertical layers of the chain. There need not be actual trade occurring between the different levels of the vertical supply chain for there to be separate markets. The potential for trade can be sufficient.

In defining the relevant markets where vertical integration exists, the ACCC will usually take into account a number of factors including:

- the patterns of exchange between firms at different vertical levels
- the split between internal transfers of each relevant product and third party transactions
- the costs involved in trading the product between firms at different vertical levels
- any obstacles to trade between firms at different vertical levels, and
- any assets or specialisation required to supply each product within the vertical chain.

Source: ACCC (sub. 17).

Competition amongst providers

As outlined in this report, the Australian financial system, for many years now, has been dominated by a handful of large players. As a result of the GFC, the dominance of the largest players, particularly in the banking sector, has been further entrenched.

Provider indicators

The key question to address when considering the supply-side of the financial system is whether both the extent of rivalry between providers in seeking market share, and the capacity for entry by new firms is such that innovation and efficiencies that improve community (consumers, employees and shareholder) outcomes are likely. Indicators considered in making this assessment include measures of market concentration and contestability.

Non-price competition and the extent of integration (upstream and downstream ownership), are also indicative of competition. For example, integration may enable a provider to create a strategic ‘bottleneck’ in the supply of a financial product and to leverage its market power into related products.

Risk is important. In financial markets, unlike most other markets, regulators are actively involved in setting the overall risk appetite of markets which can include regulation that limits pricing and product availability (chapters 6 and 7). While we assess regulator and government behaviour directly, risk also necessarily features in assessing private provider behaviour and ability to maintain profit margins. Providers classified by regulators as low risk have an advantage in the market place. This advantage may be deserved. But to the extent that it allows for adverse behaviour (for example, by discouraging innovations that are seen in equivalent markets offshore; or consumer exploitation), it should not slip through the cracks of this Inquiry.

A number of provider indicators are outlined below and are considered in chapter 3 of the Inquiry report.

Concentration

High levels of concentration within a market are often associated with lower levels of competition.

> Market shares and concentration interact with competition through the structure of the market. All other things being equal, increased concentration due to an increase in the market share of a single firm will tend to increase that firm’s ability to raise its profits by raising its own prices, lowering its service levels or otherwise engaging in less competitive activity. (King 2009, p. 265)

An examination of the number and size of providers in the financial system and their market share provides an understanding of the extent of concentration of providers within the relevant market (box 2.3). In undertaking its market assessments the ACCC measures concentration with reference to market shares, concentration ratios and the Herfindahl-Hirschman Index (HHI) (ACCC 2008a).

High levels of market concentration can raise concerns about the level of competition in that market, but the need to consider factors other than just concentration is acknowledged and has been raised a number of times. For example, firms in concentrated markets can still compete actively against one another (Bullock 2017) and a concentrated market is sometimes the result of more efficient firms being able to expand their market share (ACCC 2008a). As noted by the FSI:

> Competition can be strong between players in a concentrated market. Indeed, market concentration can be a byproduct of competition, if more efficient firms grow at the expense of their less efficient competitors. (Murray et al. 2014b, p. 2.4)

Box 2.3 Measuring market concentration and market power

Market share is defined for the relevant market as the proportion of the market that a particular provider holds. It can be calculated on a variety of bases including the percentage of sales, volume or capacity of the provider. Monitoring market share over time, considering how market share compares with other markets, or similar markets overseas can also be insightful.

Concentration ratios are used to determine market concentration. One measure used in Australia by the ACCC is the x-firm concentration ratio. This ratio is the fraction of market shares possessed by the 'x' largest firms in a given market. The higher the concentration ratio, the greater the level of concentration in the market. However, by definition the x-firm ratio does not consider the total number of firms in the market or the distribution of output among them (Allardice and Erdevig 1981).

Another concentration ratio used by the ACCC in assessing market concentration is the Herfindal Hirschman Index (HHI), which is calculated by adding the sum of the squares of the market share of an individual provider with each rival firm in the relevant market. As such, the HHI gives greater weight to the market shares of the larger firms.

> Different concentration metrics summarise the market share data in different ways and as a result highlight different features of the data. For example, concentration measures differ according to the way that they treat 'increased' concentration … Some economists argue that a concentration metric should increase as firms become more asymmetric … The HHI has this property … . The HHI has the theoretical advantage of using all relevant market share data. In contrast, [an x-firm] measure is relatively crude in the sense that it completely ignores a significant part of the market share data. (King 2009, pp. 267–268)

In undertaking merger assessments, the ACCC has said it will generally be less likely to identify horizontal competition concerns where the post-merger HHI is less than 2000, or greater than 2000 where the change in market concentration as a result of the merger (the delta) is less than 100.

> HHI of up to 1,500 is commonly viewed as indicative of an acceptably concentrated market, while an HHI of around 2,000 or more is generally viewed as problematic. In this context, the ACCC uses a threshold of 2,000 and a delta of 100. The United States Department of Justice uses a threshold of 1,500 and a delta of 100 A practice example from the CMA in the UK is that any market with a post-merger HHI exceeding 1,000 may be regarded as concentrated and any market with a post-merger HHI exceeding 2,000 may be regarded as highly concentrated. (Healey and Nicholls 2017, p. 56)

Market power is often measured by comparing costs to price — for example, when a firm has market power, they can charge premiums over their costs to the detriment of consumers. Alternatively, when there is no market power, firms cannot charge a higher price without consumers switching to their competitors to receive to a better deal.

The Lerner index is a widely used and understood measure that uses prices and marginal cost to quantify market power. It considers the difference between price charged and marginal cost — the bigger the difference between price and marginal cost, the more pricing power (or market power) a business has.

Source: Allardice and Erdevig (1981); Bullock (2017); ICA (sub. 32); Murray et al. (2014b).

The relationship between market structure, performance and the level of market power exercised by firms can also be indicative of competition, thus it is worthwhile considering measures of performance relevant to the financial system such as net interest margins, return on equity, operating costs and fees in undertaking an assessment of competition.

All of these measures must be considered carefully and care must be taken not to place too much weight on any individual measure in isolation. Often changes in indicators over time will be far more informative than snapshot measures.

Similarly, care must be taken in making international comparisons, as these performance measures are also influenced by a number of factors including the country's macro-performance and stability and the form and degree of taxation of financial intermediation (Bikker and Haaf 2000; Claessens 2009). The Commission's assessment of concentration is included in chapter 3 (for retail banking), chapter 9 (for wealth management), chapter 17 (for aspects of the payments system) and chapter 14 (for general insurance).

Contestability

A contestable market is one where the credible threat of new entrants exerts discipline over incumbent providers in their market behaviour — a provider that is inefficient or earns excess profits is likely to lose market share to, or be driven out by, a rival or new entrant that is able to take the incumbent's customers and profits as its own, in the long term. The persistent influx over time of new entrants in a market is evidence of contestability. Indeed even the credible threat of entry can have a positive impact on competition.

The ACCC notes that in competitive markets, the threat of entry and/or expansion plays an important role in constraining the price, service and investment decisions of incumbents.

> Where there is a credible threat of entry or expansion, incumbents know that if they earn profits in excess of a fair compensation for risk, or are slow to respond to the changing needs and preferences of consumers by developing new products or new business methods, they could lose market share (and future profits) to rivals. Barriers to entry and expansion tend to weaken, and in the extreme may eliminate, this threat, reducing the pressure on incumbents to constantly strive to improve their offer. (ACCC, sub. 17, p. 12)

The RBA suggests that periods of heightened competition in the Australian financial system have typically been driven by new entrants rather than established players (RBA, sub. 29). This Inquiry has found that entry is not necessarily the biggest factor in competitive pricing outcomes (chapter 4), but it can be a force for innovation.

In the financial system, the capacity for new entry is often deeply controlled by regulators. For example, regulatory requirements for authorisation to offer financial products or services and requirements to hold minimum amounts of capital. Changes (either real or anticipated) to the requirements to hold capital can deter entry.

Non-regulatory barriers also inhibit firms' ability to compete and these can include the decisions of ratings agencies, technology and know-how, capacity to be included on approved product lists and panels of approved lenders, access to established networks, growing new payment system networks, branding, product differentiation and structural issues including the minimal return needed to cover fixed costs. Box 2.4 provides examples of barriers to entry in the financial system identified during consultation and other inquiries.

The Commission's assessment of market contestability is included in chapter 4 (for retail banking), chapter 14 (for general insurance) and chapter 17 (for aspects of the payments system).

Box 2.4 **Barriers to entry**

A barrier is anything that stops a competitor or new entrant from competing away excessive profit of the incumbent.

Examples of barriers to entry in the financial system:

> There are a number of reasons why entities find it difficult to enter markets in the financial system. These can include: (a) commercial barriers, including building brand awareness and consumer trust, which is particularly important for goods with credence qualities when assessing the quality of the product is difficult; (b) regulatory requirements, including licensing and operational requirements and in some markets prudential requirements, which are important to promote financial stability and consumer and investor confidence; (c) limited resources; and (d) lack of experience with the regulatory framework. (ASIC, sub 40, p. 41)
>
> As with other industry sectors, incumbent firms in the financial system have significant advantages over new market entrants. These advantages include brand recognition, existing customer bases and established distribution arrangements. Large incumbent firms have additional advantages in sectors where scale or network effects are important, such as payments or [financial market infrastructure], in which case new entrants will find it difficult and expensive to attract customers away from existing providers. (Murray et al. 2014b, pp. 2–4)

Examples of barriers to entry in banking:

> Australia's major banks currently benefit from a historic accumulation of capital meaning that regulatory capital requirements have become barriers to entry for new players. These barriers not only impact smaller ADIs, they also impact the commercial realities of being a startup bank seeking funding in Australia. (Xinja, sub. 9, p. 2)

Non-price competition and multiple 'prices'

Providers can compete on the basis of both price and other forms of competition, including quality, as noted by the Harper review.

> Competitive markets are characterised by various forms of price and non-price competition between businesses seeking to provide what consumers want. Price competition occurs when businesses selling the same or very similar goods seek to increase sales by offering low prices.
>
> Non-price competition involves businesses seeking to gain an advantage over rivals by differentiating the goods, services and terms they offer to make them more attractive to buyers — a key mechanism for small and medium-sized businesses to compete with large businesses. (Harper et al. 2014, p. 8)

In some situations, a single financial product may have a number of 'prices' constructed in different ways to attract customers, making it difficult to assess the level of competition. For example, the RBA notes that banks might compete for housing loans by waiving application fees rather than lowering interest rates, and this can make it difficult to assess competition on the basis of interest rates alone.

In terms of insurance, the recent Senate Economics Reference Committee in its final report titled *'Australia's general insurance industry: sapping consumers of the will to compare'* noted the difficulty in making like-for-like comparisons between product offerings can result in consumers selecting a product on the basis of premiums alone, rather than considering a product's value or whether it provides a level of cover appropriate to their needs (SERC 2017).

Non-price competition and the difficulties created for consumers when comparing products when there are multiple 'prices' is considered further in the context of consumer switching (chapter 5) and product bundling (chapter 9).

Integration

Integration is a feature of Australia's financial system and a common commercial practice. The types of integration examined in this Inquiry are:

- vertical integration, where a provider has a role in a variety of parts of the supply chain — for example a bank that provides both retail loans and wholesale funding to its retail competitors
- horizontal integration, where a provider extends across related markets — for example an insurer with multiple brands in multiple markets, including potentially some that compete against each other
- conglomerate integration, where a provider acquires another business that is part of a different supply chain — for example, a bank acquiring an insurer.

Integration of itself is neither good nor bad for consumers and while it can provide benefits to consumers, it can also lessen competition in certain circumstances. As noted by CHOICE:

> When a large business stakes out multiple positions across its supply chain, the efficiency savings can be passed on to the consumer in the form of lower costs. However, it may have the effect of diminishing competition, as the distributor has an incentive to promote its owner's products above others'. There are significant risks to the consumer where the ownership relationship is disguised or undisclosed. (CHOICE, sub. 42, p. 29)

Integration in the financial system and its impacts on competition are examined further in chapter 9.

Fear of risk discourages innovation

As outlined above, a key feature for competition in Australia's financial system should be that regulators anticipate that financial products and ways of delivering them will change with technology and consumer preferences. However, both policy and regulation can operate as barriers to innovation.

> Financial markets today are characterised by rapid innovation and an evolving business environment, together with longer-term changes in customer needs and profiles. The result has

> been a greater array of participants, products, and distribution channels. In such an environment, regulatory measures that are overly detailed or too restrictive may induce distortions in the allocation and pricing of financial resources and may limit the ability of financial institutions to respond to changes in the competitive environment, which may render them unprofitable or unsafe. The ideal approach is to find an appropriate balance between preserving safety and soundness of the system and allowing financial institutions and markets to perform their intended risk management functions. (Lumpkin 2009, p. 27)

Rapid technological innovation brings opportunities to improve user outcomes and system efficiency, but also raises new risks and challenges. Regulatory and policy settings should facilitate innovation and accommodate market developments where these improve system efficiency and user outcomes. The FSI noted that:

> Government and regulators should remove unnecessary impediments to innovation by applying graduated functional frameworks in a range of areas, including the payments system. The [Murray] Inquiry supports simplifying and clarifying payments regulation to facilitate innovation; lowering interchange fees to reduce costs for merchants and prices for customers; and preventing merchants from over-surcharging customers paying with debit and credit cards. (Murray et al. 2014a, p. 27)

For example, providing the framework for more effective use of data could enable the risk weights attached to capital provisions applying to particular types of lending to be further refined and improve system efficiency and outcomes for consumers. These and other policies and regulations which identify reforms to facilitate pro-competitive behaviour that supports innovation are considered in chapters 6 and 19.

Demand-side view — consumers driving competition

Consumers play an important role in placing competitive pressure on providers, as long as they have the opportunity and can see the rewards from doing so. This pressure can be evident, for example, by the capacity to shop around, prior to committing to or switching products, to obtain a better deal that meets current and future needs.

> The role of consumers in facilitating competition, and promoting well-functioning markets, has long been recognised. In seeking the 'best' value (the good or service and price/quality combination most appropriate for them) consumers not only advance their own self-interest, but also provide signals to suppliers on the product characteristics they require. Competition between suppliers, who respond to these signals, can variously lead to lower costs, improved product quality, greater innovation and higher productivity … However, poorly informed consumers send weak and confused signals to the market, limiting the benefits they receive from transactions and reducing gains from competition more generally. (PC 2008, p. 28)

As noted by the ACCC, competitive markets are the most effective mechanism to encourage 'firms to produce and offer products most valued by consumers (allocative efficiency)' (ACCC, sub. 17, p. 12). Where providers are 'slow to respond to the changing needs and preferences of consumers by developing new products or new business methods, they could lose market share (and future profits) to rivals' (ACCC, sub. 17, p. 13). We would add to this a caveat — it is when consumers are in a position to generate material competitive pressure on financial service providers that a provider response becomes necessary in order to avoid loss of market share to rivals.

CHOICE highlights the importance of looking at the demand-side when assessing competition in relation to banking.

> Competition in the financial sector is not a supply side problem. We do not need more banks, we need better banks. We need measures which counteract the ability of large, incumbent institutions to capture major sections of the market while charging higher prices than many of their competitors. Improved disclosure is one such measure; when consumers are given timely, targeted information that allows them to evaluate the cost of a product against the rest of the market and they are more inclined to switch. Improving consumers' access to their transaction and consumption data will also make it easier than ever to switch between products. These interventions should make it easier for consumers to become unstuck from their banks and force banks to work to keep their customers. (CHOICE, sub. 42, p. 3)

Individuals, small to medium enterprises (SMEs), large businesses and government are all consumers of financial products and services. In terms of demand-side issues, the focus of this Inquiry is on retail consumers (individuals and households) and SMEs. As the Murray FSI noted, 'In some cases, small businesses are similar to retail consumers in their level of sophistication and bargaining power' (Murray et al. 2014b, p. 3.49). Similar observations were made in relation to small business access to redress by the Ramsay Review of the Financial System External Dispute Resolution and Complaints Framework (Ramsay, Abramson and Kirkland 2017).

In its submission ASIC noted that consumer vulnerability is another important consideration in understanding why some consumers may not be able to place competitive pressure on providers. Issues around vulnerable consumers were also raised in a number of submissions (ASIC, sub. 40; Australian Lawyers Alliance, sub. 45; CBA, sub. 25; NAB, sub. 31) and are discussed further in appendix D.

Disclosure, consumers and behavioural economics

Australia's regulatory framework relies heavily on disclosure to protect and empower consumers, however the traditional notion that more information (versus, say, better information) leads to improved consumer outcomes is not always the case.

> In particular, traditional models assume that people have preferences that are reasonably free from external influence. People regularly 'update' their own information from experience, and they learn from their past experiences. They also use all available information to make fully rational judgements, with the ultimate aim of maximising their utility.' (ACM 2013, pp. 7–8)

Behavioural economics, however, recognises that the effectiveness of many traditional consumer protection approaches is diminished once you can no longer assume that consumers will seek out and understand all relevant information before purchasing a financial product. Consumer behaviour and decision making are discussed in appendix D.

In designing much-needed information improvements, we have focused on how to inform consumers simply and effectively, rather than assume more information is necessarily always better. We have much better access to data today than when the regulatory regimes used in banking and insurance were first designed. Yet collection and dissemination of this information in a consumer-friendly fashion is not much evident in Australia.

Demand-side pressure

The key question to address when considering the demand side of the framework and the perspective of consumers is whether consumers can generate material competitive pressure on financial service providers, and if not, why not?

For consumers to exert demand side pressure to drive effective competition they need to be able to:

- easily access information about the products and services available in the market, and recent changes
- gain reliable assistance to assess this information
- simply and conveniently act on this information by purchasing or switching to a product that offers the best value to them (ASIC, sub. 40; Fletcher 2016; OFT 2010).

We have considered a number of factors in making this assessment including financial literacy, level of engagement, product complexity and extent of information asymmetry affecting consumer ability to engage at each stage of this process. The factors are outlined below and considered in general terms in chapter 5 the Inquiry report.

Financial literacy and product complexity

An individual who is financially literate is able to make effective decisions about using and managing money. This requires a combination of skills, knowledge, attitudes and behaviour; or alternatively, a justified reliance on information and advice from a capable and properly motivated agent.

While low levels of financial literacy inhibit consumers’ ability to generate competitive pressure on providers of financial products and services, where products are complicated, even the most experienced customer may struggle to make choices.

There is natural complexity; and deliberate obfuscation. Analysis has been undertaken for the latter (such as through product proliferation) where it may contribute unjustifiably to consumers’ inability to act in their best interests and this complexity may lead investors to misunderstand the nature of a product and its risks. As ASIC said:

> … where a product is complex, this may make the process of assessing risk more difficult. Specific features are inherently more likely to make a product complex, such as embedded leverage and inverse returns. Another key indicator of complexity is difficulty in being able to assess the potential performance and/or risks of a product (e.g. performance may depend on the

> interaction of a relatively large number of underlying components, indices or triggers … A product may have features that by themselves are not complex but, in combination with a complex product, may lead to investor detriment (e.g. exit charges, or lack of liquidity or a viable mark-to-market mechanism). (ASIC 2014e, p. 13)

There are also barriers to people making good financial decisions including ‘information and choice overload, complexity and uncertainty, time effects and pressures, over (and under) confidence, self-control and framing (i.e. how information is presented)’ (ASIC 2011c, p. 230).

This complexity in products, and the inability of many consumers to compare them, means intermediaries play a significant role in the financial system. The role of such intermediaries, particularly in regard to home lending is discussed in chapters 10 and 11.

Level of engagement

Lack of consumer engagement can stem from difficulty in understanding complex financial products.

> While consumers struggle to identify whether their financial product gives them value, targeted information provided at the right time can prompt people to assess if they are getting a good deal. This information works best when it helps people contextualise or anchor their experience to the rest of the market. (CHOICE, sub. 42, p. 15)

The Murray FSI noted that improved financial literacy may enable consumers to be more engaged and to make more informed decisions about their finances (Murray et al. 2014a, p. 193).

The more engaged a financial services consumer is, the more likely they may be able to generate competitive pressure on providers. However, during periods of personal vulnerability, ASIC has identified that some consumers may be more affected by particular biases including scarcity, availability bias and information overload. These biases can lead to a tendency to stop searching too early, disengagement from the search process, and being more likely to stay with the status quo or not take up vital financial products at all (ASIC, sub. 40).

Information asymmetry

The imbalance of information between the two parties entering into a transaction is readily observed as an issue in the financial system.

Providers typically have more information on product differentiation, pricing, risk and quality than consumers. However, asymmetry of information is not merely a demand side (consumer) issue where consumers do not have access to full information about financial products — it applies to intermediaries too. Brokers are not always accredited for all relevant products, and consumer credit information remains ‘Balkanised’, such that many providers are at an unnecessary disadvantage, compared to a comprehensive credit reporting system.

Disclosure is designed to minimise information asymmetry, but is proving insufficient in design as well as content. The Murray FSI heard that the disclosure framework, introduced following the 1997 Wallis FSI, was not achieving its objectives and should not be relied on in isolation to address information asymmetry (Murray et al. 2014a).

ASIC highlighted the problems this asymmetry of information can lead to.

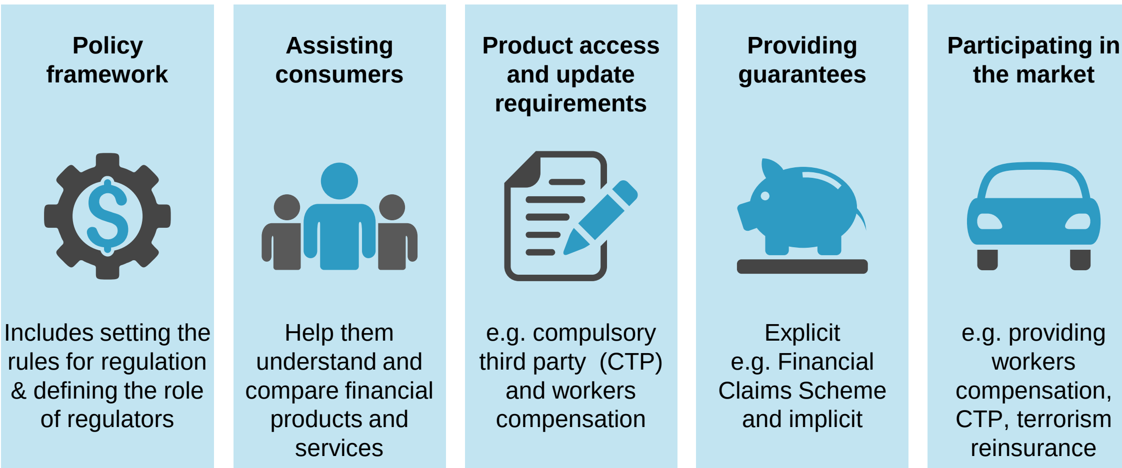
> The provider of a financial product or service generally has more information than the consumer about the terms and conditions of the product or service. Consumers are generally unable to negotiate more favourable terms or conditions. This information asymmetry creates opportunities for inappropriate or exploitative behaviour by providers. Providers could potentially design products or services that maximise their interests over that of consumers. (ASIC, sub. 40, p. 15)

This is consistent with the findings of the Commission's 2017 *Data Availability and Use Inquiry*, which highlighted that providing a disclosure statement does not guarantee either understanding or agreement (PC 2017c).

How government and regulators influence competition and market outcomes

Government has a variety of interactions with the financial system, as shown in the five areas in figure 2.3 and in the text below. The key question to be addressed in relation to the role of government and regulators in each of these areas is whether their focuses and actions are improving or detracting from competition in the Australian financial system. This is considered in chapter 18 with recommendations for change in chapter 19.

Figure 2.3 **Interactions of Australian governments with the financial system**



As noted by the Murray FSI, sound regulation underpins confidence in the system, encourages participation and facilitates efficient allocation of funding and risk in the economy. It also noted, that regulation imposes costs.

> [R]egulation also imposes costs on institutions and the economy more broadly. Regulation should strive to meet its objectives, without placing an undue burden on the regulated population. (Murray et al. 2014b, p. 3.90)

Policy framework

Australia was the first of a number of countries to adopt a ‘twin peaks’ approach to regulation, with separate prudential (APRA) and conduct (ASIC) regulators — a product of the 1997 Wallis FSI (Wallis et al. 1997). APRA has responsibility for prudential supervision including capital requirements and ASIC for consumer protection and conduct regulation (box 2.5). As noted by the Financial Planning Association of Australia, other countries have adopted an integrated approach, with a single universal regulator.

> Australia is renowned for its Twin Peaks approach to regulation — a form of regulation by objective, is one in which there is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision function (ie. APRA) and the other that focuses on conduct-of-business regulation (ie. ASIC). The Integrated Approach, on the other hand, is one in which a single universal regulator conducts both safety and soundness oversight and conduct-of-business regulation for all the sectors of financial services business. (FPA, sub. 26, p. 5)

In addition, Treasury advises the government on reform to the financial system, including legislative and regulatory changes. (The Treasury 2017e, p. 14 and 20).

There is very little activity in the financial system that does not come under regulatory scrutiny. As outlined above (and considered in further detail in chapters 7, 8 and 18) we consider the extent to which price competition is limited by regulatory interventions and funding models, the implications of implicit guarantees, the rationale for the Four Pillars policy and the impacts on smaller players.

Taxation is another area where governments influence competitive outcomes in the financial system. In addition to Commonwealth tax provisions in the areas of income and corporate tax and GST, state governments apply stamp duties to some types of insurance (see chapter 14).

As noted in chapter 18, regulation has a very significant influence on the competitive dynamics in the financial system — regulators decide who can compete and how, in which market and at what cost. As a result, regulation curtails competition in order to achieve financial stability, both deliberately and accidentally.

Box 2.5 Regulators that have a role in the financial system

ACCC: Australia's competition regulator, the ACCC has a role in 'promoting competition in financial services through our enforcement, mergers and adjudication work'. This can involve intervention in the market to promote competition, for example in preventing proposed mergers and acquisitions that would substantially lessen competition or ensuring market participants have access to infrastructure and data. In addition, the ACCC recently received additional funding to establish a Financial Services Unit (FSU) which will 'monitor competition in Australia's financial services sector by assessing competition issues, undertaking market studies, and reporting regularly on emerging issues and trends in the sector'. Whether there are additional competition issues that should be referred to FSU is an issue that is considered in chapter 19 (ACCC, sub. 17).

APRA: As the prudential regulator of the Australian financial services industry, APRA's mission is founded on the promotion of stability of the Australian financial system by ensuring the prudent management of regulated institutions in each industry. APRA oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies and most of the superannuation industry. APRA's mandate requires it to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality (see box 2.1) and, in balancing these objectives, to promote financial system stability in Australia (APRA, sub. 22).

ASIC: As the market conduct regulator for the Australian financial system, ASIC is responsible for monitoring and promoting market integrity and consumer protection. ASIC regulates Australian companies, financial markets, financial services organisations and professionals who deal in and advise on investments, superannuation, insurance, deposit taking and credit. ASIC and the ACCC share jurisdiction for consumer protection laws, with ASIC responsible for consumer protection laws applying to financial products and services, and the ACCC responsible for those laws as they apply to all other products and services (ASIC, sub. 40).

AUSTRAC: The Murray FSI noted that Australia's financial intelligence agency, the Australian Transaction Reports and Analysis Centre (AUSTRAC) which has regulatory responsibility for anti-money laundering and counter-terrorism financing, can also have a significant effect on the financial system (Murray et al. 2014a).

RBA: Another key government player in the financial system is Australia's central bank, the Reserve Bank, which is responsible for monetary policy. It also 'fosters financial stability, undertakes a range of activities in financial markets, acts as a banker to the Australian Government, issues Australia's banknotes and has policy, supervisory and operational roles in the payments system' (RBA 2017e).

The Payments System Board: The board is part of the RBA, and has responsibility for payments system policy and regulates payment system providers including MasterCard, Visa, American Express, Diners Club, UnionPay, eftpos and the ATM System. As outlined in chapter 17, the main responsibilities of the Payments System Board are to: control risk in the financial system, promote the efficiency of the payments system and promote competition in the market for payment services (RBA 2015f).

The Council of Financial Regulators (CFR): The CFR is the coordinating body for the RBA, APRA, ASIC and the Treasury. Its role is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system. While it advises government on the adequacy of Australia's financial system regulatory arrangements, it is a non-statutory body with no legal functions or powers separate from those of its members (RBA 2017c).

Governments play a role in facilitating consumers' capacity to understand and compare financial products, although as noted earlier the way information is provided may be more important than the volume or the use of disclosure remedies.

Specifically, governments use mandatory disclosure requirements for providers of financial products and services, for example Product Disclosure Statements (PDS). There are similar requirements for providers of financial services to disclose the service they are providing in a Financial Services Guide (FSG) and advisors to provide consumers with a Statement of Advice (SOA).

Disclosure requirements are set out in the *Corporations Act 2001* (Cth) and related regulations and ASIC has set out some principles of good disclosure in its regulatory guide on disclosure, which include disclosure being timely, relevant and complete, promoting product understanding and comparison, highlighting important information and having regard to consumers' needs (ASIC 2011b).

Governments are also able to assist consumers by making it easier to switch financial products or services (see chapter 5).

Assisting consumers

Governments at times also assist consumers by ensuring they have tools available to compare products, including through aggregator services. For example, ASIC currently provides a website for North Queensland home insurance which allows consumers to compare insurance policies and indicative premiums. The ACCC's (2016g) good practice guidelines for comparator website operators and suppliers were supported by a recent Senate Economics Committee inquiry.

Governments can also support consumers by ensuring there is a sound framework for dispute resolution services. The recent Ramsay Review into the Financial System External Dispute Resolution and Complaints Framework noted that alternative dispute resolution, including Ombudsman schemes, provides an alternative to resolving disputes through the Courts that is more flexible and informal. Having access to effective redress helps builds the confidence of consumers to participate in the market.

> To ensure consumers are treated fairly and can have confidence and trust in the financial system, they should have access to effective redress. Existing avenues of redress include accessing complaints handling by the financial firms (internal dispute resolution), alternative dispute resolution (ADR) and the courts. (Ramsay, Abramson and Kirkland 2017, p. 25)

Guarantees

Governments can lift consumer confidence in core aspects of the financial system by guaranteeing certain financial products. The Financial Claims Scheme (FCS) was established in 2008 in response to the GFC. It is an Australian Government scheme that provides protection to deposits in ADIs up to a limit of $250 000 per account holder and to policies with general insurers for claims up to $5000, in the event of the failure of one of these institutions. For the scheme to come into effect, it needs to be activated, which is done at the discretion of the Australian Government via a Ministerial declaration and following the failure of a financial institution. The FCS does not cover life or health insurance, and is administered by APRA (APRA 2015a).

In addition to explicit guarantees, the OECD (Denk, Schich and Cournede 2015) notes that many stakeholders potentially benefit from implicit bank guarantees. The RBA highlighted competition issues associated with the implicit guarantee in its initial submission, but noted that this has reduced recently.

> The ratings agencies have given the four major banks (as well as Macquarie Bank) an uplift to their credit ratings to reflect the perceived likelihood of government support in times of distress. Any uplift to smaller banks' ratings has been minimal or non-existent … The lower funding cost of the major banks has constrained the ability of smaller ADIs to compete since the crisis. This differential has, however, narrowed recently, as smaller banks' funding costs have declined more quickly than those of the major banks. Regulatory measures, such as higher capital requirements for the major banks, higher risk-weights on mortgage lending and the bank levy, have contributed to this … (RBA, sub. 29, p. 13)

A number of submissions also raised concerns about an implicit government guarantee for the major banks due to the perception they are 'too big to fail' (for example, COBA, sub. 21; Regional Banks, sub. 37; CHOICE, sub. 42) (see chapter 6).

Participating in the market

While historically, Australian governments directly owned a number of financial institutions (box 2.6), today there is limited direct government participation in the Australian financial system.

- Some state governments currently participate in the financial system through the provision of insurance — compulsory third party insurance and workers compensation.
- The Australian Reinsurance Pool Corporation, a Commonwealth entity, provides a terrorism reinsurance option in Australia. It was created due to market failure in the terrorism insurance market following the September 11 2011 terrorist attacks in the United States.
- A range of government owned sector- or single purpose- specific entities also operate in parts of Australia's financial system, including: the Clean Energy Finance Corporation, the Export Finance and Insurance Corporation, and the Australian Office of Financial Management.

Box 2.6 Previous government ownership of financial institutions

Prior to the 1981 Campbell FSI, Australian governments directly owned a number of financial institutions. However by the time of the 1997 Wallis FSI, governments at both state and Commonwealth levels had gradually withdrawn from direct ownership of financial institutions.

The Commonwealth Government progressively privatised the Commonwealth Bank, with an initial public offering in 1991, and a subsequent float of the remaining equity in July 1996.

The Commonwealth Government sold the Housing Loans Insurance Corporation to the private sector in 1997.

State governments also sold or privatised State financial institutions, including:

- 1991 — the Victorian Government sold the State Bank of Victoria to the Commonwealth Bank
- 1992 — the NSW Government finalised the sale of the NSW Government Insurance Office
- 1994 — the NSW Government sold the State Bank of NSW to Colonial Mutual Life
- 1995 — the South Australian Government sold the State Bank of South Australia to Advance Bank.

Some of these State Government owned entities were under financial stress prior to their sale. The State Bank of Victoria had taken over the bad and doubtful debts of its merchant bank subsidiary, Tricontinental, which had ceased trading in 1989. The following Royal Commission into the Tricontinental group of companies found that the sale of the State Bank of Victoria to the Commonwealth Bank in 1991 had enabled the Victorian Government to cushion some of the actual and potential losses on the State of Victoria.

The State Bank of South Australia had been provided with special financial support from the South Australian Government in 1991 as a result of a large number of non-performing corporate loans. The South Australian Auditor General noted in its Inquiry that the bank failed because too many of its corporate loans were ‘bad loans’ that should never have been made and that its corporate lending business was ‘incompetently conducted in almost every respect’.

Source: Campbell et al. (1981); Parliament IRS (2006); Wallis et al. (1997); Victorian Government (1991); Auditory General’s Department of South Australia (1993).

There have been some recent calls for government to provide basic banking services via the RBA, to increase competition in the banking sector (Lateral Economics, sub. 39).

Going beyond that, it has been suggested that the RBA fund ‘no frills’ home loans of up to 60% of the property’s value at an interest rate below the prevailing rate(Di Natale 2018).

Such interventions would likely result in the commercial banks being left with portfolios more oriented towards higher-risk, higher-LVR lending. This could penalise those borrowers without the substantial deposit necessary to take full advantage of the RBA lending; and surely increase systemic risk for those banks in the event of a downturn.

It is also possible that it might even make housing less affordable for those on the lowest incomes, by expanding the financial resources available to all parties. Like most efforts to put public money into the hands of home buyers, the clearest winners would be sellers and not buyers. [5] And in the competition between buyers, those with higher incomes will have relatively more ability to take advantage of the new cheaper loan.

There are also the conflicts arising from having the RBA as the institution setting monetary policy actively managing a mortgage book and competing in the home lending market. Again, this may be most evident in a downturn, when the safety of a government lender may see political pressure put on the RBA not to enforce mortgage arrears, which private banks will not be able to match. The potential conflicts in such a situation are multiple and costly.

The Commission previously considered the use of government lenders as part of its 2014 Public Infrastructure Inquiry, and did not support the establishment of a government owned bank.

> [T]he Commission can see risks associated with government ownership of a bank. Since the 1990s, the financial system in Australia has largely moved away from government ownership of financial institutions, in some cases prompted by the financial mismanagement and/or collapse of institutions, such as the State Banks of South Australia and Victoria. Over the years, various attempts by the Australian and State Governments at operating publicly funded economic development operations have also ended in failure. International research previously cited by the Commission indicates that government ownership of financial institutions is associated with slower subsequent financial development and lower productivity growth. (PC 2014b, p. 229)

For these reasons the Commission does *not* support the government using the RBA or establishing a new bank for the purposes of providing banking products such as home loans.

5 The use of government grants to assist first homebuyers has been found to add upward pressure on house prices, benefiting sellers and increasing the wealth effect of existing home owners (Eslake 2011) (Blight, Field and Henriquez 2012).

3 Market power in the banking system

Key points

- The banking system is dominated by four large players that hold the bulk of market share.
  - The relative size of major banks is such that only if *all* other banks in Australia were to merge, would they be able to rival either of the biggest two — Westpac and the Commonwealth Bank.
- Highly concentrated markets *can* be competitive or deliver beneficial outcomes for the community; nonetheless, this level of concentration does provide significant advantage to those large banks in a context where size is strongly associated with safety.
- The major banks hold substantial market power, reflecting their structural advantages.
  - The major banks have very well-known brands and substantial geographical reach. Consumers tend to perceive them as safe and stable, and levels of switching are low.
  - As a result of both their size and scope, and a status of 'too big to fail', the major banks benefit from lower operating costs, including lower costs of funds.
- Regulators are introducing policies that are said to offset some of these advantages. However, regulation that aims to increase costs to aid competitors will tend to reduce competition and harm consumers.
- There is evidence that the high concentration of market power among a very small number of institutions is resulting in poor consumer outcomes in Australia.
- The major banks' market power allows them to achieve their profit targets by adjusting the interest rates they charge borrowers. This has enabled them to remain highly profitable even in the face of significant shocks, such as the global financial crisis (GFC).
- The small but persistent decline in major banks' profitability measures since the GFC does not appear to be driven by competition but rather by a return to long-term trends.
- The expected reactions of other majors (but not smaller lenders) are an important consideration in the pricing strategies of big banks. The major banks aim to maintain a mostly uniform position, rather than compete vigorously on price.
- Other institutions generally behave as market 'followers' and mirror the major banks' pricing decisions. As a result, prices for banking products tend to cluster. This approach is unlikely to result in prices that are reflective of the cost incurred by the *most* efficient institution; at best, it will result in prices that reflect the costs of the *least* efficient major bank.
- Service competition is more apparent than price competition in banking.
- Banks suggest that the large variety of products in the market — over 4000 home loans and 200 credit cards — is an indication of competition. However, this multitude of products does not necessarily benefit the consumer. Indeed, it can diminish competition by making it harder for consumers to compare products and prices.
- The ability for regulators or customers to alter the pricing paradigm is limited by the constant reference <u>by both</u> to the desirability of a safe banking system. Yet for competition to be effective, willingness to allow some risk-taking is a necessity.

For many years, Australia's banking system has been dominated by four major banks — Westpac Banking Corporation (Westpac), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Australia New Zealand Banking Group (ANZ).

However, this dominance in itself does not necessarily mean markets are not competitive. In cases where information is easily accessible (both for consumers to assess the suitability of banking products, and for banks to assess applications for credit) and markets are contestable, banks can be highly competitive even when they command substantial market shares (Ratnovski 2013).

On the other hand, dominance by a small number of banks may allow them to stifle competition, by maintaining prices at artificially high levels or limiting innovation without losing any market share. In a competitive market, no provider (or group of providers) nor any single consumer (or group of consumers) can use their market power to exert a significant sustained influence over price or quantity without affecting their market share (chapter 2).

Every business might hold some degree of market power — from a stronger brand, a broader range of products, a specific skill set or a better level of service — that allows it to differentiate itself and continue successfully operating in the market. But market power also affords such businesses the ability to insulate themselves from competition to a greater or lesser degree (ACCC nd). In some circumstances, such power can be abused by those who hold it:

> Market power comes from a lack of effective competitive constraint. A firm with market power is able to act with a degree of freedom from competitors, potential competitors, suppliers and customers. The most observable manifestation of market power is the ability of a firm to profitably sustain prices above competitive levels. Substantial market power may also enable a firm to reduce the quality of goods or services, raise barriers to entry or slow innovation. (ACCC 2017c, p. 7)

Numerous submissions to this Inquiry — with the exception of the major banks themselves — stated that Australia's major banks hold substantial market power (box 3.1). However, as the Australian Securities and Investments Commission (ASIC) explained, a key question is how this market power is used:

> The general post financial crisis consolidation in the Australian banking sector suggests the major banks have increasing market power. This is a potential concern if it leads to poor consumer outcomes in terms of pricing, quality and choice of products. (sub. 40, p. 41)

This chapter examines the various factors that affect market power and discusses the current balance of power in Australia's banking system. This system comprises a range of different authorised deposit-taking institutions (ADIs), including banks owned by local shareholders, foreign bank subsidiaries and branches, mutual banks owned by their customers, credit unions and building societies.

3.1 How do ADIs gain — and boost — market power?

The banking market runs on information, and pervasive information asymmetries are one means by which some participants gain market power. Borrowers have more information about their financial circumstances than lenders, but the complex nature of many financial products, which can leave individuals feeling confused or disengaged, erodes the market power of consumers (Xinja, sub. DR67). Existing lenders (of all sizes) have a substantial knowledge base about their borrowers. New entrants, that are aiming to build market share by convincing some of these borrowers to switch lenders, need to make large investments in assessing the credit-worthiness of borrowers (chapter 4). The information advantage held by incumbent institutions gives them substantial market power, as it both enables them to charge higher interest rates to existing borrowers and limits new entry (Dell'Ariccia 1998).

Additional factors that influence the market power of individual institutions, or strategic groups comprising similar institutions, include the scale and scope of their activities, the strength of their brands, consumer preferences and regulatory settings.

Scale and scope

In many banking systems globally, larger institutions have more market power, and Australia is no exception. Their sheer size allows the major banks to spread their fixed costs (such as investment in new IT systems) across a broader asset base (RBA, sub. 29). They are also able to grow more quickly, as they have greater capacity to respond to an increase in demand. At the same time, size can create challenges — for example, changes are more difficult to implement in very large systems. There is a tipping point beyond which large organisations are no longer efficient and they operate at declining returns to scale.[6]

The clearest and most powerful advantage that larger banks have over smaller ADIs, and one that gives them substantial market power, is their ability to raise funds at lower costs. Larger banks have better credit ratings, and as a result, investors and depositors are willing to lend them funds at lower rates. In part, these credit ratings can reflect the ability of larger banks to hold more diversified lending portfolios. However, these ratings also benefit from explicit and implicit government guarantees, such as being considered 'too big to fail' (chapters 6, 8). Their lower costs of funding enable the bigger banks to maintain their profits and offset some of the increases in their costs resulting from regulatory change, which may prove more difficult for smaller institutions.

Larger operators also benefit, to an extent, from integration, which gives them the ability to exert additional control over some markets. Vertical integration allows larger institutions to have more control over the costs of their inputs, while smaller entities rely on third parties

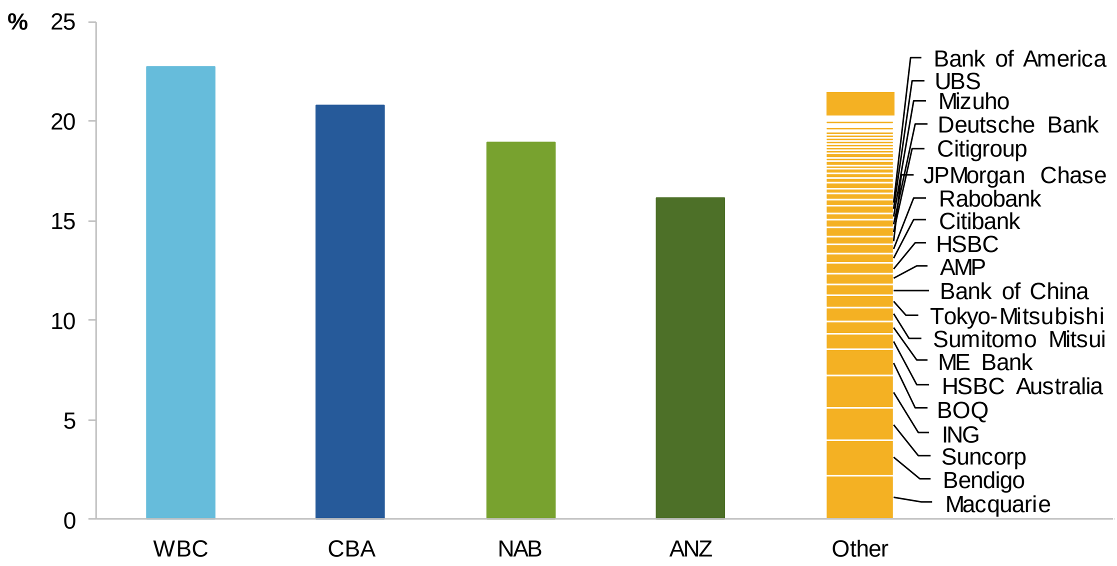
6 The most recent literature on bank efficiency in Australia uses pre-GFC data. Depending on the econometric technique used, different banks are found to be inefficient. Paul and Kourouche (2008) find that Westpac and ANZ are inefficient, while Moradi-Motlagh and Saleh (2014) find that Westpac, NAB and CBA are inefficient.

to access funding markets and other types of services. In effect, small ADIs compete against the major banks, but also depend on them to access the funds that allow them to continue competing (chapters 8, 9). Cross-product (conglomerate) integration gives the larger institutions the opportunity to cross subsidise some of their products, and also offer consumers an integrated bundle of services, which may help to lock customers into the provider and raise customer switching costs (chapter 5).

Given the importance of size, as well as the potential for cost savings, smaller players across the Australian banking system have been consolidating. This has particularly been the case for credit unions and building societies (chapter 4). But despite this trend towards consolidation, the major banks still maintain substantial market power — because the difference in size between them and the other providers in the market is exceptional. Based on the value of their assets in April 2018, ANZ (the smallest of the majors) was seven times bigger than Macquarie, the next bank by size of assets. Twenty banks (ranking 5th to 24th by size of assets) would need to merge in order to match ANZ. Only if *all* banks in Australia, other than the big four, merged would they be able to rival the biggest two — Westpac and the CBA (figure 3.1).

Figure 3.1 **To be as large as a major bank, 20 other banks would need to merge**

Banks' share of resident assets, April 2018[a]



[a] Figures reflect share of assets held on banks' domestic books.

Source: APRA (2018m)

Geography and distribution networks

An important aspect of banks' size is their geographical reach, either through branches or other distribution networks. In 2017, there were about 5300 bank branches, over 390 credit union branches and 74 building society branches. The major banks accounted for 60% of all branches, and only two other ADIs (Bendigo and Adelaide Bank and Bank of Queensland) had branches in every state and territory (APRA 2017a). Major banks are also strongly represented in other distribution networks, such as mortgage brokers (chapter 11).

Over time, the importance of physical points of presences is likely to diminish, given that consumers increasingly deal with their bank online, and some institutions operate exclusively online. For example, ING (2018) defines itself as a branchless bank, while newcomer Xinja (sub. 9) intends to operate entirely on a mobile platform. Although operating exclusively online arguably gives these institutions an almost immediate nation-wide presence, physical branches still have a role to play. The physical presence of the major banks, through their numerous branches, contributes to their strong brand recognition; combined with their established website and internet banking platforms, this makes it easier for them to attract new customers. This further cements their existing market shares, and market power.

Smaller institutions can have a prominent presence in some regional markets, where they compete against one or more of the major banks (ABA, sub. DR119). Nonetheless, given the significant cost associated with establishing a large branch network, small ADIs remain confined to relatively limited geographical areas, or choose to operate mostly online or through third party distributors such as mortgage brokers. These alternative distribution channels have increased the market reach of some smaller institutions, allowing them to expand their operations on a national scale. Nonetheless, their ability to use these channels to attain substantial market power is limited, as major banks have significant control over distribution channels (chapters 9, 11).

Branding and consumer behaviour

A strong brand is an important asset in any industry; it may allow operators to maintain and, in some cases, increase their market share. It may even allow them to consistently price similar products higher than other market operators, as consumers believe they are getting better service or quality product features when purchasing a branded product (Porter 1976). For ADIs, it means they can attract customers more easily and maintain a reputation as trusted, financially stable organisations.

Australia's major banks have some of the strongest business brands in our economy. Industry estimates put the value of their brands between $6 and $8 billion, with CBA having the highest brand value (Pash 2017). Their public image has been affected by a series of scandals and the continued community perception that they do not operate in their customers' best interests — these issues have most recently been raised in the hearings held by the Royal

Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Australian Government 2017f).

At the same time, customer satisfaction levels reported by individual banks, including the major banks, remains high (see, for example, CBA, sub. 25). While consumers may be disillusioned with the banking *system*, it seems they are satisfied with their chosen *institution*. Of course, as we note elsewhere, consumers may not always be aware of the alternative services and prices available from other institutions — or even their own institution — that may be more suitable for their circumstances (chapter 5).

The major banks benefit from the perception that they are safe, stable institutions, and that the government will step in to help them if needed (RBA, sub. 29). This supports their existing market power, and in some cases increases it further — during the global financial crisis (GFC), consumers transferred some of their savings to the major banks, as they were perceived as safer (chapter 8). Even when no financial crisis looms, small institutions may find it difficult to attract consumers from rivals that are perceived as safer. This is despite the fact that retail deposits benefit from the same government guarantee, regardless of ADI size. The measures protecting depositors if an institution were to fail — the Financial Claims Scheme and the legal protections contained in the Banking Act — apply equally to retail deposits at all ADIs (chapters 6, 7).

Smaller ADIs attempt to create a distinct public image, based around trust:

> Without the subsidy of being a 'too big to fail' bank, regional banks have needed to structure their operations or develop a level of trust in the community that enables them to overcome the disadvantages of limited scale and higher costs. (Regional Banks, sub. 37, p. 52)

Some of the foreign banks operating in Australia are part of very strong global brands, such as the Industrial and Commercial Bank of China (ICBC) and American bank Citigroup. With a few notable exceptions (such as ING), these institutions focus on specific parts of the Australian banking market, including credit to very large corporations and banking services to consumers with strong ties to the banks' home markets. For example, ICBC opened its branches in Australia with the intent of becoming one of the main providers of wealth management services to Asian investors (Cai 2012). While they may compete strongly within their chosen sectors, most of these institutions have not established a significant presence in the market for retail banking services, and do not hold significant market power in Australia in areas other than their chosen sector (chapter 4 discusses foreign banks in detail).

Consumer behaviour may also contribute to market power; the low levels of consumer switching and a general disengagement from financial services (chapter 5) help ADIs maintain their position in the market, and make it harder for new competitors to gain any significant market share.

The effects of regulation on market power

Regulation plays a large role in the operations of all financial service providers and may entrench the market power of incumbents:

> [T]he Australian financial services system is, in our view, a heavily regulated market at risk of becoming an over-regulated market. Over-regulation favours market incumbents since they possess the existing expertise and resources to better cope with the regulatory burden impacting new entrants and consequently competition. (Australian Finance Industry Association, sub. DR110, p. 1)

The major banks benefit from a substantial asset base and stable market shares, which give them the ability to cope more easily with regulatory change, while also investing and innovating — which in turn can contribute further to their market power.

For example, the major banks (as well as Macquarie Bank and ING) have invested in developing internal ratings-based (IRB) models. Approved by the Australian Prudential Regulation Authority (APRA), these models allow the IRB banks to determine their own risk weights and hold lower levels of capital than their competitors against specific loans. Smaller institutions that cannot afford such models and the processes that go with them must use APRA's standardised risk weights, which are higher for most loan types and typically increase the institutions' operating costs (chapter 8). Upcoming changes to standardised models may narrow these gaps (chapter 6). In the meantime, the larger banks enjoy lower *regulated* operating costs. While these lower operating costs reflect an upfront investment by the larger banks, they may increase their market power, aside from any ratings agency advantage that also comes with size.

Small institutions argue that their regulatory burden is disproportionately large (P&N Bank, sub. DR88; Regional Banks, sub. DR107). For some, the pace and extent of regulatory change has left them limited resources to increase market share:

> The increasing rate of regulatory change and speed of innovation in the sector means many mutual organisations need to focus on playing catch-up to meet the widening technical capability gap. They are doing this by investing capital in areas such as optimising core banking systems and enhancing loan origination systems. This means they do not have the time, financial or human resource to focus on opportunities for collaboration and innovation beyond business as usual. (CUA, sub. 15, p. 3)

Measures introduced by the Australian Government and APRA are intended, in part, to offset the cost advantages of large banks — examples include the major bank levy and potentially the specific prudential regulation imposed on domestically significant banks, which applies to the big four banks[7] (chapters 6 and 8 discuss these policies and their effect on banks' funding costs in detail). It has been argued that when such regulations raise the costs of the major banks, they may help smaller competitors (Australian Government 2017h).

---

7 The bank levy is imposed on the big four banks and Macquarie Bank. Higher capital requirements are imposed by APRA on banks designated as domestic systemically important (D-SIB). The D-SIBs designated by APRA are ANZ, CBA, NAB and Westpac.

But the objective of competition policy is not to assist some competitors by adding burdens to others, but rather to have the least necessary intervention that is consistent with allowing choice and innovation to meet consumer interests in an efficient manner. Viewed simply, to raise the cost of businesses that have market power — while doing nothing to address adverse use of that market power — risks seeing those costs imposed on customers.

Individual or collective market power?

Market power can be held either by individual institutions, or by a strategic group of similar firms. Monopolies hold nearly absolute power over their markets, while in an oligopoly, market power is shared by a small number of firms.

When firms form strategic groups and interactions occur both within and between groups, collusion and competition can coexist. Most often, these groups are formed by a small number of firms of similar size that are motivated to respond to market or regulatory circumstances in similar ways. The group of large firms tends to dominate the market while smaller firms operate in the fringe and generally follow the pricing decisions of the dominant players. In other words, it is the group of larger firms that has substantial market power and can use it to dictate prices, while firms within the dominant group may or may not hold substantial market power individually (Mas-Ruiz, Ruiz-Moreno and Ladron de Guevara Martinez 2014).

Even if a firm is not considered individually dominant in a market, non-competitive outcomes can emerge in a range of circumstances, from tacit collusion to individual rivalry in highly concentrated markets (Ivaldi et al. 2003). The departure from competition across these market structures allows individual or groups of firms to use their market power, either to maintain prices at non-competitive levels, to minimise innovations or to deter new entrants (Mas-Ruiz, Ruiz-Moreno and Ladron de Guevara Martinez 2014).

This Inquiry focused on the major banks as a group, rather than examining the market power of individual institutions. Market shares for different banking products change monthly (albeit by very small margins), and each of the four major banks may focus on different parts of the market at different points in time. Therefore, their individual power in the market may change, but as a group they remain the dominant force that controls the market.

3.2 The current balance of market power

The major banks benefit from advantages of scale, scope and branding as discussed above, which give them substantial market power and the ability to remain broadly insulated from competitive threats posed by smaller incumbents or new entrants. In the Draft Report of this Inquiry, we concluded that this balance of power gives the major banks the ability to pass on cost increases and set prices that maintain high levels of profitability — without losing market share. While the major banks rejected this conclusion, other stakeholders accepted the Commission’s view in their submissions (box 3.1).

Box 3.1 Who holds market power in the banking industry? Major banks take a very different view from all other stakeholders

In their responses to the Draft Report of this Inquiry, the four major banks each argued against the Commission's Draft Report finding that they hold substantial market power.

ANZ:

> The evidence presented in the Draft Report does not support the finding that banks hold substantial market power. None of Australia's banks holds a dominant enough position individually to sustain uncompetitive prices … If the Draft Report is suggesting that the major banks collectively hold substantial market power, this is contradicted by evident competition between the banks. (sub. DR74, pp. 3–4)

Commonwealth Bank of Australia:

> CommBank rejects Draft Finding 3.1 (The major banks' oligopoly power) and would note that concentration with a given market is not, per se, an indication of the degree of competition in a market. (sub. DR79, p. 19)

National Australia Bank:

> NAB does not agree with draft finding 3.1 … NAB competes strongly against all market participants and does not act collectively or in concert with any other market participant. NAB is not insulated from the effects of competition, which is objectively evident through changes to market share over time, as well as long term trend decline in profitability metrics. (sub. DR94, p. 6)

Westpac:

> [C]ompetition in Australia's financial system is vibrant and multifaceted … we strongly disagree with the Commission's draft finding that the major banks hold substantial market power, either unilaterally or collectively. (sub. DR125, p. 2)

The Australian Banking Association, whose members comprise the major banks as well as smaller institutions, echoed the major banks' views, while adding that:

> The [Australian Banking Association] members differ in their views on draft finding 3.1. Major banks strongly reject draft finding 3.1 … Smaller banks agree with the PC on part of the finding in that size and scope combined with regulatory advantages for the major banks, mean that competition from smaller institutions is not likely to prove sufficiently disruptive to offer consumers a market that is strongly competitive on prices. Smaller banks attribute this to two factors: differences in prudential policy, and the implicit guarantee. (ABA, sub. DR119, pp. 11–2)

Smaller institutions operating in a range of markets agreed that major banks dominate the industry. For example:

> We agree that Australia's four major banks do hold a dominant position in the Australian financial services landscape, and this is an inhibitor to competition and broader fintech industry growth. (FinTech Australia, sub. DR111, p 15)
>
> With the default regulatory position having been almost exclusively focused on safety and stability for nearly a decade, it is unsurprising that this has contributed to the emergence and maintenance of an oligopolistic market structure in retail banking. (Regional banks, sub. DR107, p. 8)

A number of stakeholders commented on the lack of market power in consumers' hands:

> When it comes to home loans, bankers and brokers have built a system that works well for them but poorly for consumers. We need to tip the scales so that consumers have more power to find and move to a better deal. (CHOICE, sub. DR97, p. 3)
>
> We note that consumers experience limited power when it comes to financial services, especially in banking and home loans. (Xinja, sub. DR67, p. 10)

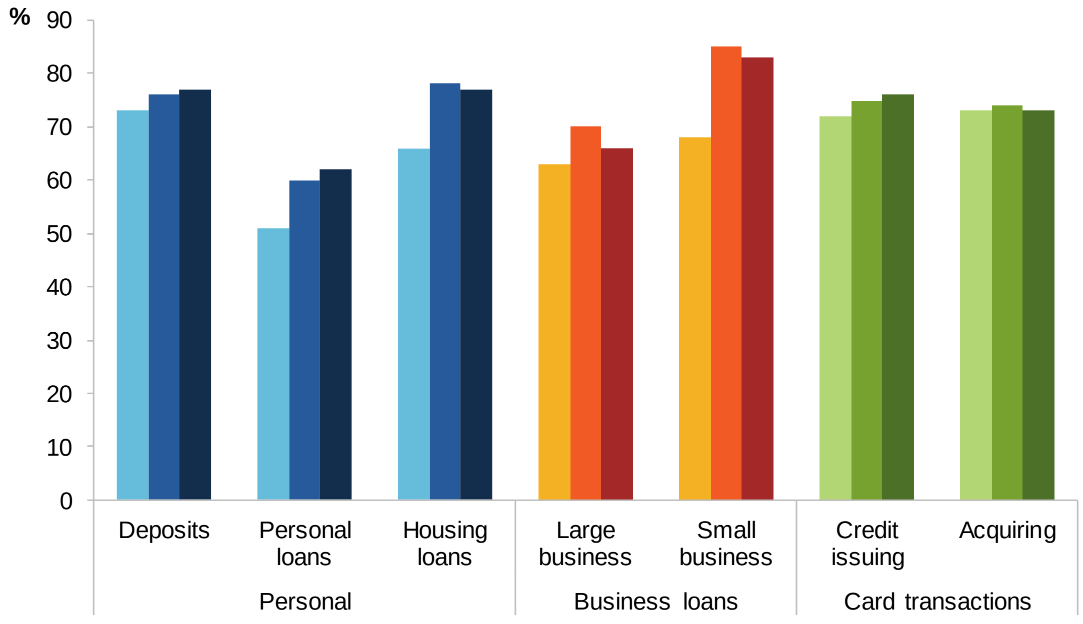
A highly concentrated market – but is it competitive?

There is little doubt that the major banks dominate most markets for banking products. The combined market shares of the major banks reach over 70% across many product lines, and they have increased slightly over the past few years (figure 3.2 — see appendix C for additional market share and concentration measures). Market shares are dynamic, and may differ month-on-month (ANZ, sub. DR74; CBA, sub. DR79; NAB, sub. DR94). However, the overarching dominance of the major banks has remained unchanged for decades.

Apart from simple market shares, there are various measures for concentration in markets that can also be used as part of an assessment of competition. Within the banking system, concentration indexes indicate that competition in some markets (for example, home lending) is stronger compared with other parts of the banking system, but these indexes change over time, and different stakeholders interpret the results in different ways (appendix C).

Figure 3.2 **The major banks dominate markets across the financial system**

Concentration in Australian banking products in 2008, 2014 and 2016-17[a]



[a] For each product group, the data presented is for 2008 on left, followed by 2014, and 2016-17 on the right.

Source: RBA (sub. 29)

But high concentration on its own is not necessarily indicative of market power resulting in inefficient pricing or (tacitly collusive) oligopolistic behaviour. The major banks have all argued that vigorous competition in the banking system is evident in a number of market outcomes:

- price competition, including lower fees and interest rate discounts for home loans (ANZ, subs. 49, DR74; NAB, subs. 31, DR94; Westpac, sub. 28)
- a large number of products being offered by a diverse range of bank and non-bank providers (CBA, sub. 25; Westpac, sub. 28)
- service competition, such as an increasing range of benefits offered to consumers and innovation (CBA, sub. 25; Westpac, subs. 28, DR125)
- low cost to income ratios reflect high level of efficiency, brought about by competitive pressure (CBA, subs. 25, DR79)
- declining profits, as measured by net interest margins and return on equity[8] (ANZ, subs. 49, DR74; CBA, sub. DR79; NAB, subs. 31, DR94; Westpac, subs. 28, DR125).

The extent to which these market outcomes reflect competitive behaviour or exercise of market power is discussed in detail below. Some submissions also raise the argument that the banking market is contestable and that new entrants play a significant role in competition (ANZ, sub. DR74; NAB, sub. DR94; Westpac, sub. DR125). Contestability and its effect on competition is analysed in chapter 4. We consider that while the market is relatively contestable, new entrants, either in the form of foreign banks or fintech companies, are unlikely to significantly alter the balance of market power.

Undoubtedly, all ADIs aim to position themselves in the market such that they maintain or grow their market share, and there are elements of competitive behaviour. However, non-competitive outcomes can emerge even when each individual firm seeks to maximise its profit independently of others, if market concentration is high. Trends in profitability, pricing and product development in the banking system show that non-competitive outcomes are common — even if the banks believe they compete on each of the factors listed above.

Is there evidence of pricing competition?

In a competitive market, there should be limited scope for a single bank or a group of firms to increase prices (in the form of fees or interest rates) above their marginal costs for a sustained period. On the other hand, in a non-competitive market, ADIs with market power are able to remain profitable even when faced with significant shocks. Pricing power gives them the ability to pass through to their customers any price increases initiated by competing firms (Taylor 2000).

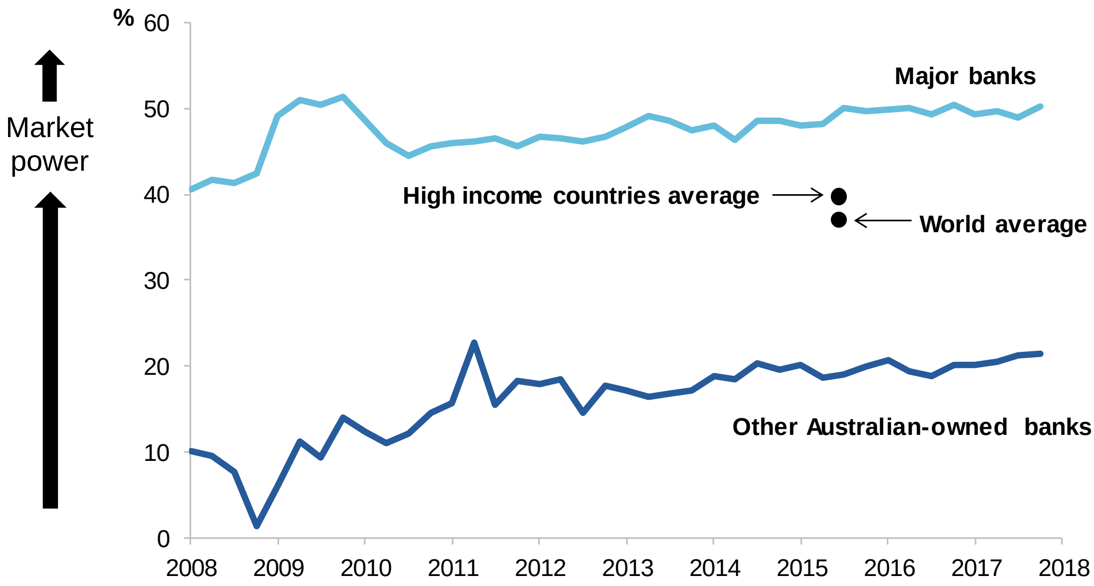
[8] Net interest margin in defined by the RBA as a measure of the difference between a bank’s interest earnings and interest expenses, expressed as a proportion of their interest-earning assets. Return on equity is defined as the ratio of net profit to shareholders' equity (Norman 2017; RBA nd).

Data shows that non-competitive pricing is evident in the banking market, particularly in the prices set by the major banks. We estimated the pricing power held by major banks and other-Australian owned banks, using aggregated data on the interest rates charged and the costs incurred by each group of institutions (chapter 2 provides more information on the Lerner index, which was used to estimate pricing power).

The analysis shows that both groups have some degree of pricing power — but major banks are the dominant force in the market. As a result, they are able to charge higher premiums above their marginal costs, compared with other institutions. Approximately half of the loan price that major banks charge is a premium over the marginal cost — double the margin that other Australian-owned banks have (figure 3.3).

Figure 3.3 **The major banks are able to use market power to keep prices above marginal costs**

Lerner index for market power in banking[a,b]



[a] The Lerner Index shows the extent to which prices (or in the case of banking, interest rates) exceed marginal cost. In a competitive market, prices are expected to equal marginal cost, and therefore the value of the index would be zero. Any number above zero indicates pricing power, and the value of the index can be compared across individual firms or groups of firms, to ascertain relative pricing power. [b] This chart compares the Productivity Commission Lerner estimates to Lerner index estimations of the World Bank. While efforts have been made to replicate the World bank methodology, this comparison is indicative only. Relative estimates of the Productivity Commission and World Bank may vary due to different input data sources and bank panel selection criteria.

Source: Productivity Commission estimates based on unpublished APRA data and World bank (2017)

Market power is evident in the way ADIs set their interest rates

Banks, and in particular the major banks, exhibit substantial pricing power. This is in part a reflection of the unique characteristics of financial products and the inherent information asymmetries in the market (ASIC, sub. DR123). This pricing power is manifested in the recurring argument used by all parties in the industry that cost increases — but not necessarily cost reductions — will have to be passed on to consumers.

This has been evident most recently in the responses to the changes to prudential regulation that increased banks' funding costs. Over the past five years, changes to prudential regulations have increased the cost of funding for the major banks. However, and as has been anticipated by regulators, they have been able to recoup these higher costs by increasing interest rates for borrowers (Atkin and Cheung 2017). This increase did not result in substantial loss of market shares to smaller ADIs. Rate increases were made possible in part by strong demand for housing loans in some segments; but even where regulators intervened specifically to curb this demand, ADIs were able to increase rates for new *and* existing borrowers, using their pricing power to increase their profits despite regulatory shocks. Other institutions followed the lead of the larger players, passing through price increases initiated by the major banks (chapter 7).

In its Inquiry into mortgage pricing,[9] the Australian Competition and Consumer Commission (ACCC, sub. DR129, p. 2) found substantial evidence that pricing decisions are not driven by competition:

> [P]rice competition between the Inquiry Banks, particularly the big four banks, has been less than vigorous. Signs of accommodative oligopoly behaviour, particularly among the big four banks, include:
>
> - an intense focus on each other with little regard to other lenders when setting variable interest rates
> - evidence they do not seek to compete by consistently offering the lowest headline rates, but instead aim to achieve a 'mid-market' position or broadly align their headline rates with the other big four banks
> - during late 2016 and early 2017, separate actions by two of the big four banks to reduce the size of discounts offered to borrowers with a view to leading rivals to follow, and achieving this result for some period.

According to the ACCC (2018), the big four banks tend to disregard the pricing decisions of smaller lenders — rather, they focus on the expected reactions of the other majors and any changes they may make to interest rates. As a result, each of the banks examined by the ACCC 'generally aim to set their headline variable rates to broadly align with the big four banks' (ACCC 2018, p. 29). The major banks view this behaviour as an attempt to compete and maximise their profits — but the end result from a consumer point of view is non-competitive pricing.

---

9 The Inquiry examined mortgage pricing policies of the big four banks and Macquarie Bank (ACCC, sub. DR129).

Some smaller institutions, such as credit unions and other customer-owned ADIs, tend to offer lower advertised interest rates than the major banks (COBA, sub. 21). They are able to do this because their business model relies primarily on deposits, which are a cheaper source of funding, and they do not need to meet the expectations of shareholders in relation to return on equity (chapter 4). But despite their lower prices, these institutions have limited competitive impact and their market share remains low. Many smaller institutions, however, reference the actions of the major banks — rather than their own marginal costs — for pricing decisions.

The lack of price competition is reinforced by obfuscation. The prices that ADIs advertise are often not indicative of what consumers actually pay (RBA, sub. 29; NAB, sub. 31).

Opaque pricing of this nature is not usually sustainable in competitive markets. For most products, consumers know in advance the price and make decisions accordingly. For loans, indicator rates are just that — indications, not actual prices. This lack of reliable information is a significant factor in keeping consumers unsure of their position, and more dependent on advice.

In the banking industry, unadvertised and uncertain discounts are common. Even more problematically, discounts are off a benchmark rate that is itself notional — the 'standard variable rate' — rather than off any substantial market price such as the actual rate offered last month to customers for a given class of loans (chapter 12).

The absence of accessible public data on *actual* prices is a distinguishing feature of this industry. This lack of transparency in pricing puts the onus on consumers to negotiate with banks without reasonable personal knowledge of the scope of possible outcomes. This puts most consumers at a severe disadvantage. The rise of brokers (and the accompanying cost) is fuelled by this lack of transparency. But brokers themselves may not know (and may not be able to offer) all the options. And where they do, they nevertheless do not owe the consumer a legal or contractual obligation to deliver them (chapter 11).

In the case of banking, discounts do not represent competitive behaviour (Sims 2018b). This is particularly so where they are based on a starting price that is not itself set competitively and that (apparently) very few people pay. According to NAB (sub. 31), discounts are applied to 70% of new home loans. If so, a reasonable question is whether the discount is real — or whether the discounted price is actually the genuine benchmark price. The ACCC has successfully taken to court parties that advertise discounts against a price that no one pays,[10] although it has not sought to do so in banking where discounts are not advertised.

Regardless of discounts offered to individuals, and the rate at which loans and deposits are advertised, the data indicates that prices of many comparable banking products tend to converge to a mean. In a competitive market, such a mean can be expected to be the efficient price. But this market exhibits an unusual degree of price discussion by regulators — through jawboning to influence the market in advance of price rises, or the actual revision of the cash

[10] For example, in 2013, retail jewellery chain Zamel's was fined for making false or misleading representations, after it advertised discounts off prices that were never or rarely charged (ACCC 2013b).

rate by the RBA or prudential requirements by APRA. With the usual follow-on language of passing on cost increases, the convergence in this case may not be solely a reflection of efficiency (chapter 7).

Particularly for home loans, interest rates offered by the major banks tend to move together, and the smaller institutions tend to mirror their decisions.

Fee changes are not necessarily indicative of competition

Banking fees have been growing at a slow rate for the past two decades (appendix C). Fees charged to households remained unchanged overall between 2010 and 2015, while fees charged to business increased annually by an average of 4.5%, mainly reflecting significant increases in the fees paid by merchants for processing the credit card transactions of their customers (Fitzpatrick and White 2017).

ADIs are able to adjust fees to support their business strategies. For example, after the GFC, when banks needed to raise deposits to continue operating, fees on deposit accounts declined significantly to attract more consumers, and they have remained low since (RBA, sub. 29).

Such evidence does not necessarily indicate that ADIs compete on fees. For households, product bundling makes it difficult to identify and compare the fees paid for specific products (chapter 9). More broadly, ADIs can substitute fee and non-fee income, for example by lowering fees on a credit card while increasing the interest rate, or lowering the annual fee while increasing other costs (RBA, sub. 29). While this behaviour may appear competitive, it may not improve outcomes for consumers, if they pay more overall. For small businesses paying for merchant services, the level of obfuscation and confusion around fees has attracted substantial regulatory intervention, but more can be done to improve competition (chapter 17).

As they do in mortgages, institutions tend to follow each other’s lead in setting fees. For example, in October 2017, it only took a few hours after the CBA announced it was removing all fees charged to customers of other banks who use CBA ATMs for all other major banks to follow its lead (Mather 2017). None of the ADIs (including the small institutions) chose to do so previously, despite the potential of this fee cut to make them appear more competitive — particularly given that this benefit would have been extended to customers of other institutions when they were using ATMs.

Competitive pressures may have contributed to lower fees for some products, but technological changes, such as an increased use of mobile banking applications, were an important factor in keeping fees low (Fitzpatrick and White 2017).

Competition in product features and service delivery?

Alongside the dominant majors, a large (albeit declining) number of institutions operate in the Australian banking system. There is still significant diversity within the system, and consumers can choose between a wide range of providers, which use a variety of different business models and marketing strategies (chapter 4).

In an attempt to broaden the range of services provided, institutions are constantly developing new products, or re-packaging existing products to appeal to specific groups of consumers. As a result, there is a very large number of products on the market, with nearly 4000 different residential property loans and 240 different credit cards on offer (Westpac, sub. 28).

This multitude of products may create the appearance of diversity, but it can also be counterproductive for consumers. Such a vast amount of apparently similar products creates confusion among consumers and deters comparison shopping and information-gathering. This level of obfuscation in markets for complex products (known as a ‘confusopoly’) can be a by-product of oligopolistic markets (Kalayci 2016).

Having more choices is not necessarily beneficial if consumers are confused and fail to choose. Superannuation is an excellent example — a number of surveys, including one conducted by the Productivity Commission as part of our superannuation inquiry, found about 60% people do not actively choose their fund (PC 2017a). It is well-established in academic studies of wealth investing that too much apparent choice creates disengagement (Barr and Diamond 2017; Fletcher 2016). So we cannot at face value accept it as evidence of effective competition.

The major banks argue that there is significant innovation across the banking system, and that this is an indicator of robust competition (for example, Westpac, sub. DR125). But while innovation may indeed be fast-paced in some parts of the banking system, this does not appear to have changed the overall competitive dynamics. The major banks have an incentive to continue investing in technology, as this both increases their efficiency and cements their market share.

Is there evidence of service competition?

Providers of financial products emphasise their efforts to improve service levels as evidence of competition. For banks, the emphasis on personalised service is driven by a need to differentiate themselves in order to maintain their position in the market and the strength of their brands (PwC 2016a). However, this is not necessarily what customers want. Surveys have shown that when choosing a financial institution, consumers are influenced more by lower prices and whether they view an institution as safe, rather than customer service (ABA, sub. 11).

Banking services have evolved over time, and nearly all providers can now offer the same level of basic service (for example, internet banking). Larger banks have the ability to offer a broader suite of products, as a result of their integration, and this is attractive to consumers due to its convenience. Branch opening hours have become more consumer friendly. Security of deposits and payments has been strongly promoted.

At the same time, some smaller institutions have emphasised services that are tailored to the needs of their local communities, as well as their regional focus. These practices have been done in different ways that suggest a fair level of service competition among ADIs.

Some small non-ADI lenders focus on service as a competitive strategy. For example, Firstmac offers fast settlement services, and Pepper Financial offers loans to customers who have not been able to secure credit elsewhere (Firstmac 2017; Pepper Group 2016). But their market shares remain very small, despite their service proposition.

Overall, while there is more evidence of variation in products on the basis of service and product features, it is likely that for many individual consumers, who only use a small range of financial products, there is ultimately little to distinguish the consumer experience across banks.

FINDING 3.1 STATE OF COMPETITION IN THE BANKING SYSTEM

Price competition in the banking system is limited. Although institutions claim that they compete in loan markets by discounting, such behaviour is not indicative of a competitive market when price obfuscation is common and discounts are specific to groups of customers.

Competition on product features and service is more evident. But the large number of marginally different products appears more reflective of a capacity for price discrimination than of competition.

Is efficiency a source of market power?

In a competitive system, all institutions would have to continuously strive to become more efficient in an attempt to maintain their market share. Australia’s large banks have relatively low operating costs, when compared to their peers overseas. According to the CBA, this is a reflection of efficiency and competition:

> The intensity of competition in Australia’s financial system has created incentives for Australian banks to become more productive.
>
> Australian banks are among the most efficient banks in the world, having a lower cost-to-income ratio, lower cost-to-asset ratio and lower operating expenses per customer than in most comparable countries … This reflects ongoing investment in technology which boosts productivity as well as improving customer service levels and outcomes. (sub. 25, p. 17)

The RBA takes a different view:

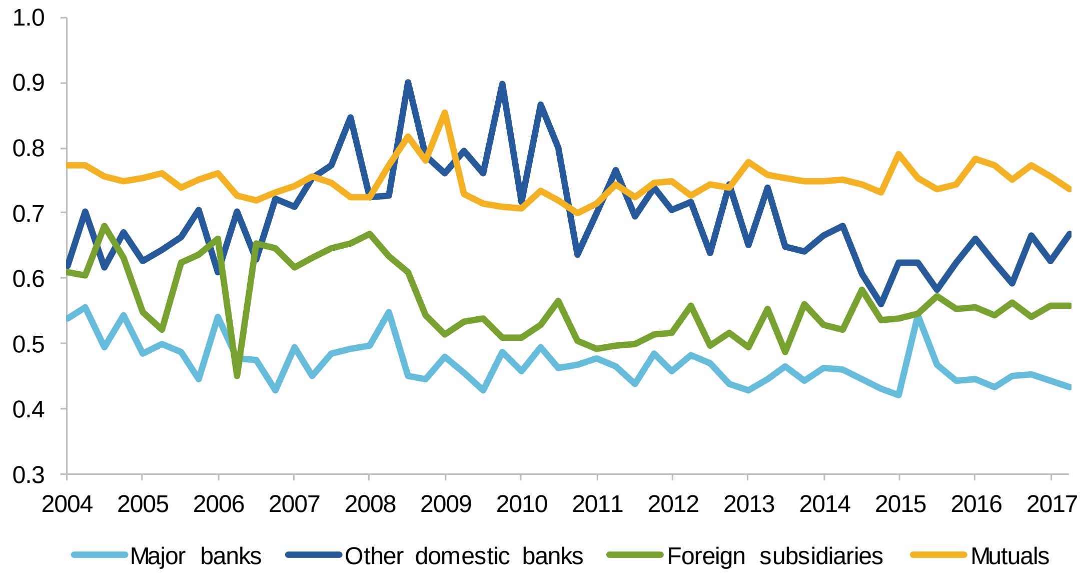
> Australian banks appear relatively efficient by international measures … However, drawing strong conclusions from such metrics is difficult, partly because variation in both ratios can reflect differences in business models (as well as regulatory and institutional differences). For

example, banks with a greater focus on traditional lending activity, including Australian banks, tend to have lower cost-to-income and cost-to-asset ratios than banks that focus on other activities, such as investment banking and wealth management. (sub. 29, pp. 10–11)

The ratio of cost to income for major banks is lower compared to other operators in the banking system (figure 3.4). But this ratio is only part of the efficiency picture. Larger banks tend to benefit from economies of scale and scope — but only up to a point (Bikker, Spierdijk and Finnie 2006; Panagiotis, Cabolis and Konstantinos 2016). A range of econometric analyses have found that most major banks are *less* efficient than smaller institutions (for example, Paul and Kourouche 2008; Saleh and Moradi-Motlagh 2014).

Efficiency can be measured in many ways, one of which is speed of service. Over time, all providers have had to make substantial investments in technology in response to shifting customer expectations (BIS 2017a). This has reduced the cost of providing banking services, but given the balance of pricing power in the banking sector, ADIs have not been compelled to pass on their individual cost savings to their customers, or use them to offset increases in cost of funding. However, new technology has improved institutions' ability to offer faster services, and from the consumers' perspective, these investments have delivered more convenient banking.

Figure 3.4 **Cost to income ratios, by type of institution**



Source: APRA (2018p)

Do profits reflect market power?

Maintaining and improving profitability are important goals for banks. The major banks explained in their submissions that remaining highly profitable allows them to maintain investor confidence, keep their high credit ratings and raise funds at lower cost (CBA, sub. DR79; Westpac, sub. DR125).

Banks’ net interest margins and return on equity — both important indicators of profitability — declined substantially over the past three decades, as a result of deregulation and the rise of brokers. This has affected both major and other Australian-owned banks.

Most recently these trends diverged during the GFC, when net interest margins and return on equity for major banks increased while the other banks experienced loss of profitability, as their cost of funding increased dramatically (Vu and Turnell 2011). In effect, the GFC consolidated the major banks’ dominant market position — they widened the gap between interest rates they charged on loans and the cash rate (net of the cash rate), depositors moved back to them and consolidation led to an increase in their market power.

Since the GFC, net interest margins (NIMs) and return on equity (ROE) declined a little for the major banks, for the most part returning to their pre-crisis levels (figure 3.5).[11] Major banks in Australia suffered minimal profit effect from the worst crisis in international financial markets for many decades; and historically the biggest shift in official interest rates. While this can be celebrated for its evidence of stability and government intervention to support the banks, it strongly suggests competitive rivalry is ineffective, within the big four as well as beyond them.

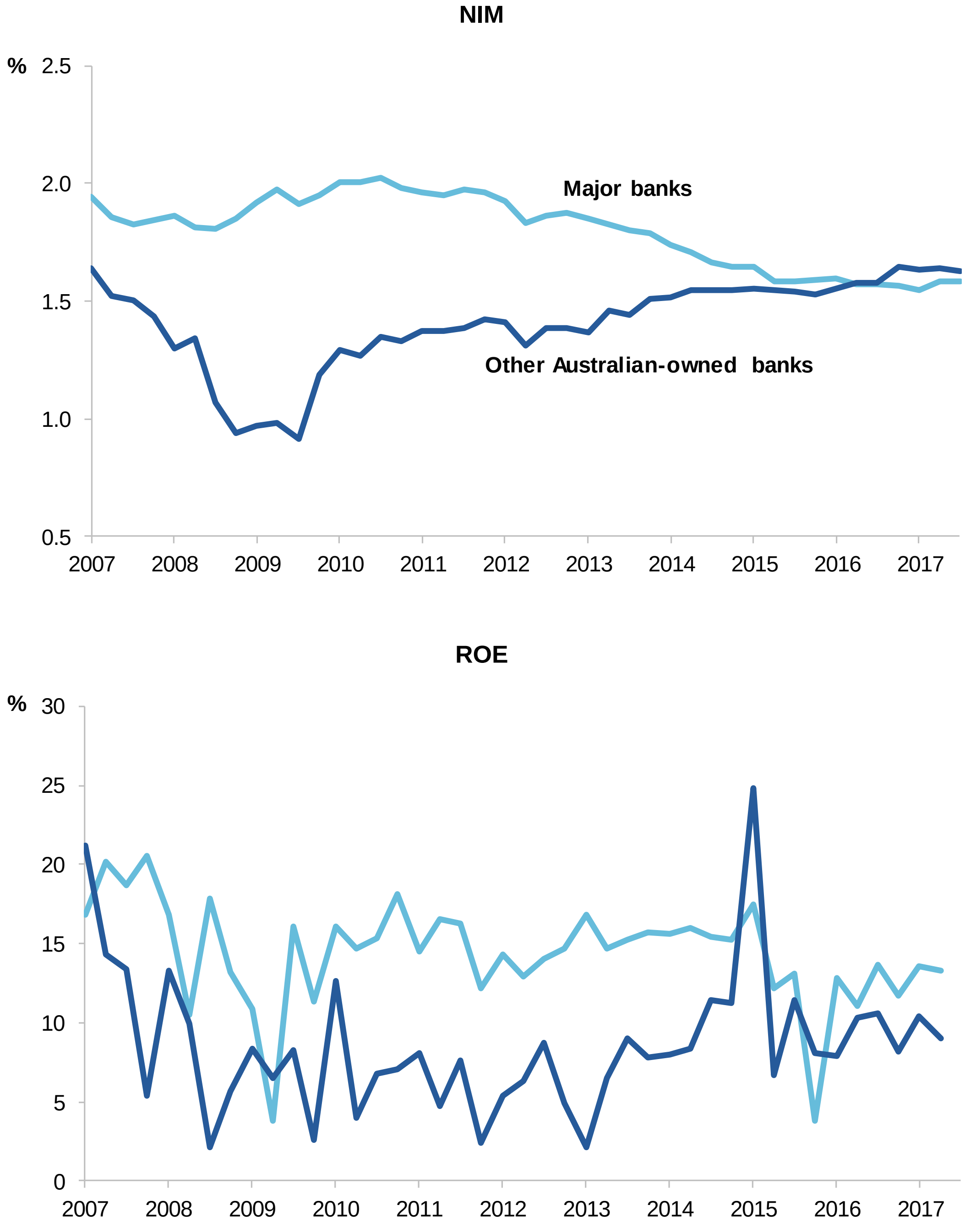
In their submissions to this Inquiry, the major banks have all emphasised the ongoing erosion in ROE as an important indicator of competition (ANZ, sub. DR74; CBA, sub,. DR79; NAB, sub. D94; Westpac, sub. DR125). The regional banks (sub. DR107, p. 25) have taken a different view, stating that they ‘do not believe that recent declines in ROE are reflective of an improvement in the competitive dynamics of the sector’.

In the Commission’s view, the reasons for the shift that did occur in large bank ROE in recent years appear to be related to factors other than competition. Regulatory changes in the wake of the GFC have been a notable factor, as banks are now required to hold relatively low-yielding liquid assets, and have had to increase their capital provision (RBA, sub. 29).

And notably, such declines have been observed in banking systems across the developed world. But compared with other countries, the drop in ROE in the Australian banking system has been far smaller and can be attributed to an expansion in banks’ assets bases and regulated capital requirements, rather than an erosion in their profits resulting from competition (as occurred, for example, in Japan) (BIS 2018).

11 Profits have been increasing in recent months, as banks have benefited from the regulatory push to curb investor and interest only housing lending (which resulted in higher interest rates charged), as well as a drop in funding costs and charges for bad and doubtful debts (RBA 2018e).

Figure 3.5 Australian banks' NIM and ROE



Source: NIM (net interest margin) — APRA unpublished data; ROE (return on equity) — APRA (2018p)

Faced with the prospect of lower profits, the major banks in some instances, increased prices, without loss of market share, so that they could achieve performance targets (ACCC 2018). They have also taken other steps, such as selling their wealth management operations, in order to maintain profitability in line with shareholder expectation (APRA, sub. 22).

For other smaller Australian-owned banks, NIMs and ROEs have been *increasing* since the GFC, as their funding costs have declined (RBA, sub. 29). Their ability to recover from the GFC shock is significant, and comes despite cost increases resulting from regulatory change. All told, profitability for this industry has proven remarkably stable despite such a massive shock. Regulator action has also contributed to profitability — most recently, regulatory intervention resulted in an increase in interest rates charged for investor and interest-only housing loans, which supported bank profits (chapter 7).

The lack of variability in market performance is celebrated by agencies that favour stability. But in discouraging risk-taking and rivalrous behaviour, the scope to act competitively is minimised.

The significance of slightly lower profits for major banks since 2013 as an indicator of competition seems overstated. It coincided with other banks lifting returns, generally not a sign of effective price competition. All in all, it suggests a reversion to the medium term market position for all banks as a group; whereas in a competitive market, significant diversion from that mean might have been expected to persist as strategies to cut costs and recover market shares would have pressured profits for all players.

The analysis thus tends to indicate that as far as profit is an indicator, competition is weak. Overall, the industry has proven remarkably resilient to extreme pressure.

Banking — an oligopoly with a long tail

Due to its economies of scale, banking is one industry where a small number of large operators can represent an efficient, low-cost market structure (RBA, sub. 29).

In Australia, there is some good evidence of relative cost efficiency by the major banks, compared to their peers overseas (chapter 8, appendix C).

Yet oligopoly behaviour and the ability to use market power adversely are also evident (ACCC, sub. DR129). Indeed, the major banks themselves are unable to identify competitive threats in the domestic markets, and they focus on large technology companies overseas as their future potential competitors (Yeates 2017b). Such threats have yet to eventuate, and will in any event need to exist in the regulated environment that consciously limits rivalrous behaviour.

The 'tail' of smaller providers aims primarily to match the major banks in their pricing. As they are subject to similar or, at times, more costly regulation and do not benefit from the funding or efficiency advantages of the major banks, they are often unable to offer prices that are substantially lower. Some of the smaller banks, in particular foreign institutions, operate in niche markets (such as agribusiness) where they can potentially benefit from specialisation and set prices that reflect their capacity to price discriminate. Others, such as credit unions and other mutually owned institutions, are consolidating in order to benefit from economies of scale (chapter 4). But in the market for retail banking services, it is the major banks that dominate, and other players follow their lead.

Competitive behaviour may show up occasionally in some parts of the market — for example, in past decades, the entry of mortgage originators and foreign banks introducing online deposits (chapter 4). But it is hard to identify contemporary evidence of effective competition or a break-out of disruption from the environment in which the tail operates.

While there is much discussion about the desirable effects of competition, and the need to achieve more competitive outcomes, regulators seem to value more highly the apparent safety of large, established operators. When combined with the scale advantages of larger banks and the tendency for smaller institutions to follow the lead of these large banks, this means that risk taking is uncommon. As long as this status quo remains unchallenged, we will have few risk takers and limited innovation and disruption.

A different status quo that supports innovation and disruption need not alter current industry structure. This report makes recommendations in a range of areas, from addressing conflicts of interest to giving competition a genuine voice in the regulatory process. While these policy measures can substantially mitigate adverse outcomes for consumers, they are not aimed at changing the fundamental structure of the banking system. This structure has evolved over many years of interactions between providers and regulators, and while it can do better, redefining its foundations will bring much more costs than community benefit.

FINDING 3.2 THE STRUCTURE OF THE BANKING SYSTEM

Australia's banking sector is an established oligopoly with a long tail of smaller providers.

The four major banks as a group hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is substantially supported by regulatory settings, which contribute to the major banks' structural advantages.

As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability — with minimal loss of market share.

The smaller banks and non-bank financial institutions typically follow the pricing trend set by the major banks, and are not a significant competitive constraint on the major banks' market power.

Adding cost to the larger banks without altering their market power does not lift competition, harms consumers and is counter-productive. Policy measures aimed at addressing either conflicts of interest or regulatory interventions that disregard competition, can mitigate adverse outcomes for consumers even if the current industry structure remains largely intact.

4 Can new players change the game?

Key points

- In the past decade, there has been substantial consolidation in Australia's banking system. Many authorised deposit-taking institutions (ADIs) have either merged or exited but relatively few have entered. Entities that have received a new ADI licence are mostly branches of foreign banks with limited scope for competitive impact.
- The experience over the past couple of decades suggests that new entrants (both ADIs and non-ADIs) have had limited success in spurring competition across the broader financial system.
- More entrants alone cannot be relied upon to drive sustained competition in Australia's financial system.
- The Australian Government and regulators are working to reduce regulatory barriers to entry, such as making it easier to become and be known as a bank. These initiatives are valuable at the margin, and other measures that lower regulatory barriers should be implemented as a matter of priority.
- In the past, foreign banks were heralded as the institutions that would provide competition in Australia's banking system. However, their presence remains limited to select areas of the system, such as corporate lending. There are a number of reasons for this.
  - The regulatory system makes it easier for foreign banks to set up 'branches', rather than fully-functional 'subsidiaries', restricting their ability to compete for household deposits.
  - It can take substantial investment to establish a presence in the Australian financial system, where the major banks have entrenched market dominance.
  - Trends in overseas regulations and market conditions in the foreign bank's country of origin can impact their appetite for expansion to other markets, including Australia.
- Although a very small part of the system, the expansion of the 'fintech' sector provides an avenue for change in the financial system.
  - Comparatively fast uptake of technology advances by Australian consumers and a premium on access to information and speed offer opportunities.
  - Insightful use of data — such as that facilitated through Open Banking and the new consumer data right — should assist new challenger banks.
- However, many fintechs appear to be looking to collaborate with incumbent banks rather than compete against them. They may thus improve some aspects of the system without radically altering it. Like all other new businesses, fintechs can find it difficult to draw in new customers, raise capital, deal with the regulatory system and compete on price against large incumbents.
- Large global technology companies, such as Apple, Google and Amazon, are also entering parts of the financial system, such as in the payments system. These companies have large networks of established customers, giving them a strong base from which to offer broader financial services, but are yet to make any significant impact.
- ASIC has very few fintechs digging in its regulatory sandbox. The Australian Government should expand ASIC's ability to include prudentially regulated fintechs that want to hold household deposits and provide other financial products or services. ASIC should also take a more hands-on approach to approving, supporting and monitoring fintechs in testing their products or services.

Contestability is a key condition for improving competition in concentrated markets. A contestable market is one where there are low or no barriers to entry and exit. In this case, a provider that is inefficient or earns excess profits would, in the long term, lose market share to, or be driven out by, a rival or new entrant that is more efficient or seeks to take the incumbent's customers and profits as its own (chapter 2). Historically it has typically been new players to the financial system that have driven competition.

> Periods of heightened competition in the Australian financial system have typically been driven by new entrants rather than established players. The entry of mortgage originators, foreign banks offering online deposit accounts and, recently, Asian banks offering large business loans have all had a significant effect on competition in their respective markets. (RBA sub. 29, p. 2)

This chapter focuses on entry, exit and contestability in Australia's banking market, with particular focus on foreign banks and the financial technology ('fintech') sector as a source of competition. Discussion of contestability in other sectors of the financial system can be found in the relevant chapters, such as general insurance (chapter 14) or the payments system (chapter 17).

4.1 Entry, exit and contestability in banking

Over the past 30 years, Australia has seen pockets of competition from new entrants. For example, the entry of Aussie Home Loans into the residential mortgage market in 1992 is widely considered to have led to a dramatic reduction in overall home loan prices. And Tyro has brought competition to parts of the payments system. Even a credible threat of entry can lead existing firms to compete harder.

However, the experience across the past decade suggests that despite their entry, new players have had limited success in spurring competition beyond their (often specialised) area of focus. There are several possible reasons for this: economies of scale that give larger incumbent banks a competitive advantage (chapter 3); vertical integration by incumbents that is used to stave off competitive threats (chapter 9); and consumers struggling to see the benefits to them from making the effort to switch banks (chapter 5). In light of such factors, more entrants alone cannot be relied upon to drive competition in the financial system.

To compete in retail banking, entities must be authorised deposit-taking institutions (ADIs). From 2005 to 2017, the number of entities with an ADI licence dropped from 239 to 148 — a reduction of almost 40% (figure 4.1). Consolidation over time is to be expected given the benefits of scale economies and lower funding costs for larger banks.

From June 2007 to June 2017, 26 entrants received a new ADI licence — all of which were branches of foreign banks.[12] Yet (as foreign branches with no authority to take domestic

[12] Four of these entrants have since exited the market. Some institutions that already had an ADI licence have since had them varied over this period. For example, Tyro (2015) (formerly MoneySwitch) received a limited licence in 2005 and had their licence varied in 2015 to become a full ADI.

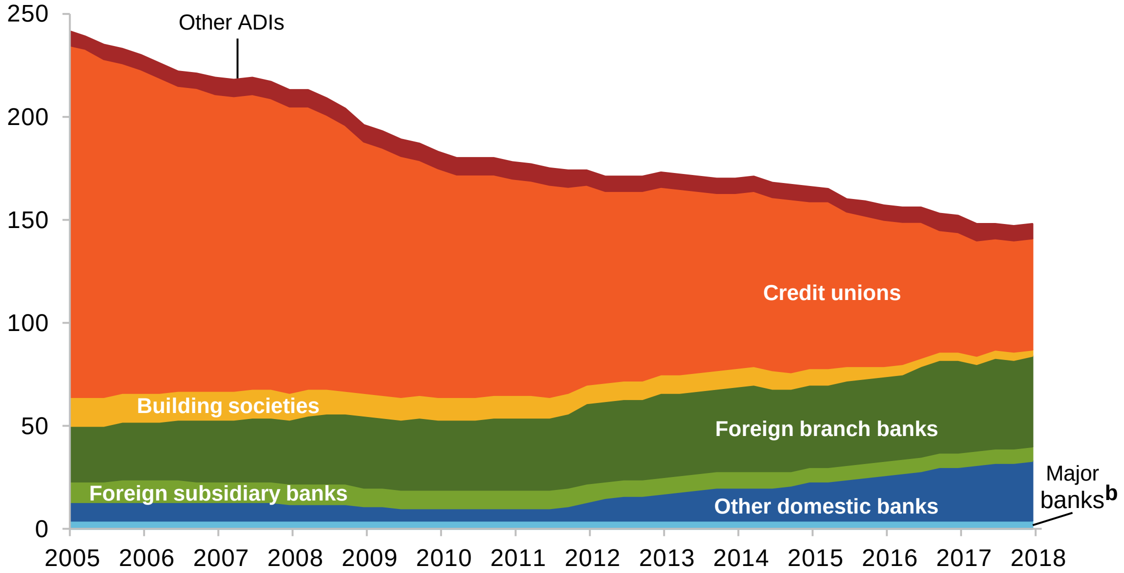
deposits) these banks have limited capacity to capture market share in Australia's retail banking markets.

There is some change on the horizon. Several entities have expressed their intention to become ADIs in the future. In 2018, volt bank became the first institution authorised for a Restricted ADI licence (APRA 2018c), and both Xinja (sub. DR67) and Judo Capital (sub. 12) are each working towards getting a banking licence in 2018.

Consolidation in Australia's retail banking system has largely come from mergers between smaller players, particularly credit unions and building societies (APRA pers. comm., 14 September 2017). Between January 2008 and June 2017, of the 71 credit unions and building societies that exited the market, 69 merged with other institutions, with 29 mergers in 2008 and 2009 alone (Productivity Commission analysis of APRA unpublished data). In comparison, during the same period 7 banks merged, and 11 banks exited the market (including 6 foreign bank branches).

Figure 4.1 **The net result of ADI entries and exits**[a]

Total number of ADIs



[a] Some ADIs have switched licence types or merged rather than formally exiting or entering the system. For example, several credit unions became 'mutual banks' and are included in 'other domestic banks'. [b] Major banks are made up of CBA, Westpac, NAB and ANZ.

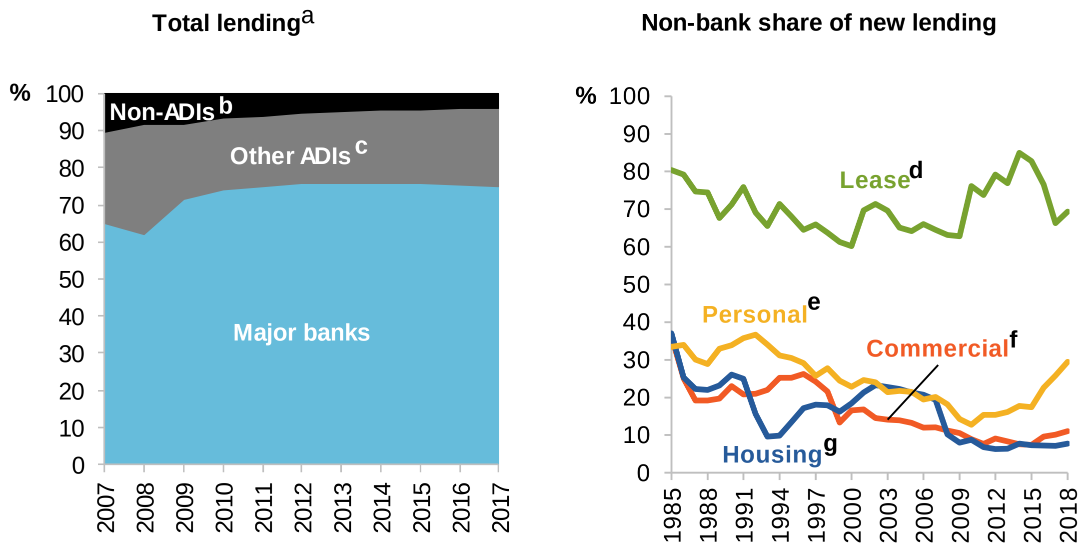
Source: APRA (2017r)

Non-ADI lenders, such as Firstmac, provide another source of competition to incumbent banks in some lending markets. Non-ADI lenders raise a significant proportion of their funds through securitisation, given they cannot hold deposits (chapter 8). However, the non-ADI share of all lending in Australia has slowly declined since the global financial crisis (figure 4.2).

Non-bank lenders (which may include some ADIs that are not called banks) have very low market shares in new owner-occupied housing and commercial lending (figure 4.2). Yet, non-bank lenders dominate the market for lease finance in Australia and have recently gained significant market share in personal lending.

Growth in the fintech sector provides a potential avenue for competition and change in Australia's financial system and worldwide. Fintech companies exploit technology and data to provide innovative financial services and products. But, instead of becoming banks, many fintechs are focusing on providing services in less-regulated areas of the financial system, such as investment and lending.

Figure 4.2 **Bank and non-bank lending**



[a] Total gross loans and advances. Domestic books for banks, licensed books for credit unions, building societies, Registered Financial Corporations (RFCs) and wholesale funders. [b] Non-ADIs are RFCs engaged in lending activities that are not ADIs. RFCs include wholesale funders. RFC data are provided by APRA, but not publicly available. RFCs initially self-identify to APRA, and are required to report only if they meet the criteria in section 7 of the *Financial Sector (Collection of Data) Act 2001* (Cth). This therefore underestimates their market share. [c] Includes all non-major banks. [d] Includes finance companies and general financiers. [e] Includes credit co-operatives and finance companies. Personal loans also includes unsecured housing finance for owner occupation. [f] Includes money market corporations and finance companies. [g] Includes permanent building societies and wholesale lenders (securitisation). Housing involves secured finance for owner occupation.

Source: ABS (2018e); APRA unpublished data

FINDING 4.1 A CONSOLIDATION IN BANKING

There has been substantial consolidation in Australia's banking system. From 2005 to 2017, the number of organisations with a banking licence fell by almost 40%. This was largely a result of mergers between institutions, rather than exits.

Regulatory barriers to bank entry are falling

High barriers to entry can deter potential competitors from entering and expanding in the financial system. Barriers to entry may be inherent, such as the advantages of scale economies, or difficulties in accessing investment and attracting customers. In other cases, regulatory requirements constructed to protect financial stability, promote consumer confidence in the financial system and discourage poor conduct can (either deliberately or inadvertently) become barriers to entry (chapter 18). For example, the Australian Prudential Regulation Authority (APRA) licenses ADIs (including banks) to facilitate financial stability. This necessarily also create entry barriers. These barriers may extend further in the future. Legislation passed in early 2018 gave APRA new powers to extend its reach to intervene in the non-ADI sector if it identifies a systemic risk to financial stability (Australian Government 2017i).

It is important to distinguish between barriers necessary to preserve regulatory objectives, such as financial stability, and those that unnecessarily inhibit competition from new entrants. Given the potential for new entrants, such as fintechs, to disrupt and compete in retail banking, unnecessary barriers to entry should be removed.

The requirement for an entity to hold a banking licence before it can accept deposits from the general public is common around the world. An entity seeking to operate a banking business in Australia must be authorised by APRA (2008a) and be subject to prudential requirements, such as regulatory capital, governance, risk management and compliance.

The Australian Competition and Consumer Commission (sub. 17) argued that regulations such as prudential and ownership requirements that make it difficult for small entities to become a bank, may be unnecessarily restricting new entry and expansion in financial services markets. This has been accepted in part by the Australian Government and APRA, and there are some initiatives in train aimed at reducing these barriers.

In 2018, the Australian Government passed legislation that removed the need for ADIs to hold $50 million in safe capital before they could call themselves a 'bank' (*Treasury Laws Amendment (Banking Measures No. 1) Act 2018* (Cth)). This measure was initially intended to give customers confidence in their financial institutions (APRA 2015c). But it may have acted as a significant deterrent for new entities and existing non-bank ADIs (such as credit unions) that might aim to compete with banks in some markets. A difference in naming conventions can create confusion for some consumers (COBA, sub. 21; Heritage Bank 2017b). Under the new rules, any ADI, regardless of size, can call themselves a bank unless APRA expressly prohibits them from doing so because they lack the ordinary characteristics of a bank, such as stored value payment facilities (APRA 2018e).

In 2018, APRA (2018a) formally established a new centralised licensing team, designed to take a more consultative approach to new entrants, and a new pathway for small entrants to become ADIs. The pathway involves a new 'Restricted ADI' licence which allows entrants to conduct limited banking activities for a maximum of two years while they are still developing the resources and capabilities necessary to become a full ADI. Restricted ADIs are limited to accepting individual customer deposits of $250 000 and aggregate deposits of $2 million.

Xinja (sub. DR67) suggested that the $2 million limit on total deposits affects their ability to offer offset accounts with mortgages because a small number of customers would likely absorb the cap. While this may slow growth initially, the Commission does not expect this cap to significantly deter entry. Prospective banks can still test their products within this cap and graduate to a full ADI licence when they are ready — in fact this is encouraged by APRA (2018a).

This cap and time limit on Restricted ADIs is also more generous than the comparable process in the United Kingdom which limits similarly-restricted banks to deposits of £50 000 and a maximum of one year in which to become fully operational (PRA 2018). And this is believed to be largely responsible for increasing the number of new entrants in the United Kingdom from 1 bank in 2010 to more than 14 since 2014 (Wallace 2016; Woolard 2017).

Restricted ADIs are only required to hold a minimum of about $4 million in safe capital ($3 million plus wind-up costs of typically $1 million). Therefore, removing the need for an ADI to hold $50 million in capital to call themselves a bank, and the introduction of a Restricted ADI licence means the financial barrier to becoming a bank is now much lower. While full ADIs do not have a set dollar threshold for becoming a bank — they have a minimum capital ratio in percentage terms — they would likely be expected to hold at least as much as that required of Restricted ADIs.

APRA's new framework is already yielding results. In May 2018, volt bank became the first institution authorised for a restricted ADI licence (APRA 2018c) and others such as Xinja (sub. DR67) expect to follow suit. However, this does not mean the work is done. APRA should be conscious that in the future new entrants will come in various shapes and sizes, have innovative business models and use new ways of meeting regulatory requirements. This is particularly likely to be the case with the introduction of Open Banking. APRA should be flexible and accommodative to give potentially vigorous competitors a chance to compete.

The reduction or removal of similar barriers should be high on the Australian Government's and regulators' priority lists. This includes initiatives already in train, such as potential changes to the ownership cap under the *Financial Sector (Shareholdings) Act 1998* (Cth) (discussed in chapter 6). Further, this Inquiry has made several recommendations to review or lower regulatory barriers to entry and growth in the payments system (chapter 17) and financial services more broadly (section 4.3). The Australian Government and regulators, including the new competition champion, must continue to search for opportunities to remove unnecessary regulatory (and other) barriers to entry and growth in the financial system.

4.2 Foreign bank impacts are limited to select markets

In the past, foreign banks have been heralded as the entrants that will provide competition in Australia's banking system (Fear, Richard and Richardson 2010). This may be the case in the select markets in which they have chosen to focus, but they have not yet proven a significant source of competition to the major banks across the broader financial system.

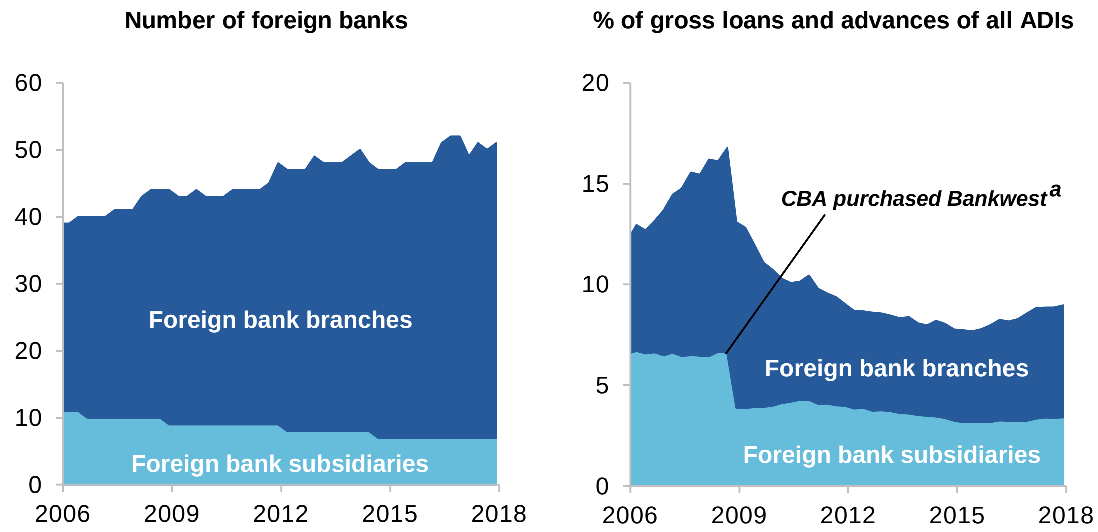
How foreign banks fit into Australia's banking system

As noted above, the vast majority of new entrants in the banking system have been foreign banks. The presence of these banks remains relatively small — they held just 9% of gross loans and advances of all ADIs by the end of 2017 (figure 4.3). As at December 2017, the largest foreign bank in Australia was ING, which accounted for just 2% of gross loans and advances and 2% of total deposits (APRA 2018n).

Foreign banks operate in Australia either as subsidiaries or branches of their overseas parent company. The main difference is that 'foreign bank subsidiaries' are incorporated in Australia and can accept retail deposits (of less than $250 000) from Australian residents, meaning that they face the same prudential requirements as domestic ADIs (table 4.1). This compliance makes it more difficult for foreign banks to enter as subsidiaries, particularly if APRA's prudential settings are conservative relative to those in the foreign bank's home country.

In contrast, 'foreign bank branches' are not locally incorporated and are therefore mainly supervised by the prudential regulator in their home country. These branches do not face the same prudential requirements as domestic ADIs and can only accept retail deposits from Australian residents or non-corporate institutions of $250 000 or more (APRA 2008a). It is much simpler for foreign banks to open and operate a branch in Australia than a subsidiary.

Figure 4.3 **Foreign banks in Australia**



[a] Bankwest was acquired by the Bank of Scotland in 1995, operating as a foreign bank subsidiary. In 2008, CBA purchased Bankwest and its assets were no longer recorded as a foreign bank subsidiary.

Source: APRA (2017r)

Foreign banks were first allowed to enter the Australian banking market in the mid-1980s. Over the past decade, the number of foreign banks operating in Australia has grown, largely driven by an increase in the number of foreign bank branches (figure 4.3). Foreign banks' share of all ADI assets grew prior to the global financial crisis. But their market share sharply reversed soon after, as many foreign bank parent institutions reduced their Australian exposures (RBA sub. 29).

Most foreign banks operate as branches. Just one foreign bank subsidiary has entered the Australian financial system since 2003, but more than 30 foreign bank branches entered over the same period (though some have since exited) (APRA pers. comm., 14 September 2017). Further, some subsidiaries have since exited or merged. For example, Bankwest was acquired by the Bank of Scotland in 1995, operating as a foreign bank subsidiary, after which it was purchased by the Commonwealth Bank of Australia (CBA) in 2008 (RBA 2012b).

Table 4.1 **Overview of foreign banks operating in Australia**[a]

Foreign bank	*ADI*	*Locally incorporated*	*Retail deposits*[b]	*Other deposits*	*Number*[c]
Subsidiary	Yes	Yes	Yes	Yes	7
Branch	Yes	No	No	Yes	44
Representative office[d]	No	No	No	No	12

[a] Some foreign banks operate both a branch and subsidiary in Australia. [b] Retail deposits are deposits accepted from Australia residents and non-corporate institutions of less than $250 000. [c] Number as at 18 May 2018. [d] Foreign banks can also establish representative offices in Australia to conduct research or liaise with Australian customers of the bank, but these are not ADIs and cannot accept any deposits.

Source: APRA (2007, 2008a, 2017g, 2017l)

In the past, some foreign banks replaced their subsidiaries with branches (RBA 2012b). This preference to operate as a foreign bank branch is likely explained by the difference in regulatory treatment between a branch and subsidiary. This includes differences in regulatory requirements between these two types of banks, but also differences between Australia’s regulatory requirements (including financial system, taxation, corporations and employment laws) and those in other countries in which the foreign banks operate.

Foreign banks largely specialise in particular market segments

In Australia, foreign banks have been competitive in particular market segments at different times, but not more broadly across the financial system. Since 2002, foreign banks have held significant market share in business loans, credit cards and business deposits (figure 4.4). But depending on the type of bank, the markets in which they operate differ markedly.

Foreign bank branches tend to be active in *business* lending and deposits, and hold significant market shares (figure 4.4). Over the past decade, foreign banks have increased their share of business deposits, largely driven by foreign bank branches. And over the past five years, foreign bank lending to businesses has increased, again driven by foreign bank branches. In fact, foreign bank subsidiaries’ share of business lending has declined since 2007. The major banks hold significantly lower shares in the market for large business loans (60–70%), where foreign banks are more active, compared to personal deposits and housing loans (70–80%) (RBA, sub. 29), with returns on business lending competed down.

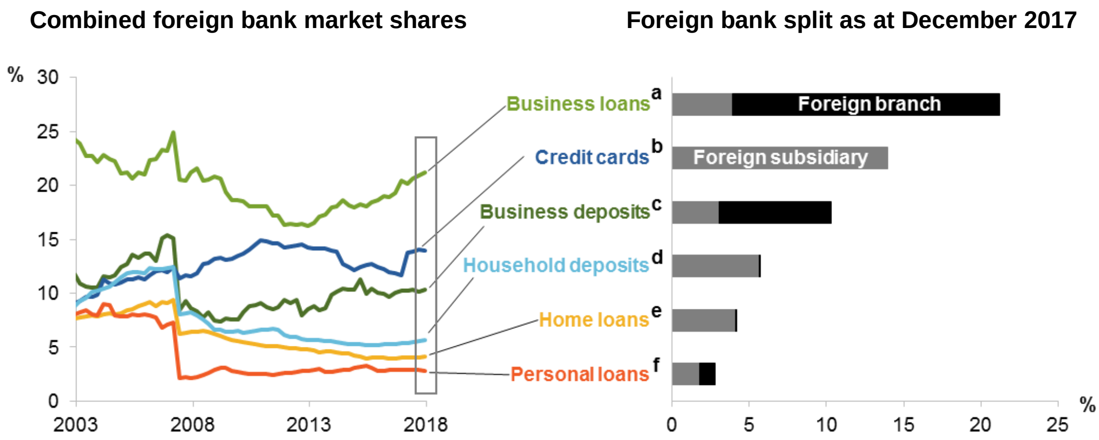
> Over the past few years, the [interest rate to cash rate] spread on large business lending has declined as competition has emerged from foreign banks. (RBA, sub. 29, p. 15)

In contrast, foreign bank subsidiaries are the main foreign players in *household* lending and deposits, but they tend to hold comparatively small market shares (figure 4.4).

During the late-1990s and early 2000s, some foreign bank subsidiaries, such as ING (sub. 20), pioneered high-yield online savings accounts in Australia. These accounts typically offer deposit interest rates around or above the RBA cash rate target. This is likely to have contributed to a significant increase in the foreign banks' (mostly foreign bank subsidiaries) market share of household deposits during the early to mid-2000s (figure 4.4). Subsequently, Australian-based banks introduced similar accounts. This is an excellent example of new entrants providing an innovative banking product at a competitive price, and pushing their peers to compete.

More recently, foreign bank subsidiaries have steadily increased their market share for credit cards (figure 4.4). A number of smaller ADIs advised the Commission that they use foreign banks, such as Citibank, to issue credit cards for their customers.

Figure 4.4 Foreign bank market shares in select product segments



[a] Loans to non-financial corporations. [b] Credit card loans to households. [c] Deposits from non-financial corporations. [d] Deposits from households. [e] Loans to households for owner-occupied and investment housing. [f] All other loans to households.

Source: APRA (2018n)

Foreign banks are less active in the small business lending market (chapter 16). Again, this is likely because it is foreign bank branches that have increased their business lending in the past, but they are unable to offer a broader banking relationship to many small business customers — they cannot take deposits below $250 000 from non-corporate businesses. Therefore, lending to small businesses is more likely to come from foreign bank subsidiaries in the future. The RBA (sub. 29, p. 40) stated that 'the small business market could most benefit from foreign entrants at present'. Some foreign banks have managed to successfully build market share in parts of the small business lending market.

> While the major banks tend to offer lending products to most segments of the small business loan market, many smaller local and foreign lenders tend to specialise. One example is the large market share in lending to the agricultural sector by foreign banks. (RBA, sub. 29, p. 26)

For example, Rabobank specialises in agricultural banking and lending globally. This gives its Australian subsidiary a competitive advantage in access to an international network of resources and expertise in its core focus of lending to agricultural businesses (Rabobank 2014).

The inactivity of foreign bank branches in the market for household and small business lending, including mortgages, in part reflects their inability to offer retail deposits to these groups. Indeed, incumbent financial institutions use product bundling strategically to protect their market power by making it harder for those who do not bundle to compete (chapter 9). For example, while a foreign bank branch can offer individuals a home loan, they may be unable to offer them an associated offset or transaction account, limiting their ability to compete in a market where these products are often bundled together.

Both types of foreign banks can derive a cost advantage from being able to access funds globally through their parent company. This should give them another potential source of funding which may be cheaper and relatively easier to get than some of their Australian counterparts. However, to the extent that Australian retail deposits are a relatively low-cost source of funding, this restriction can limit the ability of foreign bank branches (but not foreign bank subsidiaries) to provide effective competition in household lending.

> Branches tend to concentrate on wholesale banking operations because they have more flexibility to access funding globally, including through their parents, and are less constrained by large exposure limits, which helps them meet the demands of large corporate clients. By contrast, subsidiaries tend to be more retail focused, where large exposures are less significant, and their access to local retail depositors means they fund a larger share of their lending through deposits. (RBA 2012b, p. 38)

Are there additional barriers to foreign bank entry and expansion?

In principle, the consistent profitability of Australia's larger banks has the potential to make the local market attractive to new foreign operators (chapter 3). While the same regulatory barriers (discussed earlier) affecting new domestic banks also affect foreign banks, the foreign banks have the option of drawing on the resources and reputation of the foreign operator to establish a branch in Australia, either as a part-way step to being a retail bank or to service the business or wholesale market.

Yet, foreign bank branches have to decide whether the additional regulatory burdens required of foreign bank subsidiaries is worth the potential benefits of accessing new markets. Experience to date suggests the benefits generally do not outweigh the costs.

It can take substantial investment for foreign banks to establish a presence in the Australian financial system, where the major banks have entrenched market dominance. However, structural barriers to foreign entry, such as the costs of establishing a distribution network, are falling as technology develops and the use of alternative distribution channels increases. For example, ING (sub. 20) (a foreign bank subsidiary) uses an established network of mortgage brokers and financial planners to tap into the residential home loan market.

Foreign banks may choose to target and specialise in providing services for particular market segments. For example, established Asian banks may find it easier to achieve brand recognition and loyalty in communities where there is a larger population with ties to Asia.

The RBA suggested that one of the most important factors influencing the entry and expansion of foreign banks in Australia remains conditions in their country of origin.

> … participation of foreign banks in Australian markets has been heavily influenced by conditions faced by their parent entities and in their home economies. Prior to the financial crisis, European and US bank participation in Australian banking markets had increased rapidly as their home economies experienced strong growth. However, as a result of the crises in these regions, these institutions quickly reduced their Australian exposures. (RBA, sub. 29, p. 18)

Indeed, several regional banks suggested that trends in overseas regulation can also act as a barrier to foreign banks becoming vigorous competitors in the future.

> The trend in regulation since the [global financial crisis] is to encourage international banks to reduce their size and geographic footprint, not expand. Globally systemic banks (G-SIBs) are subjected to higher capital charges and domestic regulators are wary of the taxpayer implications of allowing these banks to expand outside their home jurisdiction. Many countries are discouraging growth with taxes on total liabilities. (Regional Banks, sub. DR107, p. 4)

FINDING 4.2 FOREIGN BANKS TEND TO OPERATE IN SELECT MARKETS

Foreign banks have shown that they are willing to enter Australia’s banking system — between 2007 and 2018, the vast majority of new entrants to the banking system were foreign bank branches.

The regulatory framework incentivises foreign banks to enter and compete in the wholesale banking sector, rather than compete for household deposits. While they are important to innovation and to price competition in certain market segments, foreign banks remain focused on specific market segments, and are not likely to prove a competitive threat in the broader retail banking sector.

4.3 Fintechs can change the rules of the game

Broadly, fintechs use innovative technology and business models to enable or enhance the provision of financial services.[13] This means they can be start-ups, mature companies and even non-financial services entities. Fintech opportunities can arise from the operational and process shortcomings of incumbent entities.

Australia's retail banking system offers a variety of opportunities for innovative fintechs to enter, grow and compete. Profits of larger members are generally high (chapter 3); Australians are, for the most part, comparatively quick to take up new technology; and the premium placed on ready access to information makes the provision of financial services vulnerable to disruption and evolution as technology advances. For example, the introduction of ATMs, electronic payments and internet banking have changed the way people access financial services in the past (BIS 2017a). EY (2017b) estimated that 37% of Australia's digitally active population are fintech users.

Fintechs are often seen as a potential source of competition in Australia's financial system. The number of fintechs is growing rapidly. In recent years, the fintech sector in Australia has grown from less than 100 start-up companies in 2014 to nearly 600 in 2017 (KPMG 2017a). However, fintechs are yet to grab a significant share of the market.[14] One estimate shows new fintech lending to businesses was about $480 million[15] in 2016, a drop in the ocean compared to over $390 billion in new business lending across the entire financial system in 2016 (ABS 2018e).

The many faces of fintech

Fintechs offer a range of financial services, such as wealth and investment services, lending and payments facilities (figure 4.5). In some countries, such innovative companies have become a significant provider of some financial services. For example, China has experienced rapid growth in digital payments, largely as a result of the mobile payment fintechs, Ant Financial and WeChat (BTCA 2017).

In Australia, the potential for fintechs to compete is supported by broader changes in the community. The underlying technology (such as mobile phones) has become ubiquitous and transformed consumer behaviours and expectations of digital services. For example, Australia has a very high penetration of smart-phones (Deloitte 2016b). Further, younger generations tend to be more tech-savvy and open to alternative providers of financial services (Telstra 2016).

---

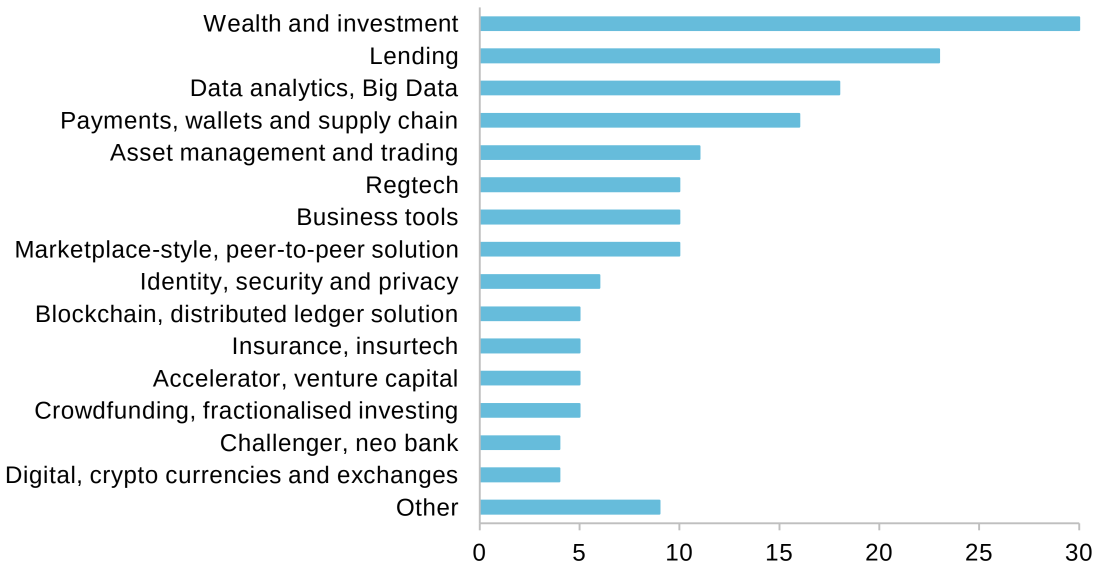
13 This definition is based on the one used in the EY FinTech Australia Census (2016). Fintech can refer to the type of technology used or the organisation using it. APRA defines fintech as 'technology-enabled innovation in financial services' (APRA 2017k, p. 6).

14 For example, non-ADIs (which includes fintechs) have a very small share of lending (figure 4.2).

15 Based on an estimated US$354 million in fintech business lending at an average USD/AUD exchange rate of 0.7434 during 2016 (ASBFEO 2018; CCAF et al 2017; RBA 2018c).

Figure 4.5 **Financial services offered by fintechs in Australia**

% of fintechs surveyed in 2017[a]



[a] Responses in multiple categories were possible.

Source: Based on EY (2017a)

The Bank for International Settlements classifies two ways that fintechs can compete in banking (BIS 2017a). First, they can provide the underlying financial services, such as lending, deposit-taking, payment and investment services. Second, they can provide an innovative customer relationship, distribution channel or interface. As fintechs continue to develop, they can compete in either or both of these product dimensions. This can lead to a number of different scenarios (or combination of scenarios) emerging in the banking market (figure 4.6).

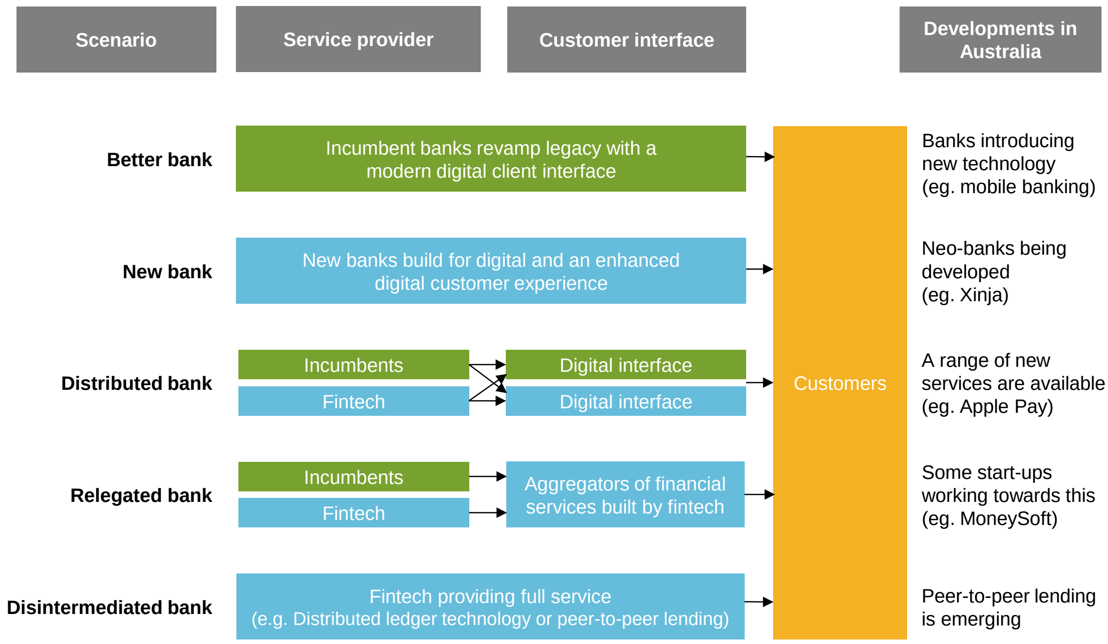
- Better banks — incumbents may upgrade their existing customer platforms and use innovative technology to provide better services. Many Australian banks have taken steps in this direction (for example, CBA (sub. 25), Westpac (sub. 28) and NAB (sub. 31)).
- New banks — new ‘challenger banks’ may enter the banking system and compete to provide innovative financial services and enhanced customer experiences. A ‘neo bank’ is a type of challenger bank that operates exclusively on digital platforms.[16] Xinja (sub. 9) and volt bank are examples of neo banks attempting to establish themselves in Australia.
- Distributed banks — banks can co-operate with technology companies, so that each provides the service they specialise in with links or referrals between them. For example, some banks

16 There is some debate as to whether a neo bank refers to a digital-only bank with its own banking licence, or a digital-only customer interface without a banking licence that is partnered with a traditional bank. This report uses the former definition.

allow customers to use third party digital wallets, such as Apple Pay (chapter 17). In another example, if a customer does not meet an established lender's requirements, the lender may refer the customer onto a peer-to-peer lender[17], such as SocietyOne.

- Relegated banks — if financial services become increasingly commoditised, aggregators of financial services can become major players in the banking system. Under this scenario, customers access a platform developed by a fintech, which brings together the most suitable financial services for their needs from a range of providers. For example, an aggregator could place a customer's deposits with one bank, establish a home loan with a peer-to-peer lender, and use a digital wallet offered by a fintech. Such platforms are emerging in China, where fintechs (such as WeChat) are using big data to identify financial products from third party providers that would be suitable for their clients (BIS 2017a).
- Disintermediated banks — it is conceivable that financial intermediation between customer and provider may disappear altogether. Under this scenario, banks are essentially replaced by technology that allows customers to interact directly with providers. For example, peer-to-peer lending platforms connect investors to borrowers directly. In another example, distributed ledger technology allows people to transact without the involvement of a trusted third party.

Figure 4.6 **How fintechs are competing in the banking system**



Source: Adapted from BIS (2017a, p. 16)

17 Peer-to-peer (marketplace) lending matches investors with borrowers.

In Australia, fintechs are working towards each of these scenarios. Many fintechs offer consumers automated financial advice, peer-to-peer lending and crowd-sourced property investment (figure 4.5). Others are focused on providing financial services to businesses and government, such as data analytics ('big data'), insurance services ('insurtech') and supporting regulatory compliance and monitoring ('regtech'). Developments in data sharing from Open Banking (Farrell 2017) and the new Consumer Data Right (PC 2017c) hold significant potential for competing and complementary providers of banking services (such as fintechs) to attract potential customers and develop new products suited to customers' needs (chapter 5).

Fintechs are focusing on less-regulated financial services

New types of challenger banks, particularly neo banks (digital-only banks with no physical branches), are emerging around the world (BIS 2017a, pp. 17–18). In the United Kingdom, a number of neo banks have gained banking licences (Dunkley 2017). For example, Atom is one of a number of neo banks that have set up new back-end systems and operate exclusively through digital customer channels, such as online or mobile applications (Wallace 2015).

The United Kingdom's recent experience with challenger banks demonstrates the potential for these types of competitors to enter in Australia. Simpler business models and greater use of technology means many challenger banks can offer better savings rates for customers, have lower costs and greater return on equity (KPMG 2016). Indeed, the Bank of England (2017) now includes increasing competitive pressure from fintechs in some of their bank stress-testing scenarios. However, these banks remain in their infancy and are yet to gain significant market share given barriers to expansion, such as reluctance for customers to switch (BIS 2017a; Dunkley 2017; WEF 2017a).

In Australia, start-up fintechs tend to focus on relatively less-regulated areas of the financial system, such as money management and lending services, rather than retail deposit-taking which involves more onerous prudential regulation (figure 4.5).

> It is not surprising that the growth in innovation and competition in Australia's financial services sector has not been in banking, but in specific niche areas of financial services with lower capital and regulatory hurdles to be able to offer a service in the market: peer to peer lending, investing, mortgages, and small business lending are good examples. (Xinja sub. 9, p. 2)

Challenger banks are yet to make strides in Australia. Only a small proportion of Australian fintechs consider themselves to be potential challenger banks (figure 4.5) and there have been very few entrants that were not already associated with a bank. Tyro (2015) (formerly MoneySwitch), which operated on a limited licence since 2005, had their licence varied in 2015 to become a full ADI. And PayPal Australia received a conditional ADI licence in 2006, but cannot operate in the retail banking market. That said, as noted above, the introduction of APRA's Restricted ADI licence has already garnered interest from potential challenger banks. In contrast, the United Kingdom approved at least 14 banking licences since 2014 (many of these neo banks) and many more entities are in talks to obtain a licence (Wallace 2016).

While a plethora of start-up fintechs have emerged in Australia, competition in financial services may also come from large retailers (such as Woolworths or Coles) or global technology companies ('big tech'). Indeed, several big tech companies are taking an active role in financial services, such as Google, Amazon, Facebook and Apple (BIS 2017a). Many of these companies offer lending or payments services in Australia and abroad (chapters 16 and 17). One reason big tech firms may be motivated to compete in the financial system is access to their customer's financial data, which can offer insights into customer behaviour or be used to provide additional products (Popper 2017).

While big tech companies have significant potential to change the nature of competition in financial services, to date they have had limited impact. For example, ANZ is the only major bank to offer Apple Pay, and its customers made fewer than 0.5% of credit/debit card transactions using mobile wallets in the financial year 2016-17, and spent less than 0.01% of the value in December 2017 (Productivity Commission analysis based on: Price 2018; RBA 2017m, 2017n). That said, many smaller ADIs and other card issuers (such as some foreign banks operating in Australia) offer their customers ApplePay and other digital wallets via payment providers, such as Cuscal.

It remains to be seen how big tech players will ultimately choose to compete in the global (and Australian) financial system. They may choose to specialise in providing the customer interface for financial services, such as creating aggregation platforms for customers. Or they may move to provide financial services themselves. Either way, their behaviour is likely to shape the future of banking globally (WEF 2017a).

FINDING 4.3 MOST FINTECHS ARE FOCUSING ON LESS-REGULATED SERVICES

Australia's fintech sector has grown substantially in recent years and offers a range of financial services.

However, few fintechs consider themselves to be challenger banks. The vast majority are focused on providing services in areas of the financial system with less onerous prudential regulation, such as small-scale funds management and lending, and payments systems.

Global technology companies, said to be the potential disruptors, are yet to make a mark in banking and the broader financial system in Australia.

To compete or to collaborate, that is the question

Fintechs have the potential to be a source of competition in some financial markets in the future. However, many fintechs are still in their infancy and those that have operated for some time remain a very small part of the markets in which they operate.

One reason why fintechs may not prove to be fierce competitors is because many have discerned benefits from collaborating with incumbent financial institutions, rather than competing directly against them. That is, incumbents can be seen as a provider, partner, investor or acquirer to a fintech business. In a survey of Australian fintechs, only 36% of fintechs said their biggest competitors were incumbents in 2017 (EY 2017a).

> … there is now more engagement and the standpoint is less black and white. There is broader recognition of the potential for collaboration. There has been a mindset shift in the fintech sector from earlier outlooks and it's also a shift that is occurring in the incumbents themselves. (EY 2016, p. 30)

There may be several reasons for increased collaboration between fintechs and incumbents.

- Fintechs can find it difficult to grow as customers tend to be reluctant to switch financial service providers (chapter 5). Collaborating with incumbents would give fintechs access to a large established customer base.
- Fintechs can find it difficult to raise or access capital to fund their entry and growth (Money Quest, sub. DR57; McLean Roche Consulting, sub. DR64). Incumbents may be willing to invest in fintechs to improve their products and services. That said, the pool of fintech investment is continually growing and recent tax incentives have been well-received (EY 2017a).
- Fintechs may be focusing on products or services that are complementary, rather than substitutes, to those of incumbents.
- Partnering with incumbents can reduce barriers to entry, including regulatory barriers.

Indeed, a study by Capgemini and the University of Sydney (2017, p. 18) noted:

> Fintech start-ups that have previously considered themselves as competitors with a differentiating value proposition to poorly served customers are now considering partnerships to overcome existing barriers around customer acquisition costs, capital access, solutions scalability, and compliance with existing regulations.

On the other hand, incumbents are also increasingly looking to collaborate with fintechs (Capgemini and The University of Sydney Business School 2017). For example, each of the major banks noted that they are partnering with, or investing in, fintechs (ANZ, sub. 49; CBA, sub. 25; NAB, sub. 31; Westpac, sub. 28). This benefits incumbents as it provides a simple way for them to outsource innovation while avoiding the threat of future competitors (Capgemini and Efma 2017).

> The rapid growth of the fintech ecosystem allows firms to externalize parts of their innovation function, as they wait and see which new offerings gain traction before deploying their own solutions … The proliferation of fintechs provides financial institutions with a "supermarket" for capabilities, allowing them to use acquisitions and partnerships to rapidly deploy new offerings. (WEF 2017a, p. 13)

The Commission considers that this overall trend towards collaboration between fintechs and incumbents may improve efficiency of operations and reduce transaction costs for both fintechs and incumbents. It could also result in a greater range of consumer-oriented products that are complementary to those on offer by incumbents. But such collaboration would also likely reduce the potential for these new entrants to be a source of competition.

However, if barriers to entry and growth continue to fall, and data reforms are pursued effectively by the Australian Government, fintechs will find it easier to compete against incumbents.

FINDING 4.4 FINTECH COLLABORATION AND COMPETITION

Fintechs are not, on present indications, likely to have the kind of competitive disruptive effect that would alter the market power of major banks in the foreseeable future.

In the long term, lowering barriers to entry and growth, including greater access to consumer data, may lead fintechs to favour competition against incumbents over collaboration.

We must look further afield for substantial offsets to current market power.

Fintechs are slowly overcoming barriers to entry and expansion

Only one in three Australian fintech companies see government or regulatory issues as an external impediment to their expansion (EY 2016).[18] More typical concerns include issues common to start-ups in all industries, such as access to funding, customer acquisition and building relationships with other market participants.

Access to funding

Like many other start-ups, fintechs face large fixed costs to set up the necessary systems and business capabilities to offer financial services, and therefore must raise significant investment capital. This is difficult when many of these establishment costs are incurred upfront, before any services are provided. Further, start-up banks can find it difficult to compete on price with much larger incumbent financial institutions that have economies of scale and can raise funds at lower costs than smaller financial institutions (chapters 3 and 8).

Australia’s growing fintech industry has begun to attract more investment in recent years (KPMG 2018). In 2012, about US$50 million was invested in fintechs in Australia (KPMG 2017b). This has grown significantly in recent years largely as a result of a several key investments. Over US$650 million was invested in Australian fintechs in 2016 largely driven by a handful of high-valued acquisitions and venture capital funding rounds.

Since 2002, the Australian Government has provided tax relief for venture capital investment funds that invest in early stage unlisted businesses that are structured as a company or unit trust (PC 2015a). However, funds are not permitted to invest in businesses where the predominant activity is *engaging* in banking, financing, leasing, securitisation, insurance or making investments — although funds can invest in businesses that *facilitate* these activities. In early 2018, the Australian Government (2018d) introduced a Bill into parliament to clarify

18 AFIA (sub. DR110) anticipates this could be higher in 2018 as growth in the industry means more fintechs will be coming up against regulatory issues.

that these venture capital funds can invest in fintech businesses that *develop* technology for use in finance, insurance or making investments, or engage in activities that are ancillary to developing these technologies. This reform should broaden access to venture capital for new fintechs that want to develop innovative products.

In recent years, the Australian Government introduced additional initiatives to help start-up fintechs raise investment capital. From July 2016, early stage investors (including individuals) in qualifying companies may be eligible for favourable tax treatment (ATO 2017). Further, following legislation passed in 2017, in January 2018 the Australian Securities and Investments Commission (ASIC) (2018f) licensed the first crowd-sourced funding intermediaries under a new regime, allowing them to raise funds for start-ups and small to medium sized companies.[19] This new funding source is already being used by potential challenger banks.

> It is fantastic that these regulatory barriers have been removed and Xinja can now access the funds needed to help build our product offerings and give the entrenched banks something to think about … (Xinja and Equitise 2018)

Access to a customer base

When it comes to dealing with money and personal information, trust is one of the most important factors for consumers when choosing a financial service provider. Indeed, surveys show that people tend to trust banks more than other institutions, including fintechs (Capgemini and Efma 2016; Telstra 2016). Therefore, winning the trust of consumers is one of the most important ways fintechs can compete in retail banking.

That said, as the fintech industry matures, the trust gap is beginning to close (Capgemini and Efma 2016). This is because consumers, particularly younger generations, are embracing the convenience, technology and innovative solutions offered by fintechs, and growing more comfortable with alternatives to traditional financial institutions.

Further, many consumers appear open to banking with big tech companies, such as Apple, Amazon or Google (Bain and Company 2017). This trend is also evident in Australia (Accenture 2017). These companies have already established a large network of customers with strong relationships and trust, making it easier for them to find customers for their products and making the leap from traditional banks less of a concern for consumers.

> These well-respected companies have built extensive relationships and trust with customers across the world. Their market penetration and embeddedness in customers' daily lives, through mobile technology use in particular, makes them powerful competitors in what has traditionally been the arena of large banks. (Capgemini and The University of Sydney Business School 2017, p. 7)

[19] Crowd-sourced equity funding, typically done online, allows a large number of individuals to make small financial contributions towards a company, in exchange for an equity stake in the company.

Traditional financial institutions have the advantage of incumbency when it comes to retaining customers. Customers are generally reluctant to switch financial services providers (chapter 5). Any new entrants would likely have to offer services that are of great enough value to consumers that they outweigh the costs of switching, or otherwise compensate consumers for the effort of maintaining relationships with multiple institutions. That said, initiatives such as the introduction of a consumer data right and Open Banking, may begin to erode some of the barriers to switching and also provide a fertile data-driven environment that could encourage new fintechs to thrive (chapter 5).

Expanding ASIC's regulatory sandbox

All financial service providers, including ADIs regulated by APRA, are subject to market conduct requirements imposed by the *Corporations Act 2001* (Cth), which are administered by ASIC (appendix B). These requirements can be difficult for start-up fintechs to understand or may become a strain on their already limited resources, such as time, money and access to professional advice (ASIC 2017g).

More importantly, they are often designed for an existing paradigm and can, if not given latitude, stymie innovation. Therefore, in 2015, ASIC (sub. 40) established an Innovation Hub to assist start-up fintechs to understand and navigate ASIC's regulatory system. This includes providing informal assistance to businesses and the creation of a 'regulatory sandbox'.

The sandbox is 'a lighter touch regulatory environment' in which start-up fintechs can operate while they test their business model (ASIC, sub. 40, p. 64). It uses three broad options for testing a new product or service without a licence:

- rely on existing statutory exemptions or flexibility in the law
- using ASIC's new 'fintech licensing exemption' to test specified products and services
- individual relief from ASIC.

These initiatives go some way towards reducing barriers to start-up fintechs. This is particularly the case with the fintech licensing exemption, which is aimed at reducing barriers to new start-up fintechs that are not already licensed by ASIC. But at the same time, it provides a set of minimum conditions on the exempt fintechs to reduce the risk of poor consumer outcomes during the unlicensed testing period.[20] By the end of 2017, the Innovation Hub had given informal assistance to almost 200 entities, almost 40 of which were granted new financial services or credit licences (ASIC 2018i).

However, by April 2018, just six businesses had used the fintech licensing exemption (ASIC 2018j). The low usage is likely because the exemption only applies to fintechs that

[20] Other conditions for the exemption require fintechs to have no more than 100 retail clients (unlimited wholesale clients), limits to the amount retail clients can invest or lend, total customer exposure of no more than $5 million, adequate compensation arrangements (such as professional indemnity insurance), adequate dispute resolution processes and must meet certain disclosure and conduct requirements (ASIC 2017z).

provide advice or distribute products (table 4.2). Under current rules, the exemption does not apply to fintechs *issuing* their own product or *providing* credit to consumers. The limitation of this exemption means issuers of financial products and credit providers must be licensed by ASIC (therefore facing greater consumer protection standards). But this distorts the entry decisions of start-ups, by encouraging them to act as an intermediary, rather than a provider. Indeed, a survey found that about 80% of Australian fintechs believed that an expanded and more flexible regulatory sandbox environment would be an effective way to grow and promote the fintech industry (EY 2017a).

In February 2018, the Australian Government introduced legislation into parliament to enable associated regulations for an 'enhanced regulatory sandbox' to broaden the scope of activities that can apply for the exemption (Australian Government 2017d, 2018c). This includes the ability for fintechs to issue some consumer credit and non-cash payment products and increases the testing timeframe from 12 to 24 months (table 4.2). However, this enhanced sandbox still excludes fintechs that want to *take* household deposits and *issue* most other financial products, such as home loans. Most of these products are also prudentially regulated, and therefore any start-ups that want to provide these products already face intense scrutiny when applying for a licence from APRA.

Table 4.2 **Regulatory sandbox comparison**

Fintech licensing exemptions for financial services provided to retail clients

	Original sandbox	*Enhanced sandbox*	*What's left*
Eligible financial products			
Deposit product[a]	▲●	▲●	◆
Payment products[a]	▲●	◆▲●	
Simple managed investment scheme	▲●	▲●	◆
Commonwealth debenture, stock or bond	▲●	▲●	◆
Listed or quoted Australian or international securities	▲●	▲●	◆
General insurance product[a] (e.g. home contents and personal property)	▲●	▲●	◆
Other general insurance[a] (except for consumer credit)		▲●	◆
Life insurance product[a]		▲●	◆
Superannuation product[a]		▲●	◆
Crowd-funding service		◆▲●	
Eligible credit activities			
Credit contracts with certain features[b]	▲●	◆▲●	
Other credit contracts (e.g. reverse mortgage or small amount credit)			◆▲●

● Provide advice or assistance. ▲ Act as an intermediary (dealing in or arranging for, except by issuing or providing). ◆ Issue or provide. [a] Issuer is regulated by APRA. [b] Provision of credit is limited to a term that does not exceed 4 years and with a limit between $2000 and $25 000.

Source: ASIC (2017q, 2017z); Australian Government (2017e)

In this Inquiry's Draft Report, we requested stakeholder feedback on the possibility of expanding ASIC's regulatory sandbox to include fintechs that take household deposits and issue or provide other financial products and services, such as prudentially regulated fintechs.

The Commission considers this is a useful way to broaden the range of fintechs that may wish to test innovative product designs, encouraging more fintechs to enter and compete in retail banking or other financial services. We note that for many challenger banks, the necessary compliance with prudential regulation may be a more significant hurdle to entry. Participating in the regulatory sandbox should not exempt a fintech from also needing to comply with prudential regulations imposed by APRA. That said, the temporary exemptions from ASIC's licensing regime under the regulatory sandbox could complement APRA's Restricted ADI framework for new fintechs that want to become a bank.

We also asked stakeholders whether, with the proposed expansion in the sandbox, any additional consumer protections would be necessary to prevent poor conduct and retain consumer confidence. Several submissions supported the idea of expanding the sandbox as a way to lower barriers to innovative new entrants, as long as there are adequate protections in place for consumers (for example, Fintech Australia, sub. 111; ICA, sub. DR62; Petsure, sub. DR66).

> If such an option was available to Xinja, it is likely that we would have been able to enter the market with a lower cost MVP that was not as capital intensive as the path we have had to follow, which would have changed our investment profile and made access to capital less restrictive due to the ability to demonstrate traction faster, earlier, and with less cost and risk. (Xinja, sub. DR67, p. 13)

Other stakeholders were more wary about the potential for such an expansion to lead to poor consumer outcomes and suggested some extra protections or limits be put in place (for example, CHOICE, sub. 97; FPA, sub. DR81).

> The sandbox must be made safer by requiring that ASIC assess applicants before they're granted a regulatory exemption or entry into the sandbox, ensuring that sandbox participants are genuinely innovative, will benefit consumers and are ready for testing. In addition, some products should not be subject to testing in a sandbox environment under any circumstances because of the likely harm to consumers in the long or short-term. One category of product that should not be subject to testing is small amount credit contracts (SACCS or payday loans) … In addition, products that have long-term importance to consumers should not be the subject of sandbox testing. For example, superannuation products … (CHOICE, sub. DR97, p. 20)

> … a condition of the regulatory sandbox should be that fintechs have a plan to get out of the sandbox by satisfying regulatory requirements and building professional expertise. (FINSIA, sub. DR96, p. 2)

We consider there is merit in further expanding the sandbox, but are cognisant of stakeholder concerns around the potential for poor consumer outcomes. The two are not mutually exclusive. We consider ASIC can do more to encourage and support fintechs to test their products, assess the benefits of these products and monitor them closely to prevent poor outcomes.

Currently, ASIC's innovation hub is geared towards providing information to fintechs to help them navigate the regulatory framework. While this is a useful service, ASIC should follow the lead of other regulators by developing a regulatory sandbox with a more hands-on approach.

For example, in the United Kingdom, the Financial Conduct Authority (FCA) operates a regulatory sandbox that takes a more active approach to encouraging fintechs. Every 6 months, the FCA (2017b) accepts a new cohort of fintechs and provides a safe regulatory environment for them to test their products in the market. Fintechs must apply to be accepted into the UK's regulatory sandbox by explaining how they meet the FCA's default standards and broader eligibility criteria. For example, they must be genuinely innovative, aimed at the UK market, benefit consumers, and be ready for testing (FCA 2017a). Once accepted to a cohort, the FCA provides each fintech with a dedicated case officer to support the design and implementation of product testing. Taking on a more active role can even give regulators a better opportunity to prevent poor outcomes for consumers.

> This close contact enables case officers to help firms understand how their innovative business models fit within the regulatory framework. It also ensures that appropriate safeguards are built into innovative products and services during and after testing. (FCA 2017b, p. 4)

This is in contrast to joining Australia's regulatory sandbox which is closer to a box-ticking exercise — fintechs that meet specific conditions (for example, have no more than 100 retail clients) are required to notify ASIC before they begin their product testing (ASIC 2018m). Indeed, ASIC (2017v, p. 8) noted that 'our fintech licensing exemption allows eligible businesses to notify ASIC and then commence testing without an individual approval process.' Fintech Australia (sub. DR111) suggested that the current lack of oversight from ASIC has led it to place strict limits on the types of fintechs and products that can make use of the sandbox.

The UK's sandbox has been far more successful getting a large number of fintechs to test a variety of new products, technologies and business models. The sandbox had over 200 fintechs apply to join its first three cohorts, over 50 of which have since tested or will be testing their products (FCA 2017a). This is a stark contrast to the 6 fintechs making use of Australia's fintech licensing exemption. Further, the UK fintechs cover the spectrum of financial services, such as retirement income, insurance, lending and investments, yet about half of all fintechs tested some form of retail banking product (FCA 2017b). They also test a variety of technologies and business models, such as distributed ledger technology, biometrics, Application Program Interfaces (APIs) and insurance mediation.

ASIC cannot meaningfully amend its regulatory sandbox on its own. It requires the Australian Government to expand the range of products that can be tested in the sandbox.

> … we proposed to retain (and not extend) our current licensing exemption, as we consider that we have gone as far as we can in balancing facilitation and consumer protection within our regulatory remit. (ASIC, sub. DR123, p. 32)

ASIC has also expressed concern that it does not have capacity to deal with the potential number of unlicensed entities under the Australian Government's proposed enhanced regulatory sandbox, let alone expanding it further.

> Potentially, a material portion of these businesses could decide to rely on the proposed enhanced regulatory sandbox. This could be in the hundreds per year. These will be unlicensed entities and as such ASIC will not monitor or supervise them. This is consistent with our approach to the ASIC regulatory sandbox. While ASIC does monitor and supervise existing licensed businesses this is supported by a broad regulatory toolkit and framework applicable to licensed financial services. We do not have this capacity or capability for unlicensed entities. (ASIC 2017l, p. 3)

However, ASIC (2018d) recently moved to an industry funding model, which should give it the capability to recover the necessary costs of expanding the regulatory sandbox and taking a more active role in supporting fintechs.

In summary, the Commission considers that the Australian Government, in consultation with ASIC, should expand the scope of products eligible for testing under ASIC's regulatory sandbox. This should be expanded beyond the proposed enhanced regulatory sandbox, to include prudentially regulated fintechs that want to hold household deposits and issue or provide other financial products or services. At the same time, ASIC should take a more hands-on approach with fintechs that want to enter the sandbox, by developing an application and testing process and more closely supporting (and monitoring) fintechs through their product testing phase. This has proven to be a more effective method of facilitating entry.

This type of support and close monitoring can also allay fears that any further expansion of the regulatory sandbox may invite unwanted products, services or practices that are likely to harm consumers. This approach may also give ASIC a stronger role in mentoring start-up fintechs in their compliance with financial laws and regulations as well as the scope to work more closely with other regulators, such as APRA and the RBA, to facilitate fintech entry where their business model touches regulations beyond ASIC's remit.

With the focus of ASIC's Innovation Hub and regulatory sandbox being on start-ups, some incumbents claimed that this unnecessarily inhibits innovation and collaboration from established institutions (for example, CBA, sub. 25; CUA, sub. 15; ICA, sub. DR62). Innovation from incumbents to date would not suggest this is a serious threat.

The Commission is in favour of regulator efforts to help start-up fintechs *independently* innovate, and offer assistance in innovative approaches to meeting regulatory requirements. Compared with start-ups, incumbents have significantly more experience in dealing with regulators such as ASIC. They also have greater ability to test new products and invest in and expand their operations, relative to start-ups with limited capital.

However, the economy needs innovation in all sectors and amongst all firms. ASIC should consider requests from existing institutions to access the sandbox on a case-by-case basis. It should be wary of its apparently limited resources being overwhelmed by incumbents' requests, but not reject them if resources are available.

RECOMMENDATION 4.1 EXPANDING ASIC'S REGULATORY SANDBOX

The Australian Government, in consultation with ASIC, should expand the scope of products eligible for testing under ASIC's regulatory sandbox, beyond the proposed enhanced regulatory sandbox, to include prudentially regulated fintechs that want to hold household deposits and issue or provide other financial products or services.

At the same time, ASIC should take a more hands-on approach to approving and supporting fintechs in testing their products or services, particularly to help with judgments on whether and how products may harm consumers.

ASIC should also consider requests from existing institutions to access the sandbox on a case-by-case basis.

An ongoing program of regulatory improvement in support of the sandbox should be a standing item for the Commonwealth Treasury's legislative program.

5 Can consumers change the game?

Key points

- Consumers are an essential part of the competition story. In strongly competitive markets, the choices and actions of active consumers exert demand-side pressure, inducing providers to compete with each other to gain new customers or retain their existing ones.
- Consumers can exert pressure on providers of financial products by:
  - acquiring new financial products, ending relationships with financial services providers or switching between products and providers
  - choosing to use or not use the financial products that they hold
  - negotiating with financial services providers for better prices, products or terms
  - giving feedback about products or services.
- Views about whether consumer engagement is too low or not are mixed. But the evidence suggests that many consumers do not readily switch between products or negotiate with providers, even when doing so would have benefits for them.
- Recent demand-side reforms to improve consumer engagement have largely focused on lowering the cost of switching products held. These reforms have only partly addressed the problem.
- Broader reforms that are in train have the potential to improve active consumer engagement in financial services markets — such as the introduction of new consumer data rights. These reforms can ameliorate the power imbalance between providers and consumers by helping consumers navigate the market and make decisions relating to their financial affairs.
- However, in the Australian financial system, individual consumer behaviour does not appear to be translating into competitive pressure or stronger competition in the market as a whole. There are two likely reasons for this.
  - Some products (such as transaction accounts and some types of cards) contribute relatively little to providers' bottom lines. In these markets, the extent of demand-side pressure that consumers can generate through switching the products they hold or changing their usage of them is limited by the value of their custom.
  - Providers are able to segment consumers into submarkets, or induce consumers to identify themselves with particular product categories, and restrict the offer of particular products, prices or terms to particular submarkets. As a result, the demand-side pressure exerted by consumers and the benefits they receive is confined to the submarket they are in and cannot spill over to the broader market.

In strongly competitive markets, the relationship between consumers and competition is a symbiotic one. Consumers' actions and choices exert demand-side pressure in the market, which encourages providers to innovate and improve their product offerings. This creates a dynamic and competitive market, which in turn can induce consumers to shop around and be active participants in the market.

This chapter is about the ways in which consumers can *act* on information about products and services and be active market participants. It begins with a discussion of the two broad ways that consumers can take action in financial services markets. First, consumers can make decisions about which products they hold or use (section 5.1). This includes when consumers:

- acquire new financial products or exit relationships with financial service providers
- choose to use or not use the financial products they currently hold.

Consumers can also participate in financial services markets through exerting pressure from within their relationships with providers, such as renegotiating prices or terms, or giving feedback about products or services to providers (section 5.2).

The chapter then turns to policy initiatives to boost the ability of consumers to participate in markets (section 5.3) and considers the question of whether active consumers are able to drive increased competition in the Australian financial system (section 5.4).

5.1 Consumer switching

Consumer switching is a hallmark of competitive markets. It can generate demand-side pressure, which encourages providers to innovate and improve their product offerings. As the Customer Owned Banking Association said:

> [C]onsumers … play an important role in driving competition. They can do this by comparing different products and switching to the one that is the best value for them. This forces firms to innovate and provide sufficient value to ensure that the consumer is receiving the most appropriate product for their situation. (sub. 21, p. 35)

For competitive processes to work, it is essential that consumers are able to search for, identify and switch to products or providers that are suitable for them with relative ease. However, it is not necessary that consumers switch *per se*. This is because a credible threat of switching can induce providers to compete with each other to retain their existing customers.

Moreover, it may not be necessary for all consumers to threaten to switch. The propensity to switch varies between customers — realistically, at any given time, only a subset of consumers is actively thinking about switching. In principle, a critical mass of active consumers may exert sufficient demand-side pressure so as to increase competition in the market overall (although, as discussed in section 5.4, there can be exceptions). This occurs when providers compete for those consumers who are likely to switch and, in doing so, increase the level of competition in the market as a whole. In these circumstances, consumer switching can drive competition even if the rate of switching is low. However, if the proportion of active consumers falls short of the critical mass, there will not be sufficient incentive for providers to compete for them.

Why switch?

Switching behaviour is motivated by consumers shopping around for a better deal. The decision to shop around and switch products is motivated by whether the expected benefits of switching (such as financial gain or improved services) exceed the expected costs (such as search costs and the implicit and explicit costs of switching).

This means that to induce a consumer to shop around and switch, the expected benefits of doing so must be sufficiently high. This could explain why, for example, people with higher credit card debts are more likely to perform a balance transfer than those with lower debts (CreditCard.com.au 2014) — switching to a card with a lower interest rate is likely to generate greater savings for those with higher outstanding debts.

Switching for a better price

In many instances, the 'best deal' is determined by price. For example, consumers consistently report that price is the most important factor when choosing a home loan (Deloitte 2016a). This implies that the availability of lower-priced products should be a strong motivator of consumer switching.

- A survey conducted by the Queensland University of Technology found that 71% of those who switched home loan providers in the past five years cited the availability of a cheaper option as the reason for doing so (Silva-Goncalves 2015).
- A survey conducted on behalf of Customer Owned Banking Association found that when switching home loan providers 57% and 56% of respondents said that lower interest rates and lower fees and charges, respectively, were 'most important' to them (Blackmarket Research 2017).

In general, consumers who switch service providers are likely to make significant monetary savings (Silva-Goncalves 2015).

Switching for product or provider features

For some financial products and some consumers, however, price is not the only consideration. For example, for insurance products, consumers are likely to also care about the type and extent of coverage, the size of excesses or deductibles, and waiting periods. In the home loan market, Blackmarket Research (2017) found that great customer service, honesty, trust and valuing customers are also key factors that consumers consider when changing home loan providers. In these instances, consumers may opt for a product that better meets their needs or for a service provider or product that has superior 'soft' attributes.

Why stay?

Switching may not be necessary if consumers are already matched with the product that is best for them. For example, the Australian Bankers' Association reported:

> More than half (58 per cent) of those who did not switch banks said that they were comfortable with their own bank. (sub. 11, p. 31)

In the home loan market, a 2015 survey found that 43% of those who had not switched their home loan provider in the past five years considered that they already had the best deal (Silva-Goncalves 2015), although it is also possible that some consumers are not aware of their options. Apparent satisfaction rates are particularly high for those who have recently taken out a loan or switched to a new lender, making these consumers unlikely candidates for (further) switching. In a survey of borrowers who had obtained a home loan in the past two years, Deloitte (2016a) found that approximately 90% felt that they held the best product for their needs — although satisfaction levels for those who had refinanced their home loan were highest at 95% and 91% for investor and owner-occupier refinancers respectively.

While it is not necessary that consumers switch *per se*, what is important is that consumers have and exercise meaningful choice regarding whether or not to switch. An essential component of this is that consumers shop around on an ongoing basis, even if they decide not to switch (Fletcher 2016). As Deloitte said:

> … it is important to be aware of where current offers are in the market. Often a good deal some years ago, may not be the best that could be achievable in the current market. (2017, p. 4)

Evidence about switching behaviour

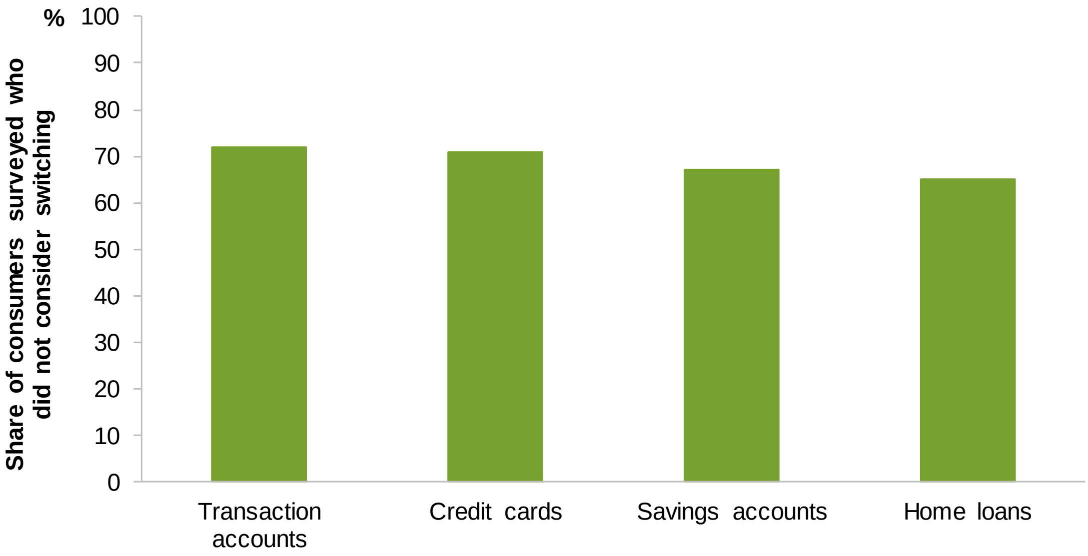
Do consumers consider switching?

Once consumers have chosen a product, they do not continue to shop around. Research conducted by CHOICE (sub. 42) indicated that most consumers had not even considered switching in a two-year period (figure 5.1).

In the home loan market, a Queensland University of Technology survey found that 61% of consumers had not considered switching their home loan in a five-year period (Silva-Goncalves 2015). Similarly, a survey conducted on behalf of Customer Owned Banking Association found that 65% of respondents said they were not at all likely or not very likely to consider changing their home or investment loan provider in the next 12 months (Blackmarket Research 2017).

Figure 5.1 **Most consumers do not consider switching products**

For the two-year period 2015–2017



Source: CHOICE (sub. 42)

ME Bank (2017) found that the proportion of consumers who periodically review their home loan (62%) is lower than the proportion who periodically review their insurance policies (70%), telecommunication services contracts (68%) and energy contracts (65%).

How many consumers actually switch?

Financial products are often described as 'sticky' (CHOICE, sub. 42; Consumer Action, FCA and Financial Rights, sub. 23; John Dahlsen, sub. 43, att. 2; RBA, sub. 29), meaning that switching rates between products or providers tends to be low. However, evidence about the rate of switching is mixed across different financial products (figure 5.2).

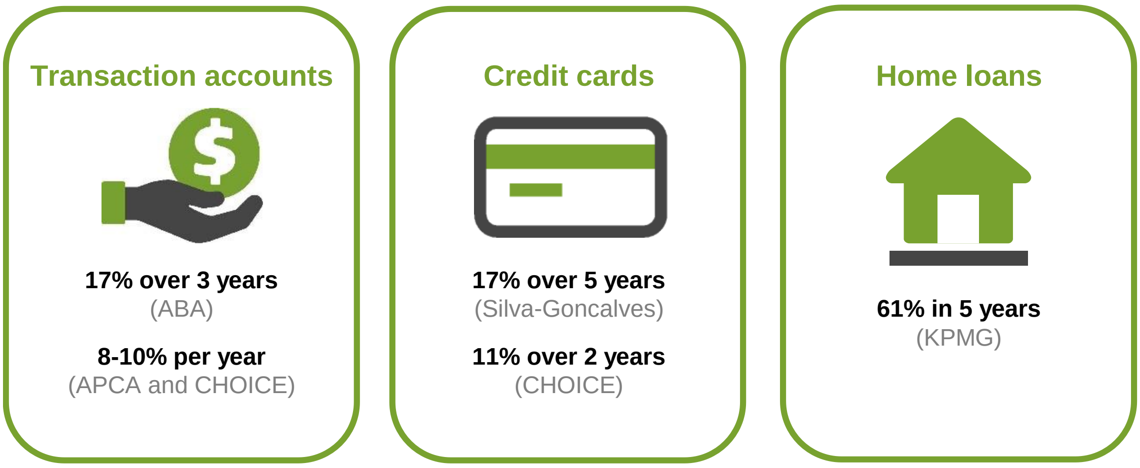
For transaction accounts, the rate of switching is low. A survey by Galaxy Research for the Australian Bankers' Association found that only 17% of respondents had switched banks in a three-year period, while 83% had not (ABA, sub. 11). During roundtable hearings, ASIC observed:

> A recent survey found that over 50% of Australian adults have always been with the bank they first opened an account with, which is an interesting indicator of the stickiness that you get in the market (Kell 2017b).

Similarly, Consumer Action, FCA and Financial Rights reported that:

> … two out of five people still use the same account their parents set them up with. That's seven million Australians who have never switched bank accounts. (sub. 23, p. 8)

Figure 5.2 **Rate of switching across different financial products**



On the other hand, Westpac suggested that switching rates for transaction accounts are higher.

> At an industry level, previous estimates provided by the Australian Payments Clearing Association (APCA) and Choice to the Senate Economics Committee Inquiry into Competition in 2010 suggested switching across the banking sector may be around 8-10% per annum for transaction accounts … These figures are not inconsistent with Westpac's experience. (sub. 28, p. 31).

For credit cards, estimated switching rates are similarly low. For example, 17% of a survey sample had switched credit cards between 2010 and 2015 — about 3% a year (Silva-Goncalves 2015). This is broadly in line with a CHOICE survey which found that 11% of consumers switched credit cards in a two-year period — just over 5% a year (CHOICE 2015a).

In the general insurance industry, the Senate References Economics Committee (2017, p. 24) noted 'low rates of consumer switching between insurers'.

By contrast, many Inquiry participants said switching was common in the home loan market (ABA, sub. 11; ANZ, sub. 49; CBA sub. 25; COBA, sub. 21; Westpac, sub. 28). For example, Customer Owned Banking Association said:

> It is estimated that the average home loan borrower changes their loan every four to five years. A KPMG survey found that 'sixty one percent of respondents renegotiate their home loan at least once every 5 years'. (sub. 21, p. 36)

The extent to which these comparatively frequent home loan changes are due to borrowers selling property or simply adding or changing features to loans (as opposed to refinancing loans on existing security or negotiating for lower interest rates) is not reported.

Switching rates can be an indicator of the level of competition

In highly competitive markets, providers compete with each other for customers. To gain new customers or retain existing ones, financial service providers must offer lower prices or innovate and improve their product offerings in ways that align with what consumers value. As the ACCC (sub. 17, p. 8) explained, competitive financial markets would be characterised by a 'healthy level of customer switching'. Switching is also evidence that a market offers meaningful choice for consumers and that those consumers are, in fact, able to exercise that choice.

That said, 'there is no particular level of switching which would indicate that [a] market is strongly competitive' (PHIAC 2015, p. 16). The optimal level of switching depends on the characteristics of the product (including its life cycle or how often it needs to be replaced) and market characteristics. As an example, some products must be held for fixed lengths of time (such as fixed rate mortgages or term deposits) and the need for consumers to review these product holdings will depend on the life span of the product.

Yet overall, the ACCC considers that low levels of switching in the markets for at least some of Australia's retail banking products are indicative of weak competition:

> When we look at retail banking markets in Australia we observe a number of indicators that, taken together, suggest that the current oligopoly structure is not vigorously competitive and has not been for some time, including … low levels of customer switching. (sub. 17, pp. 8–9)

On balance, it appears that many consumers are not actively engaging in the decision about whether or not to switch. It also appears that for some financial products many consumers do not switch, even when superior alternatives are available, especially for credit cards and transaction accounts. However, as discussed below, this could be because these are products which are inexpensive for consumers to hold in duplicate.

Duplicate product holdings

Some types of products are relatively inexpensive for consumers to hold (at least at this point in time) — including transaction accounts, savings accounts, debit cards and some types of credit cards. As a result, consumers are more likely to hold multiples of these products.

For example, a survey of credit card holders found that around a third of respondents held more than one credit card (CreditCard.com.au 2014). Similarly, many consumers hold multiple transaction accounts. According to AusPayNet, the number of open transaction accounts has grown over time.

> Over the last two years on average approximately 450,000 transaction accounts have been opened by personal customers each month compared to approximately 300,000 transaction accounts closed each month. (pers. comm., 20 April 2018)

The low cost of maintaining multiple versions of some financial products can reduce the need for consumers to switch providers — or rather, allow consumers to 'switch' through product usage rather than product holdings. For example, some consumers hold multiple savings accounts and reallocate their funds between those accounts when relative interest rates change. Similarly, some consumers prefer to use American Express cards because they offer more favourable awards points, but also hold a MasterCard or Visa because they are more widely accepted. These consumers are able to 'switch' between cards depending on what card a merchant accepts and the scope to accrue award points or other benefits, without opening or closing accounts.

From the perspective of competition, customers with duplicate product holdings may be able to exert demand-side pressure through product usage. In this way, consumers signal whether products meet their needs through their decisions to use or not use the products that they hold. Correspondingly, providers can gather information about consumers' willingness to pay or what product attributes consumers value based on usage data. The effectiveness of this mechanism depends on whether financial service providers are responsive to trends in the volume of business that they receive, or just the number of customer accounts that they have.

The low cost of holding certain products can also mean that, when consumers do intend to move from one provider to another, they do not always close their accounts. The Commonwealth Bank of Australia (sub. DR79, p. 44) said that about 5% of its core everyday transaction accounts are in a dormant state and that 'a large share of dormant accounts is correlated to customers switching providers or products'. Data obtained from other ADIs indicated a high degree of variation in the proportion of inactive accounts, ranging from around 2% of the ADI's accounts to around 25%. This variation could be due in part to the different definitions of what constitutes a dormant or inactive account — some ADIs used account activity alone as a measure of dormancy, whereas others used account balance or a combination of the two.

This can mean that data about account openings overestimate and data about account closures underestimate the number of consumers who actually switch. Customers who switch do not necessarily close their old accounts; consumers who open new accounts are not necessarily switching. Even survey data — where consumers are asked directly whether they have switched — is likely to reflect whether consumers have functionally switched between products or providers, rather than whether or not they have actually closed their old accounts.

5.2 Consumer feedback and negotiation

Another way that consumers can participate in financial services markets is through exerting pressure from within their relationships with providers, rather than severing those relationships. As Hirschman explained:

> Dissatisfied consumers … can 'kick up a fuss' and thereby force improved quality or service … To resort to voice, rather than exit, is for the customer or member to make an attempt at changing

> the practices, policies, and outputs of the firm … Voice is here defined as any attempt at all to change, rather than to escape from, an objectionable state of affairs. (1970, p. 30)

In the context of financial services, this includes providing feedback, making complaints and negotiating with the provider for improved prices or terms. There are several mechanisms through which consumers can exert demand side pressure through feedback and negotiation, including:

- by communicating with the provider directly, for example through branches, telephone, website or email, or formal internal complaints processes
- through the media or social media
- through external bodies, such as consumer interest groups or complaints procedures, such as financial sector ombudsmen.

Consumer feedback and negotiation can play an important role in driving improved consumer outcomes in financial services markets. In part, this is because many consumers do not consider those markets to offer genuine product variety. For example, John Dahlsen (sub. 43, p. 5) submitted that 'banks are all the same'. A survey by Blackmarket Research (2017) found that 26% of respondents said that they did not expect to save much by switching home loans and 15% responded that all banks are the same.

The importance of feedback and negotiation is reinforced by the fact that many consumers cannot realistically opt out of consuming some financial services.

> Because customers do not have the option of not consuming in these markets, they cannot express their dissatisfaction in the normal way … Unlike consumers in other markets, [they] do not have the option of not making a purchase no matter how much prices increase or how poorly they're serviced. With limited options available to them, it is not surprising — indeed, it is quite predictable — that [they] will express their dissatisfaction politically rather than commercially. (Ben-David 2018, p. 50)

According to Hirschman (1970, p. 28), inducing switching in these circumstances is 'wasteful and diversionary' — even if a consumer wanted to switch, they could find themselves with nowhere better to go.

Broadly speaking, feedback and negotiation can influence provider behaviour in two distinct but related ways. The first is that it gives providers access to information about consumer preferences. The second is to mobilise public opinion, which can compel a firm to act in a way that it would otherwise prefer not to.

Role of customer feedback

Consumer feedback can give providers insight into consumer preferences that might not be evident through product sales.

As an example, on 24 September 2017, the major banks announced that they would remove ATM withdrawal fees for customers of other banks. All four major banks cited consumer feedback as the key motivator for the change (although, as discussed later, it is likely that other motivations were also in play).

> We know ATM fees are one of the most unpopular [fees] … this is another example of acting on customer feedback as well as genuine reform from the industry. (ANZ 2017a)
>
> Australians have complained for some time about being charged fees for using another bank's ATM … As Australia's largest bank, with one of the largest branch and ATM networks, we think this change will benefit many Australians and hopefully demonstrate our willingness to listen and act on customer feedback. (CBA 2017c)
>
> Since 2009, NAB has led the industry by removing many of the fees and charges that annoy customers the most … NAB's commitment is to back our customers by continuing to listen to them, and respond to their concerns and needs so we can be a better bank … (NAB 2017c)
>
> We understand that the [ATM withdrawal] fee has been deeply unpopular with consumers … Westpac is listening and responding to consumer concerns … (Westpac 2017b)

According to data provided to the Commission by ADIs, thousands of customers use their formal internal complaints or feedback mechanisms each year. In the case of the major banks, the customers using these mechanisms each year number in the tens or hundreds of thousands. This represents only a small fraction of the total number of consumers who give feedback or complaints to providers, including through informal methods.

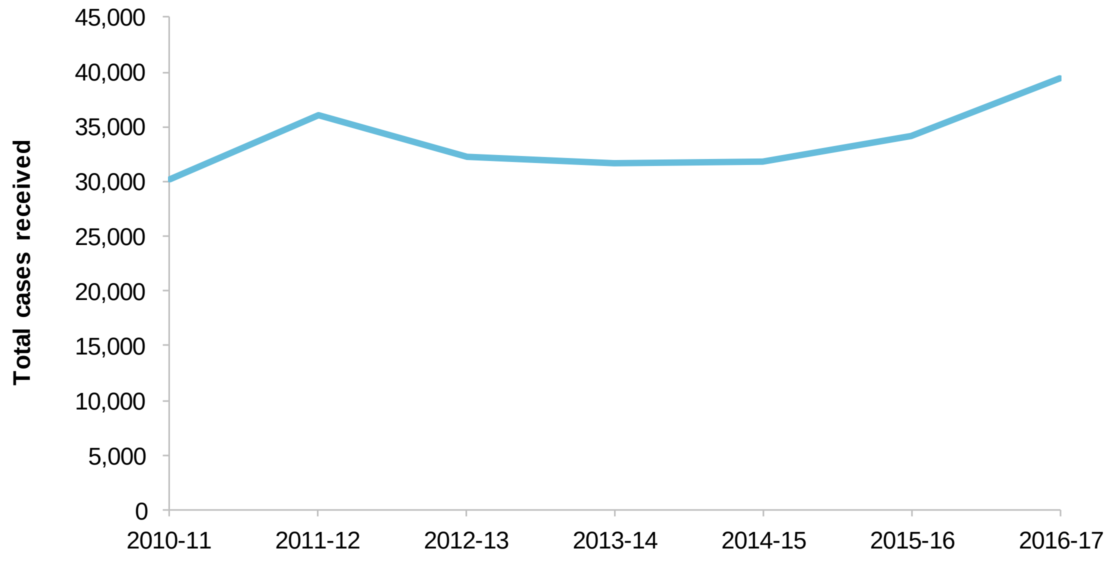
These data also indicated a high degree of variation in the proportion of complaints that were resolved in the customer's favour, ranging from about 20% to about 90% of complaints received through internal complaints mechanisms. In part, this variation could be driven by differences in what resolutions were considered to be in the customer's favour. Some ADIs also provided information about whether a payment was made to the customer to settle the complaint. Of these, most indicated that around a quarter of all complaints resulted in a payment being made to the customer, including refunds of fees and charges.

Customer feedback can also occur through external parties, such as consumer interest groups. These groups can act as advocates for consumer interests and from time to time may run campaigns on specific consumer issues. For example, the Consumer Action Law Centre is currently running a campaign to help consumers obtain refunds for add-on insurance policies that have little or no value (box 15.5).

In some cases, consumers who are unable to resolve their complaints with financial service providers may also lodge a dispute with an ombudsman. For example, the Financial Ombudsman Service and Credit and Investment Ombudsman receive complaints and disputes from consumers and act as external dispute resolution schemes. Following the Ramsey Review (The Treasury 2017d), the *Treasury Laws Amendment (Putting Consumers First — Establishment of the Australian Financial Complaints Authority) Act 2018* (Cth) was passed to replace these schemes with a single scheme: the Australian Financial Complaints Authority.

Currently, the Financial Ombudsman Service receives between 30 000 and 40 000 disputes per year (figure 5.3). About 60% are accepted for case management, with 22 475 out of 39 479 being accepted in 2016-17. And the Credit and Investment Ombudsman reported that, in 2016-17, it received more than 25 000 phone calls and almost 6000 complaints (CIO 2017).

Figure 5.3 **Disputes received by the Financial Ombudsman Service**



Source: FOS (2017a)

Role of public opinion

In an environment where providers hold a large degree of market power, the use of public opinion can amplify the bargaining power of a consumer over and above the value of their individual custom. This is because public opinion represents a threat to a provider's reputation as a whole across multiple product markets, whereas individuals switching represent a threat to (a small part of) the provider's bottom line.

For example, it is likely that the announcements to remove ATM withdrawal fees were, at least in part, motivated by public opinion. While the four major banks claimed that the move was a response to customer feedback, CHOICE noted that it had been campaigning for the abolition of these fees for six years (CHOICE 2017a). Instead, CHOICE attributed the change to the mounting distrust in banks and increased scrutiny of the sector, including through this Inquiry and the calls for a Royal Commission. In particular, it noted that the Commonwealth Bank of Australia (who was the first to announce the change) had faced a number of recent controversies and was in need of 'a good news story' (Snow 2017).

Public opinion can also act as a constraint on providers making decisions against consumers' interests, for fear of reputational damage. In its interim report for the *Residential Mortgage Price Inquiry*, the ACCC noted that:

> [Banks] are sensitive to the media attention and public criticism that can follow a decision to raise prices or to 'hold back' part of a reduction in the Official Cash Rate (OCR). In one case, for example, [a bank] began considering an interest rate increase, but staff recommended deferring any increase until a 'trigger event' occurred (either an OCR change or a rate change by a big four bank) due to concerns about adverse publicity. At a different [bank], as another example, a proposal to increase fees was substantially modified due to concern about reputational damage. (ACCC 2018, p. 8)

While public opinion has been and remains important for securing better outcomes for consumers, it is not a mechanism that can be leveraged from a public policy perspective. This is because regulatory tools rely on being able to influence behaviour in a systematic and predictable way. By contrast, public opinion is disruptive and unpredictable by nature: that is, it is most effective when it disrupts or threatens to disrupt the status quo.

5.3 Recent policy activity

Over the last decade, reform efforts to boost consumer engagement in financial markets have mostly focused on revitalising consumer switching. In particular, the objective of most reforms has been to lower the cost to the consumer of making a switch. However, these policies, at best, have only led to a modest increase in switching. There are a range of reasons for this. In some cases, reforms have gone 'under the radar'; in others, reforms have paid insufficient attention to behavioural barriers to switching.

In addition, broader reforms have the potential to impact the way in which consumers can participate in financial markets — reforms to data sharing and access arrangements could have flow-on effects that enable consumers to make decisions about their financial affairs.

The focus has been on lowering the costs of switching

Consumers have limited resources (in terms of time, money and energy) to allocate to a variety of tasks and responsibilities. According to CHOICE, many consumers do not switch because the cost of doing so is too high.

> - 36% of people who had not switched said switching was 'too much hassle' …
> - Across all products, 30% of consumers faced an issue when switching. (sub. 42, p. 15)

These barriers to switching include both monetary and non-monetary costs (box 5.1). As a result, consumer switching can be facilitated by making the processes for doing so quicker and easier, and many policy initiatives around the world have sought to achieve this (Fletcher 2016).

Box 5.1 Costs associated with switching

Transaction costs

Consumers incur transaction costs from performing a switch (Klemperer 1995). This includes both monetary and non-monetary costs of closing an existing account and opening a new one (ACCC, sub. 17). For example, when opening an account:

> Legislation requires identity to be proved and verified. Credit standing will need to be established for lending products. (ABA, sub. 11, p. 33)

And, when refinancing a mortgage, consumers may incur costs associated with legal fees, mortgage registration, and complying with administrative requirements (including paperwork). In a recent survey, COBA found that for home loans, 'more than one-third of people say they haven't switched because the process is painful'. (sub. 21, p. 36)

Switching costs

Switching costs are one-time costs that are incurred because the consumer has made relationship-specific arrangements with one provider, that would need to be duplicated with the new provider (Burnham, Frels and Mahajan 2003; Farrell and Klemperer 2007). That is, undoing existing arrangements and setting up new ones is costly. For example, consumers who have regular or scheduled payments linked to an existing account (such as a transaction or credit card account) will incur non-monetary costs in cancelling those payments and re-instating them with their new account (ABA, sub. 11; CBA, sub. 25).

Where financial services are bundled (such as a credit card tied to a transaction account), consumers also face barriers associated with disentangling these services when looking to switch only some of those products.

Ongoing costs

In addition, consumers also exhibit a strong preference against the ongoing cost of managing affairs with multiple financial institutions. According to the RBA (sub. 29), consumers find it more convenient if multiple financial services are provided by the same institution. CHOICE found:

> 32% of people who had not switched said they wanted to keep all their accounts with the same institution (sub. 42, p. 15)

This could be one of the reasons many financial institutions offer, and consumers are increasingly taking up, package home loans — a 'package deal' that usually includes a home loan, a credit card and a transaction account (Canstar 2017a; Terrano 2017). For most consumers, a home loan is one of the most significant financial commitments they will make, so many may prefer to structure their other financial affairs around their home loan arrangements. In addition, credit card or account keeping fees sometimes are waived as part of a package home loan (Canstar 2017a), reducing the ongoing monetary cost of holding multiple products.

According to CHOICE (sub. 42), a survey of consumers found that about half of respondents had a transaction account and a credit card with their home loan provider. Similarly, data provided by ADIs indicated that, in 2015-16 and 2016-17, consumers who had a mortgage with a major bank typically held at least two other financial products with the same bank.

Many Inquiry participants argued that further steps need to be taken to remove barriers to switching (ACCC, sub. 17; ASIC, sub. 40; CHOICE, sub. 42; COBA, sub. 21; Consumer Action, FCA and Financial Rights, sub. 23; ING, sub. 21; RBA, sub. 29). For example, Customer Owned Banking Association (sub. 21, p. 6) submitted that 'interventions are needed to empower consumers to switch between banking products'.

Timely and easy switching

Some initiatives to improve the timeliness of switching involve imposing timeframes within which actions must be completed — but, in some cases, these timeframes are not binding. For example, the Bulk Electronic Clearing System Procedures, which govern how financial institutions respond to requests to switch transaction accounts, provide a non-mandatory and unenforceable timeframe of three days for actioning those requests (APNL 2017). The Australian Bankers' Association (sub. 11) has committed to reforms to the Code of Banking Practice, which would include obligations to close transaction and card accounts when requested without delay. That said, it should be noted that the Code of Banking Practice is not mandatory and does not cover all banks.

In many instances, improvements to switching processes are driven and enabled by technological advances. For example, in the real estate market, the move to electronic conveyancing via Property Exchange Australia (PEXA) allows online lodgements and property settlements, and has removed the need for bank cheques, postal services and attending settlement in person in most parts of Australia. According to the Australian Bankers' Association (sub. 11), PEXA has reduced average settlement times from 40 days to 20 days, which has implications for how quickly a consumer can refinance a mortgage with a new provider.

Removing 'red tape' barriers to switching

Unnecessary obligations or regulations that apply to opening or closing accounts can also discourage consumer switching. According to Fletcher (2016, p. 65), interventions to remove of these restrictions can be 'powerful in cases where switching [is] limited by a clear contractual restriction', such as cancellation fees, exit fees and waiting periods (for some types of insurance).

In the home loan market, exit fees on standard variable rate mortgages have been banned for loans taken out after 30 June 2011 (*National Consumer Credit Protection Regulations 2010* (Cth) r. 79A(1)). In addition, some lenders have removed exit fees from loans taken out before 30 June 2011, and other lenders will pay exit fees for customers who switch to a home loan provided by them (ASIC 2017n).

But, providers can also impose 'soft' restrictions on consumer switching in the form of unnecessary administrative or bureaucratic processes. This could include requirements to complete what could be regarded as excessive paperwork, attend a branch in person or provide evidence of compliance with certain requirements. For example, some banks still use the 100 point identity verification system (such as through generic processes offered by Australia Post) for checking customer identity, even though this a much more prescriptive process than what is required by law (AUSTRAC 2011).

That said, providers have sufficient incentives to minimise red tape barriers around *entering into* financial relationships. This is because it is in their business interest to make it as quick and easy as possible to sign up new customers. However, providers also have strong incentives to increase the cost of *leaving* financial relationships. CHOICE said:

> At the moment, it is incredibly hard to cancel or switch a credit card. Most of the major banks require you either to go into a branch, where they can then hit you with the sales tactics, or to get on the phone. Some of them require you to write to them or send that card. (Mr Alan Kirkland, Chief Executive Officer, CHOICE, Official Committee Hansard, 27 August 2015, p. 51)

> For many years, CHOICE had been concerned with the 'red tape' and asymmetry associated with credit card cancellations. The big four banks have quick online application forms to get a credit card or increase debt limits, sometimes with answers provided in a matter of minutes. Yet, the process of cancelling a credit card has been particularly onerous for consumers. (sub. DR97, p. 21).

To this end, the Australian Government has passed legislation to require credit card providers to provide an option to close a credit card or reduce a credit card limit online, which will take effect from January 2019 (*Treasury Laws Amendment (Banking Measures No. 1) Act 2018* (Cth)).

In addition, government regulation can sometimes impose excessive compliance burdens, thereby creating unnecessary barriers to switching. As a matter of principle, regulatory requirements that govern or affect consumer switching should impose as low a cost on the consumer as possible, while still achieving their regulatory objective.

Redirecting recurring payments

In its review of the four major banks, the House of Representatives Standing Committee on Economics considered that transferring recurring payments from one account to another to be 'one of the most significant barriers to switching' (2016e, p. 48). Across the world, various initiatives have been introduced to try minimise the consumer effort required to redirect recurring third party payments (box 5.2).

Transaction accounts

In Australia, a bank account switching initiative (known as 'tick and flick') was introduced in 2012. Under this initiative, a consumer opening a transaction account with a new bank can request to have their recurring payment arrangements switched to the new account (APCA 2012).

Box 5.2 International initiatives for recurring payments

- In 2013, the United Kingdom adopted the 'Current Account Switch Service'. The service is designed to enable quicker and more reliable switching, by making financial institutions responsible for executing the switch on behalf of customers to a particular standard. This includes moving all incoming and outgoing payments, transferring the outstanding balance and closing the old account (BACS 2017). Consumer awareness of the program is relatively high (at 76%) (BACS 2018), but the rate of usage remains low.
- In the Netherlands, Dutch payment service providers have implemented the Switching Service (Overstapservice), which was introduced in 2004. Customers can request the service with their new bank, whereupon transactions will be redirected to the new account for a period of 13 months and, during that time, creditors will be informed of the new account number (Dutch Payments Association 2017). However, this initiative does not appear to have reinvigorated switching, with over half of Dutch consumers having never switched (MFS 2014).
- In Sweden, consumers can choose to make or receive payments via Bankgiro number (Bankgirot 2017). Users can link the number to any bank account, which can be changed at any time. This allows consumers to easily redirect funds when they switch by changing the bank account details associated with their Bankgiro number.

A number of Inquiry participants deemed this initiative to be ineffective. For example, ING said that the initiative did not do enough to alleviate the amount of customer effort required to switch.

> The current Account Switching Package in Australia requires too much customer effort and has not delivered a 'real choice' to the customer. In the 11-month period from its inception on 1 July 2012, Treasury has reported only 15,500 people switched accounts using the account switching package. For the past 6 years (2011–2017) the number of people switching banks in Australia has flat lined at 8% of the bankable population. (sub. 20, p. 3)

A large part of the failure of 'tick and flick' may be attributable to low awareness about its existence and the failure of banks or government to promote the initiative. For example, CHOICE said that banks have kept the initiative a 'deep dark secret' (CHOICE 2017b). Consumer Action, FCA and Financial Rights (sub. 23) also suggested the low take-up rate was in part because the initiative was not promoted by banks. As noted earlier, the comparatively low cost of having multiple transaction accounts is likely also to reduce the need for consumers to use facilities such as tick and flick. Either way, as a policy initiative, 'tick and flick' is not achieving its intended outcome.

Stakeholders also suggested account number portability as a means of streamlining switching for transaction accounts. Account number portability would allow consumers to use the same bank account number when switching between financial institutions. However, in 2011, the Fraser review found that it was likely to be too costly to introduce account number portability at that point in time.

> Implementation of full account portability, however, would be far from simple, and not at all analogous to telephone number portability as sometimes suggested. It would involve the replacement of the bank, state, branch (BSB) system of numbering, and wholesale revamping of

> the existing payments infrastructure and the systems of all the financial institutions which interface with it. It would be a major and costly undertaking. (Fraser 2011, p. 7)

Even if this cost has decreased since the Fraser review, it is likely that other reforms (such as the New Payments Platform (chapter 17), Open Banking and consumer data rights) will diminish the need for account number portability.

The New Payments Platform (NPP) has the potential to reduce the effort required to change customers' recurring billing arrangements (chapter 17). Among the innovations of the NPP is an easy-to-remember banking address for users with the ability to pay someone using a 'PayID', which is an alias linked to a BSB and account number. Under these arrangements, a consumer changing banks will only need to change the account details associated with the PayID. At this stage, the extent to which the NPP will remove barriers to switching is not a settled matter, although it is clear that the PayID functionality has untapped potential (chapter 17).

Credit cards

Consumers need to redirect recurring payments when they switch credit cards held. At present, this must be done by 'contact[ing] each service provider to cancel the existing payment and to arrange a new recurring payment to the new card' (ABA, sub. 11, p. 34). Westpac argued that the cost of doing this was relatively low.

> [R]ecurring credit card payments are now typically set up online and new cards can easily be substituted online. Consumers are increasingly accustomed to adding, removing and replacing card-on-file details for electronic commerce (including where credit cards expire), and this process is facilitated by web browsers and extensions that can securely store credit card details and insert them into web forms. (sub. 28, pp. 41–2)

The Australian Bankers' Association (sub. 11) said that it is considering a number of other reforms to make redirecting recurring payments easier. This includes reforms to the Code of Banking Practice to require banks to provide a list of recurring payments on all accounts (including credit cards) to customers on request. This would allow consumers to identify recurring payments, so that they know which merchants need to be notified of their new card number. In addition, the Code would include an assurance that recurring payments will not be processed against credit card accounts that have been closed (ABA, sub. 11; CBA, sub. 25).

Similarly, CHOICE (sub. 42) and Consumer Action, FCA and Financial Rights (sub. 23) suggested that arrangements similar to 'tick and flick' should be introduced for credit cards (despite its apparent failure to improve switching processes for transaction accounts).

However, there are difficulties in developing a solution of this type (ABA, sub. 11). First, while credit card schemes allow merchants to set up recurring payments, they do not always process and mark regular payments in this way, so there can be difficulty in identifying what payments are truly 'recurring'. In addition, many repeat transactions actually involve card-on-file payments, whereby the merchant stores the customer's credit card information and that is charged from time to time when the customer makes a purchase. As a result, even if recurring payments were redirected, the consumer would still need to change their details with each merchant who has their card on file.

One emerging solution to this problem is tokenization, whereby a merchant stores and processes payment via a 'token', rather than credit card details (3 Delta Systems 2013). A token is associated with, but does not contain information about, credentials for a particular payment method, such as a credit card. Although initially developed as a security measure, tokenization can also make it easier for consumers to redirect payments, by changing the payment credentials associated with the token. Examples of tokenisation in use today include Android Pay, Apple Pay and Samsung Pay (Worthington 2016).

Policy efforts aimed at behavioural barriers have been limited

In addition, there are 'behavioural' barriers to consumers being active participants in financial markets (Nicholls 2017; OFT 2010). This includes cognitive and behavioural biases that have the result of reducing consumers' desires to review or take action in relation to their financial affairs (box 5.3, appendix D).

For instance, consumers sometimes have biases about, and therefore do not always accurately assess, what products might be best for them. For example, according to Customer Owned Banking Association:

> [M]any consumers optimistically (and often mistakenly) believe at the time that they apply for a card that they will always pay off the balance by the end of each statement period and, hence, that the rate of interest charged on a card is not a relevant consideration. (sub. 21. p. 37)

In practice, however, only about 60% of credit card holders pay their balance in full each month (ASIC 2017h).

Collectively, these biases and patterns of behaviour can manifest as 'consumer inertia' (ABA, sub. 11; ASIC, sub. 40; COBA, sub. 21) — that is, consumers sometimes do not switch or do not negotiate with their bank, even when doing so offers a net benefit and they have sufficient information about their options and the capacity to do so. It can often be difficult to determine the extent to which behavioural and cognitive biases affect consumer behaviour, because individuals may misreport their 'true' reasons for taking or not taking a certain action.

To date, policy efforts to revitalise consumer switching in financial services markets have acknowledged the existence of behavioural barriers. But, on the part of policymakers, efforts to address behavioural barriers are relatively new and, as a result, have been limited (BIT and BIU 2014; PM&C 2016; Victorian Government 2016). Moreover, it can take time for initiatives to flow through to implementation. In part, this stems from the fact that it can be costly, both in terms of time and resources, to design solutions in this space. Consumer testing, monitoring and evaluation are essential to behavioural solutions, because it can be difficult to predict how consumers will respond to specific interventions.

Box 5.3 **Some types of cognitive and behavioural biases**

Preference for the status quo

In financial markets, some consumers exhibit a preference for the status quo or default option (Madrian and Shea 2001). As a result, they tend to overvalue and stick with that option, even if an *ex ante* superior alternative arises (Samuelson and Zeckhauser 1988). This can lead consumers to underestimate the relative benefits of other options and the value of shopping around and switching (COBA, sub. 21).

Consequently, consumers often require a ‘trigger’ to prompt them to search for an alternative. These triggers usually take the form of external events, rather than being built into a regular schedule. The Australian Bankers’ Association identified the main triggers as:

> … either high levels of dissatisfaction (often linked to an error or penalty charge) or a change in circumstances that disrupts existing banking arrangements, e.g. moving home or a bank closure. (sub. 11, p. 66)

But, in many cases, there is a ‘lack of natural trigger points’ (COBA, sub. 21, p. 35), because there is ‘no clear prompt for consumers to regularly review or compare their current product with others on the market’ (ASIC, sub. 40, p. 74). Financial service providers also lack the incentive to create trigger points for their customers, such as by giving notice about the end of honeymoon periods or the end of terms for term deposits. As a result, consumers can become entrenched in their previous financial decisions, despite changes in market offerings or their own circumstances.

Overestimating costs

Consumers can also be deterred from switching because they *perceive* the process to be costly or difficult (COBA, sub. 21; RBA, sub. 29). The Australian Bankers’ Association said:

> Successive Australian governments have undertaken reforms to reduce impediments to switching in financial services and substantial progress has been made. Nevertheless, a perception remains that switching is difficult and this stops customers from moving their banking relationship. (sub. 11, p. 30)

These perceptions are not always accurate, as consumers often overestimate the cost or difficulty of switching. According to Fraser (2011, p. 4), ‘the perceived hassles involved in these processes by prospective switchers are usually greater than the problems experienced by people actually making switches’.

A study for the Australian Energy Market Commission found that, of those surveyed, 77% of customers who had switched banks in the past five years found it very easy or fairly easy to do so — compared with 62% of customers who had switched their energy provider (Newgate Research 2017). Likewise, a survey conducted for the Australian Bankers’ Association found that, of customers who had switched banks in the past three years, only 11% said that they found the experience to be difficult (Galaxy Research 2017).

FINDING 5.1 CONSUMERS' CAPACITY TO PUT COMPETITIVE PRESSURE ON PROVIDERS IS OFTEN LIMITED

For many financial products, consumer responses to variations in price and service are limited. Consumers lack meaningful transparent information and face switching barriers; and they perceive insufficient ongoing difference between providers and product offerings to make the process worthwhile.

Broader reforms could impact how consumers participate

Reforms that confer new consumer rights or allow individuals to better exercise the rights they currently have (such as those that exist under 'tick and flick' arrangements) could help consumers to both assess the merits of alternative or complementary products and act on this assessment.

Reforms underway include the adoption of Comprehensive Credit Reporting (chapter 16) and Open Banking (box 5.4). By directing providers to share their data, consumers may be able to gain access to better and a greater range of product and service offerings, and making shopping around, switching or negotiating more attractive. These include:

- products that are better suited to their needs
- products that would not otherwise have been available to them
- better services, including financial management, accounting and budgeting tools.

In its report about *Data Availability and Use* (PC 2017c), the Commission recommended that consumers (individuals and small businesses) should have a new consumer data right that allows them to:

- receive a copy of their consumer data
- request edits or corrections for reasons of accuracy
- direct holders of such data to copy the data in machine-readable form, either to the consumer directly or to a nominated third party
- be informed about the trade of any element of this data to third parties
- be advised of disclosures of data to third parties.

Such a right would support consumers in making the most of their data to take up new competing or complementary financial services and mitigate the risk of information being 'lost' when consumers switch.

The Australian Government has undertaken to implement significant aspects of the consumer data right in parallel with the adoption of Open Banking (box 5.4). Notably, however, Open Banking appears to be limited to banking transactions data initially (whereas the consumer data right, as recommended by the Commission, is broader) and does not confer rights in relation to editing data (an aspect that may be especially important to small businesses, which do not have any existing rights under Australia's privacy regime).

The new comprehensive right for consumers will be known as a 'Consumer Data Right', which will, in the first instance, allow customers 'open access to their banking, energy, phone and internet transactions' (Taylor 2017).

Box 5.4 About Open Banking

Open Banking refers to consumers, businesses and government being able to access banking data readily. One feature that Open Banking can enable is to give consumers greater access to, and control over, their own banking data. This should extend to allowing the consumer to direct the circumstances and extent to which their data is made available to others.

The Australian Government has announced that it will introduce an Open Banking regime in Australia. Important in its own right, Open Banking is also seen as a first step in introducing a new consumer data right across the Australian economy, as recommended in the Commission's Inquiry into *Data Availability and Use* (PC 2017c).

The Australian Government commissioned a review into Open Banking in Australia, which reported in December 2017. The review made recommendations about:

- a regulatory framework for implementing and administering the regime
- what data should be shared, and between whom
- how to ensure shared data is kept secure and privacy is respected
- how data should be shared
- implementation issues.

The Australian Government has accepted the recommendations of the review. It intends to phase in Open Banking for all major banks, with data on credit and debit card, deposit and transaction accounts available by 1 July 2019 and mortgages by 1 February 2020.

Source: Australian Government (2018b); Farell (2017); The Treasury (2017c); PC (2017c).

RECOMMENDATION 5.1 DATA ACCESS TO ENABLE CONSUMER CHOICE

The Open Banking system proposed for Australia should be implemented in a manner that enables the full suite of rights for consumers to access and use digital data (as set out in the Productivity Commission Inquiry report, *Data Availability and Use*).

5.4 Consumers and demand-side pressure

Active and engaged consumers are an essential part of any competitive market. To this end, there have been a range of reform efforts designed to make it easier for consumers to make and act on decisions relating to their financial affairs.

It is often assumed that the converse is also true: that having active consumers in a market will naturally translate into demand-side pressure and heightened competition. But, in financial services markets, this does not appear to be the case. Rather, it appears that by switching, making complaints or negotiating with their providers, consumers are able to obtain better outcomes for themselves — but the extent to which this induces better outcomes for consumers as whole or stronger competition is limited.

We have identified two reasons why individual consumer behaviour does not translate to demand-side pressure in the Australian financial system as a whole. In this section, each of these is discussed in turn.

Products that are inexpensive to hold

As discussed above, some types of products are (currently, at least) relatively inexpensive for consumers to hold. These include transaction accounts and debit cards. For customers who pay off their balance every month, credit cards can also be held relatively cheaply.

As discussed above, the ability for consumers to hold multiple accounts means that consumers can switch through product usage rather than product holdings. Whether this translates to demand-side pressure depends on the extent to which financial service providers are responsive to the volume of business that they receive, or just the number of customer accounts that they have.

In addition, these products are likely to be ones where providers do not extract much profit from consumers, at least directly. This means that, in these markets, the prospect of consumer switching poses a limited threat to a provider’s bottom line. This threat is especially weak when the provider is large and an individual consumer represents only a small part of the provider’s total business. In other words, the extent of demand-side pressure that consumers can generate through switching is limited by the value of their custom.

Many recent reform efforts have focused on making switching easier in these markets — specifically, bank accounts and credit cards. However, while these types of reforms have been important from the perspective of individual consumer choice, they have had limited impact on the market as a whole. Moreover, the fact that consumers can hold multiples of these products relatively cheaply diminishes the need for consumers to switch vis-à-vis acquiring an additional product.

While a baseline level of ongoing pressure is required to maintain the existing level of competition in those markets, we consider that, at this point in time, there is a limited role for further switching reforms in driving increased competition in markets for low cost products.

FINDING 5.2 VARYING PRODUCT USAGE RATHER THAN PRODUCT HOLDINGS

Multiple account holdings (such as transaction accounts and credit cards) allow consumers to change their product usage but not switch their product holdings. Whether this translates to demand-side pressure depends on the extent to which financial service providers are responsive to the volume of business that they receive, or just the number of customer accounts that they have.

Where multiple products that are very similar can be held at a relatively low cost, switching (in product holdings) and the long history of reforms aimed at this, become less important as policy objectives.

Market segmentation

The ability for consumers to generate competitive pressure can also be restricted where providers are able to confine that pressure to particular segments of the market. That is, providers may offer better prices, products or services exclusively to consumers who are more likely to switch or ‘kick up a fuss’. Thus, providers are able to confine the offer of better deals to a subset of ‘active’ consumers, while passive consumers do not receive the same benefits.

As a result, a minority of active consumers may be unable to drive competition in the market as a whole, because providers isolate those consumers into a separate sub-market. For example, a subset of consumers who negotiate with a provider or make complaints may obtain a better price or outcome for themselves, but these usually do not flow on to consumers as a whole. This can also take the form of price discrimination — that is, where providers charge different prices for what is essentially the same product.

Price discrimination is commonly used as a tool to capture particular consumers and influence their decisions around switching. Specifically, consumers face different prices based on their propensity to switch, with those more likely to switch being offered better prices. Providers may be able to gauge a consumer’s propensity to switch using information about how ‘active’ they are, including their recent account activity.

To attract consumers who are likely to switch, financial service providers often offer favourable upfront prices for new customers (box 5.5). In its interim report on residential mortgage prices, the ACCC noted:

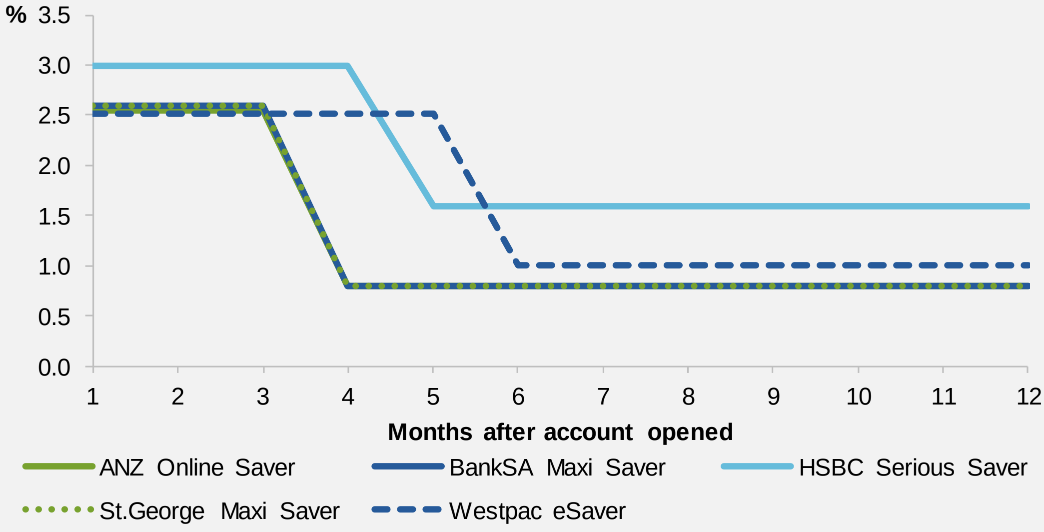
> Based on data supplied by the big four banks for 30 June 2015, 30 June 2016 and 30 June 2017, their existing borrowers on standard variable interest rate residential mortgages were paying interest rates up to 32 basis points higher (on average) than their new borrowers. (2018, p. 7)

While market segmentation can benefit certain consumers, it can also result in inequitable outcomes. For example, the process of negotiating a better deal or making a complaint favours those with high financial literacy and those who are strong self-advocates.

Box 5.5 Upfront and ongoing prices

Many financial service providers offer favourable upfront prices for their products, which are designed to attract new customers. Once the introductory period has lapsed, these prices usually revert to 'ongoing' rates that are less favourable to the consumer.

- Credit card providers often offer low interest or interest-free periods for new consumers who transfer their existing balance to a new card. Balance transfers with zero interest for the introductory period are increasingly common (SERC 2015).
- Some home loan lenders offer 'honeymoon' mortgage rates that are often significantly lower than those for the lender's other home loan products (RBA, sub. 29). Once the honeymoon period ends, interest rates increase to less favourable rates.
- Some insurance policies offer favourable upfront pricing, followed by a significant price increase when the insurance policy falls due to be renewed (Kell 2017c).
- For savings accounts, it is common for a favourable promotional rate to be applied for several months when the account is first opened (Liu 2016). As an example, the figure below depicts the applicable interest rate for savings accounts available as at 30 November 2017.

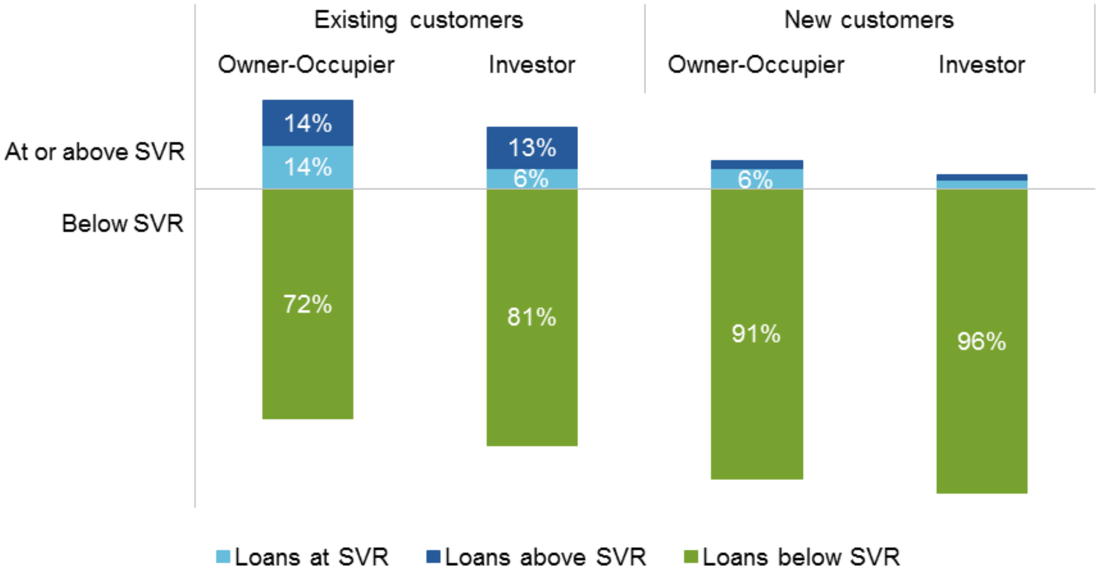


- For term deposits, ASIC (sub. 40, p. 58) found that 'ADIs promoted their term deposits by advertising the high rates available on a limited number of term deposit periods, while maintaining significantly lower rates for all other deposit periods ('dual pricing'). This resulted in many customers receiving significantly lower rates if they stayed with their provider through automatic rollover of their deposit.'

The Reserve Bank of Australia (sub. 29, p. 8) noted that price discrimination between existing and new customers means that 'established and less mobile customers are subsidising low margins (or loss leaders) for new customers'. For example, for the average lender, about 5% of new home loans granted in 2016-17 attracted an interest rate greater than or equal to the standard variable rate (SVR); by contrast, more than 15% of existing loans from the average lender had an interest rate greater than or equal to the SVR (figure 5.4). We estimate that consumers who switch to take advantage of introductory rates could save $66 to $87 per month on the average home loan balance (box 5.6).

Figure 5.4 **New home loan customers pay lower interest rates**

Share of home loans for select ADIs in 2016-17



Source: Productivity Commission estimates based on data collected from ADIs, including the major banks

Box 5.6 **How much do new customers save on their home loans?**

In 2017, the average loan size was around $375 000 (ABS 2017c).

According to data provided by ADIs, in 2017 the standard variable rate for a home loan was around 5.2%. On average, a consumer would receive a discount of 0.9% on the standard variable rate (RBA, sub. 29), meaning that the applicable interest rate for the average consumer would be around 4.3%.

Based on data collected by the RBA (Kohler 2017) and data collected from ADIs, customers with new home loans receive a discount of around 0.3%-0.4% on the applicable interest rate, relative to existing customers. This is broadly consistent with the ACCC's (2018, p. 7) finding that existing borrowers pay about interest rates up to 0.32% higher than new borrowers.

Noting that new loans represent only a small share of total outstanding loans (Kohler 2017), this means that the applicable interest rate for a new loan is around 3.9%-4.0%. For a loan taken out over 30 years and repaid in equal instalments, this translates to a saving of about $66-$87 per month.

The ability to discriminate between customers is characteristic of markets where providers have substantial market power. In the case of financial markets, this power arises from the wealth of information providers have about individual consumers, which gives them a basis for making differential offers to different consumers. By contrast, consumers in many other markets (such as consumer goods markets) are required to give providers very little information about themselves.

Attempts to price discriminate by providers can be defeated if arbitrage is possible — that is, consumers who receive lower prices can buy and resell the product to those who would otherwise face higher prices. For many markets, the internet has increased arbitrage opportunities and reduced the ability for providers to effectively price discriminate. However, this has not been the case for most financial services markets — in most cases, the exchange or resale of financial products is impractical, if not unlawful. In the Australian financial system, the prevalence of market segmentation and price discrimination as a practice is evidence of the market power that financial service providers hold over consumers.

FINDING 5.3 MARKET SEGMENTATION CURTAILS CONSUMER COMPETITIVE PRESSURE

Financial service providers are able to selectively offer products, prices or terms to different customers, using the information they have about individual consumers. This curtails the ability for an active subset of consumers to drive increased competition in the broader market.

6 Policy settings and interventions affect competition

Key points

- Regulatory settings and the (actual or perceived) interventions of the Australian Government are having a significant impact on competition in the financial system.
- The major banks have a clear advantage in accessing capital markets due to their higher credit ratings. The major banks' access to cheaper capital is highly desirable, for Australia and Australians.
- Major banks' higher ratings reflect their fundamental characteristics, such as size, ability to manage risk and balance sheet strength, but are also due to the expectations that government support may be provided in times of stress.
  - From a competition perspective, it is not wise to attempt to nullify these advantages.
- When intervening, whether to alter risk by non-price measures or to directly re-price it, regulators should recognise *all* costs in their pre-implementation analysis, not ignore some simply because they are inconvenient or inevitable in the practice of prudential management.
- The subsequent public explanation when adding cost that inevitably burdens consumers or limits competition needs to recognise that a true objective of regulation is not to punish the most efficient, larger banks.
  - Smaller banks may cheer such intervention but, in circumstances where the largest institutions clearly enjoy market power, higher costs for those with power will see them lead prices up to compensate, and deliver healthier profit margins for smaller players but no improvement in competition or consumer benefit.
  - Simply put, competition is not improved if all an interventiondoes is raise the costs of the larger banks.
- Where costs must rise to achieve a desired gain in system stability, regulatory measures should be finely targeted in order to impose the least necessary cost.
- More targeted regulatory risk signals can instead lower costs and improve competition without compromising prudential outcomes, as shown in recent proposals to recognise low risk loan profiles in standard risk weights.
- Some interventions are squarely aimed at reducing competition. Regulators should pay more attention to the question of 'who pays' and at 'what price' when designing interventions.
- Ownership restrictions — the Four Pillars policy and the 15% ownership cap for ADIs — can protect poor management and deter competition. The existence of the Four Pillars policy (and equally its abolition) would not alter competitive circumstances at all. Competition is better protected through the general competition laws that prevent anti-competitive mergers.

Regulation for the protection of depositors and financial stability is an inherent and desirable part of the Australian financial system landscape. A regulatory focus on stability has contributed to an operating environment that imposes different costs and benefits on similar institutions and limits competitive pressure in some circumstances.

Aspects of financial stability policy and regulation that particularly influence competition include:

- prudential standards
- targeted prudential interventions
- implicit and explicit government support, and
- ownership restrictions.

This chapter explores how intervention in these policy areas can interact with competitive outcomes. We focus on competition, not whether the overall level of regulation is sufficient or excessive in and of itself.

6.1 Prudential standards

Prudential regulation of authorised deposit-taking institutions (ADIs) is intended to address:

- the inability of depositors to adequately assess and monitor the risks ADIs take with funds deposited
- concerns over the stability of the banking system as a whole and its effects on the broader economy.

The Australian Prudential Regulation Authority (APRA) has developed regulations known as prudential standards to help ensure financial institutions can meet their obligations to their customers (including depositors, insureds and superannuants). These standards prescribe minimum requirements in relation to, for example: holdings of regulatory capital (liquid capital held for regulatory requirements, box 6.1); holdings of high quality liquid assets; governance standards; the management of operational risk; and public disclosure standards. In the case of ADIs, many of these standards are influenced by the international regulatory framework for banks overseen by the Basel Committee on Banking Supervision (BCBS).

Prudential standards require financial organisations to quantify their risks to ensure they are adequately accounted and provisioned for in their own organisations. For example, an ADI's home loan book has a risk of default. The risks of the home loan book can be quantified using measures such as loan-to-value ratios (LVR) or the extent of use of lenders mortgage insurance (LMI). APRA then prescribes a risk weight to the loan book — the ADI is required to hold a certain fixed rate of regulatory capital against this risk weighted asset (box 6.1). Where a bank has sufficient funds, size, capability and historical data, it can use internal ratings based (IRB) risk modelling to determine the risk weights of its assets. If a bank does not use IRB risk modelling, then it must use the standardised risk weights as set by APRA.

Box 6.1 Regulatory capital requirements

APRA requires ADIs to hold regulatory capital (see table) so that losses from their loan portfolios (and other assets and activities) can be absorbed without impacting depositors. All Tier 1 Capital would need to be lost before the holders of Tier 2 Capital instruments could be exposed to loss. Common Equity Tier 1 Capital is the most exposed to loss and so is typically the most expensive form of capital.

	Examples (lists are not exhaustive)	*Purpose*
Tier 1 Capital		
Common Equity Tier 1 Capital	• **Paid-up ordinary shares** • **Retained earnings**	Known as going-concern capital. Tier 1 Capital is available to cover losses while an ADI continues to operate. It will also absorb losses should the ADI ultimately fail.
Additional Tier 1 Capital	• **Preferred shares:** shares with a higher claim on dividends and ADI assets than ordinary shares. • **Hybrid debt securities:** instruments that have both debt and equity properties but are most similar to equity or can be converted to equity.	
Tier 2 Capital		
	• **Other hybrid debt securities:** instruments that have both debt and equity properties but are less like equity. • **Subordinate debt securities:** debt securities (such as bonds) that rank after secured creditors and senior bonds in liquidation but before shareholders • **General provisions:** money set aside to cover expected losses.	Known as gone-concern capital. Tier 2 Capital is to absorb losses after an ADI fails until such time as it is wound up or the capital is otherwise written off or converted into ordinary shares.

The availability and cost of different capital instruments vary across ADIs. For example, mutual ADIs are limited in their capacity to issue new equity (chapter 7). The current minimum levels of regulatory capital ADIs are required to hold are:

- a Common Equity Tier 1 Capital ratio of 4.5% of risk-weighted assets (below)
- a Tier 1 Capital ratio of 6.0% of risk-weighted assets
- a Total Capital ratio of 8.0% of risk-weighted assets.

APRA can require ADIs to hold additional capital to the minimum requirements. For example, APRA announced in July 2017 that the four major banks would be required to hold Common Equity Tier 1 Capital equal to 10.5% of their risk-weighted assets to meet the unquestionably strong benchmark.[a]

Risk-weighted assets

Loans and loan portfolios are scaled according to their risk profile to determine the amount of regulatory capital to be held against them. This is known as risk-weighting and there are two approaches to it: the *standardised approach*; and the *internal ratings based (IRB) approach*.

The standardised approach is the default approach, used by the majority of ADIs. This approach prescribes fixed risk weights for different types of loans and borrowers.

In contrast, the IRB approach allows ADIs to use internal modelling to determine risk weights (subject to limits set by APRA). Using the IRB approach requires APRA approval and many years of data on the performance of loan portfolios, in-house modelling expertise and supporting technology. The total cost of this has been put at ‘hundreds of millions of dollars’ by Davis and Lawrence (2015, p. 6).

[a] The new minimum requirement should not be directly compared to the current 4.5% minimum as it includes all additional buffers and holdings (such as the conversion buffer).

Source: APRA (2017c); Prudential Standard APS 110

Internal risk weight modelling under the method developed by the Basel committee allows for the use of precise risk signals to avoid the losses or risks of over or under provisioning. IRB models typically produce lower risk weights for assets than the standardised rates, due to more precise risk quantification, reducing regulatory capital obligations. But they have high implementation and ongoing costs. Currently only ANZ, CBA, NAB, Westpac, Macquarie and ING use IRB models in Australia. Though varied at the institution level, the reported combined cost of IRB accreditation across the major banks is in excess of $1 billion (including both implementation and ongoing costs, based on data provided by ADIs). The implications of IRB accreditation on funding costs are explored in chapter 5.

Basing mortgage risk weights on risk

The Murray Financial System Inquiry (FSI) considered the arguments for both a reduction in standardised risk weights for eligible residential mortgages and an increase in the risk weights applied to IRB banks. It considered the case for a reduction in standardised risk weights was poor — instead, the Murray FSI argued for a 25–30% floor on the average risk weight applied to residential mortgages by IRB banks, in order to decrease the risk weight difference between IRB and standardised banks. At the time, there was an approximate 20 percentage point difference in average risk weights between IRB and standardised banks — a core concern for smaller banks (Murray et al. 2014b). APRA implemented a 25% floor in 2016.

As noted by one major bank in their discussions with the Murray FSI, risk weights should, in principle, only reflect the risks of underlying assets and risks inherent to the predictive capacity of IRB or standardised systems (Murray et al. 2014a). In the presence of the market power held by larger institutions (see chapter 3), increases to risk weights above the intrinsic risk level will merely jack up prices, somewhere in the banking system.

Differences in the costs of funds faced by banks that have invested in IRB risk models and those that have not, are *not* a desirable target for policy. Yet this has been regularly cited recently as being pro-competitive for smaller banks. Unjustifiable differences in *risk*, of course, are a legitimate target for policy change. Interventions should thus both focus on and apply the language of risk, not the language of cost. Of late, this vital distinction is being publicly lost.

Accordingly, the Commission supports measures implemented by APRA to ensure that the way that risk weights are set *for all banks* accurately reflects risk. Our concern lies with arguments employed at times by government, which appear to equate cost rises for major banks as being pro-competitive.

The simple truth is that, in market circumstances that exist for home loans in Australia, cost rises are not pro-competitive. For example, APRA's proposals to add greater granularity to standardised risk weights will allow for near equal regulatory capital provisioning for low-risk customers between IRB and standardised banks. Unlike aggregate increases to IRB risk weights, these measures offer scope to improve both the level of competition and the stability of the financial system — more granular risk weights for standardised banks create both disincentive for high risk and incentive for low risk lending, reinforcing stability *and* competition in safer market segments. In the case of improved and staged IRB accreditation, transitioning more banks to IRB systems not only decreases costs of lending but improves prudential outcomes with more sophisticated risk quantification.

Mortgage risk weight precision

The Basel Committee on Banking Supervision (BCBS) considers LVR to be a good predictor of a loan's default. This is the main reason for using LVR as the basis of the standardised risk weights. Also, the potential for loss on a loan generally falls with the LVR. For example, a property's value would need to more than halve for a lender to sustain loss on a loan with a LVR of 30%, whereas a 25% fall in value could see the lender exposed to loss on a loan with a LVR of 80%.

The BCBS (2017) has recently finalised risk weights based with improved risk-weight granularity for low LVR loans but notes that any risk weights need to be tailored to, and informed by, local conditions. Accordingly, APRA has begun consultation to localise and implement new residential mortgage risk weights (APRA 2018r) — their initial consultation paper considers both more granularity for lower LVR loans and risks pertaining to customer profiles (table 6.1).

Table 6.1 **Standardised risk weights for standard eligible mortgages**
Loans covered by lenders mortgage insurance[a]

		Finalised Basel III		*APRA indicative proposed risk weights*	
	Currently enforced	*Where payment is not dependent on cash flows generated by property*	*Where payment is dependent on cash flows generated by property*	*Owner-occupied with principal and interest repayment*	*Other standard residential mortgages*
	%	%	%	%	%
LVR ≤ 50%	35	20	30	20	30
50% < LVR ≤ 60%	35	25	35	25	35
60% < LVR ≤ 80%	35	30	45	30	45
80% < LVR ≤ 90%	35	40	60	40	60
90% < LVR ≤ 100%	50	50	75	50	75
LVR > 100%	75	70	105	70	85

[a] Assumes the borrower is not in default of their loan agreement.

Source: BCBS (2017), APRA (2018r)

APRA's proposed alterations to risk weight policy allow for more targeted risk signals, helping prevent both the over-provisioning of safe assets and under-provisioning of riskier assets. Moreover, increased granularity for risk weights can lower costs for standardised banks (when competing for low LVR loans).

Though cautious of overall impacts, Australia's regional banks have welcomed the proposed reduction in risk weights for lower risk mortgage loans, which should enable them to be more competitive with the IRB banks for low risk lending (sub. DR107).[21] In this sense, greater precision of risk weights will add to efficiency, but who captures the benefits — consumers or banks — is quite debatable.

Improving the risk sensitivity of risk weights will not result in a decrease in the risk weights applying to all mortgages written by smaller, standardised ADIs. IRB banks hold more capital against some loans compared to their standardised peers, suggesting standardised risk weights closer to underlying risk will increase in some cases. APRA's consultation paper proposals increase the risk weights for interest-only and investor mortgages relative to current settings, and larger banks may be better placed to cope with those, if capital is reallocated.

Easier IRB accreditation

There is a significant cost to becoming IRB accredited, including ongoing staff, compliance and information technology costs. By way of example, since its introduction the IRB system has collectively cost major banks over one billion dollars (based on data provided by ADIs). The majority of ADIs are not of a scale to make such an investment cost-effective (Murray et al. 2014a). With the implementation of a 25% average risk-weight floor on residential mortgages for IRB banks, the potential net benefits to be derived from the IRB approach have been limited, creating further disincentives for investment in this cost-reducing approach to risk measurement by banks.

Any regulatory process should only impose the minimum burden necessary to achieve its objectives. Recognising this, APRA (2015e) has announced changes to its IRB accreditation process to make it easier for ADIs to achieve accreditation without weakening the overall standards that accreditation requires. These changes include a staged accreditation processes and a delinking of the previous eligibility requirement of having advanced modelling to determine the capital held against both credit and operational risks.[22] Since the introduction of staged accreditation, one additional bank has been accredited for IRB credit risk modelling (ING Bank) and other banks have indicated to the Commission that they are currently in discussion with APRA for accreditation.

[21] On the implications from risk weight adjustments, the regional banks' submission caveats that risk weights for interest only and investor mortgages increase (sub. DR107, p. 12). Though this may increase costs for regional banks, APRA have flagged an equivalent adjustment in correlation factors for similar loans on IRB banks' books. So long as these adjustments appropriately align with risk, this will not undermine competition but allow market rates to better reflect risk (APRA 2018r).

[22] Credit risk is the risk of default on a debt that may arise from a borrower failing to make required payments. Operational risk is the risk of failure due to *operating* within a certain field or industry, and is separate from systemic or market-wide risk.

The Bank of England’s Prudential Regulation Authority (2017) has also moved to make it easier for smaller banks to become IRB accredited. Its approach has focused more on the initial engagement between the regulator and applicants, setting clear expectations on the requirements for accreditation and how banks can use external data when they do not have sufficient data of their own for the IRB modelling.

We have heard varied evidence on the ease of IRB accreditation in Australia. Consultation with banks that are IRB accredited in multiple jurisdictions indicated that APRA processes do not seem more onerous than those of prudential regulators in other countries. Nevertheless, there is substantial expertise required in model development and relevant regulation — an Australian bank without existing data, modelling skills and experience in accreditation will have additional costs in gathering resources before even developing a model or seeking accreditation for it.

Some submissions report historical data as the largest barrier to accreditation (sub. DR79). Australian ADIs can already use external data (including pooled data) in certain circumstances (APRA 2012b, 2013c) but there may be scope to expand its use and/or provide clearer guidance to ADIs. NAB’s submission stated that use of external pooled data such as Global Credit Data could be beneficial to the entire industry, not just small banks seeking accreditation (sub DR94, p. 13).

The Commission supports APRA’s efforts to decrease accreditation burdens and encourage further recognition of external data sources to bridge information gaps for banks without sufficient data. In addition, we see merit in (in the future — once the use of Comprehensive Credit Reporting and analytical techniques with available data are better able to be used by institutions in assessing credit risk) an investigation by APRA into expanding the new staged accreditation process to allow for partial accreditation classifications, not just as an interim stage to full accreditation. APRA could allow partial accreditations for portfolio or risk type (for example, credit) depending upon where models are easily separable without compromise. Though prudential regulators would prefer a full IRB accreditation, accrediting some functions of an ADI would be preferable to no risk modelling whatsoever and importantly, allow more banks to achieve lower costs for their major lending portfolios.

Lenders mortgage insurance and risk-weighting

The regulatory treatment of lenders mortgage insurance (LMI) forms a subset of the concerns around risk-weighting differences (LMI is discussed in detail in chapter 13). Regulatory recognition of LMI is different for IRB and standardised ADIs:

- The standardised approach prescribes the minimum requirements for LMI to be recognised for regulatory purposes and the risk weights that will apply.
- ADIs using the IRB approach can recognise the effects of LMI in their modelling as means of decreasing loss given default (LGD, see box 6.2). However, APRA (2014a) has set a 20% floor on the LGD for those using IRB models, limiting the benefits from LMI.

> The introduction of a 25% floor on the average risk-weight for the residential mortgages of IRB banks has also embedded a lack of capital benefits of LMI for IRB banks.

Floors in IRB modelling prevent the same level of LMI recognition in risk weights compared to standardised banks, meaning there is less regulatory incentive for IRB banks to insure mortgages. In particular, the 20% floor on LGD estimates prevent full acknowledgment of risks removed from an IRB bank's book when they use LMI.

The LGD floor is a more conservative treatment than that originally prescribed under Basel II (which required a 10% floor). The floor on LGD estimates was originally driven by APRA's concern over the IRB banks' inability to demonstrate the credibility of their LGD estimates in a downturn scenario. However APRA has flagged the potential to decrease LGD floors to 10% where a bank can demonstrate robust LGD modelling (APRA 2018r). The regional banks have expressed concern that this reduction is likely to 'undermine the capacity of smaller banks to compete on price for lower risk loans'; but they note it is hard to give an overall assessment at this stage (Regional banks, sub. DR107).

A lower LGD floor would be a less conservative interpretation of Basel, allowing IRB banks to hold less provisions for low risk credit products. Halving LGD floors is consistent with a decrease in the Basel III LGD floor from 10% to 5% (BCBS 2017).

Box 6.2 **Loss given default and other inputs to IRB models**

Loss given default (LGD) is a key parameter in IRB models. It is an estimate of the proportion of the total loan amount that would be lost (written off) should a borrower not meet the terms of their loan contract (for example, by failing to make the agreed loan repayments).

LGD estimates are combined with the following to construct an estimate of the expected loss for a loan:

- an estimate of the probability that a borrower will become unable to meet the terms of their loan contract (known as the probability of default (PD))
- the amount the borrower will owe the ADI at that time (exposure at default (EAD)).

The expected loss on a loan informs the risk-weight that is to be applied to that loan. In turn, that risk-weight informs the level of regulatory capital the IRB bank will need to hold against the loan.

While there may be little, if any, capital benefit to IRB banks of using LMI currently, they often continue to do so. For example, NAB (2017b) requires LMI for the majority of its residential mortgages with a LVR over 80% and has a longstanding requirement for LMI on investor loans against inner city residences with a LVR over 70%.

The reasons put forward for the ongoing use of LMI by IRB banks include the desire to smooth the variability in losses over time (APRA 2014a) and the transfer of credit risk to a third party (RBA 2013c). There can be other benefits to ADIs from using LMI, such as having a second review of riskier high LVR loans. These other benefits are also likely to influence the decisions of IRB banks to use LMI. Chapter 13 also notes some practices that may offer incentives to banks to use LMI, without apparent benefit to consumers.

Some IRB banks are choosing not to use LMI. QBE Insurance Group (sub. 34, p. 7) has noted that some IRB banks are:

> …[using] a combination of 'un-insured risk retention' (charging the borrower a fee and retaining the risk on balance sheet without insurance), waiving of LMI (retaining the risk on balance sheet without charging a fee or seeking insurance), [and] other credit risk mitigants provided by entities not regulated by APRA, along with LMI.

Genworth (sub. 44, p. 6) expressed concern about mortgage risk retained on IRB banks' books as a potential for buildup of risky, high-LVR loans that could leave IRB banks open to 'significant exposures if an extreme stress scenario results in unexpected losses'. It is unclear to what extent the use of LMI reduces the risk for an individual IRB bank, or the broader financial system, under such a scenario. On the one hand, the major banks have many times the financial resources (including capital) available to them compared to the LMI industry (APRA 2014a). Further, given the stronger credit ratings of the major banks relative to LMI providers, self-insurance may be a rational (and effective) strategy.[23] On the other hand, APRA regulates the LMI providers to a very conservative standard and they can also spread their risks through international reinsurance arrangements.

In general, we consider that it should be for individual banks to decide the extent to which they use LMI and which providers to use — but with greater care on price and consumer terms (see chapter 13). The prudential regulatory settings, this chapter's primary interest, should simply reflect as accurately as possible the relative risk of different options so that these decisions can be taken without any distortion to either competition or system stability.

6.2 Targeted prudential interventions

In addition to prudential regulation, APRA may implement targeted interventions into particular market segments where the ongoing regulatory program cannot provide sufficient coverage or speed for imminent market problems — most recently, segments of home loan market that APRA considers a higher prudential risk.

In 2014 and 2017 APRA, backed by the Council of Financial Regulators (CFR), advised all ADIs of new benchmarks for first, investor mortgage growth and then, the share of interest only mortgage in their portfolios, with potential consequences for those ADIs that exceeded the benchmarks (chapter 7). These benchmarks were introduced to counter what APRA saw as competition eroding lending standards (sub. DR116, p. 13). By April 2018, APRA was satisfied that ADIs' lending policies had improved, and the investor mortgage benchmark

[23] The major Australian banks have issuer ratings of AA- from Standard and Poor's compared to the mortgage insurance arm of QBE and Genworth that have financial strength ratings of A+.

was replaced with a requirement for ADI boards to provide assurances on their lending policies and practices. The benchmark on interest only lending will continue to apply (APRA 2018g).[24]

Price and competition consequences

Though APRA achieved the intended corrections to lending standards through the benchmarks (The Treasury, sub. DR126), there have been negative consequences for the availability and price of some mortgage products. Under the benchmark interventions, any ADI charging a materially lower interest rate than its competitors would receive an outsized number of loan applications that, if approved, could result in it breaching APRA's growth limit for the investor segment. As a result, ADIs increased their pricing for investor and interest-only lending — including both new and existing loans — or temporarily discontinued cheaper products (chapter 7).

The choices of banks to increase *existing* investor mortgages prices was a predictable, profit maximising response by ADIs to APRA's intervention that should have been anticipated. When there is a limit on competitor responses (that is, all ADIs were prevented from offering better rates to attract customers of other ADIs by the APRA growth limit), all banks can increase the price to existing customers without fear that the customer could refinance to a cheaper product elsewhere.

The public statements of various banks rationalised these increases in standard variable rates as a means to compliance (for example, CBA, sub. DR79), but pricing documentation acquired by the ACCC show that at least one of the major banks was incentivised by the 'substantial economic benefit of hundreds of millions of dollars in additional revenue' (sub. DR129, p. 4).

Despite this, the RBA consider that APRA should not be responsible for, or have to consider, the increased prices to investor customers as price movements are at the discretion of individual firms (sub. DR82) — oral advice suggests Treasury hold a similar view. Yet, as described in this section, the market observed a predictable pricing response across ADIs, not a series of individual responses.

This denial of the relevance of a predictable cost is inconsistent with the thought that should precede any billion dollar decision, be it an infrastructure project or a prudential intervention. Cost–benefit analysis (or any equivalent) should encompass all costs.

Such responses from banks are likely to be repeated in the next round of prudential interventions, even if they do not raise costs. Rather than accept them as natural consequences, regulators should minimise the opportunities for banks to turn regulatory intervention into a profit-enhancing opportunity. The new processes recommended by the Commission in chapter 19 can go a considerable way towards this goal.

24 APRA retained the option to maintain the benchmark for ADIs whose boards were unable to provide the expected assurance, or where ADIs had operated above the benchmark in the six months prior to its amendment (APRA 2018g).

Targeting underlying drivers of poor lending practices

APRA's interventions did not address the underlying cause of poor lending. APRA recognised this and complemented its benchmark intervention by acting to directly control the underlying problems of lending standards (as well as competition as a proxy to lending standards). The 2014 investor lending intervention included increased scrutiny of loan repayment affordability, the 2017 interventions placed restrictions on high LVR interest only loans and throughout the interventions, APRA has assisted ASIC in investigating and tightening lending standards (sub. DR116, pp. 14–15). The Commission believes such measures (which directly target lending standards), in conjunction with proposed risk weights (which recognise the risks inherent to investor and interest only loans), will serve as more sustainable deterrents of excessive risk taking behaviour.[25]

As noted by Treasury, poor lending standards posed an immediate risk to the Australian economy (sub. DR126 p. 7) and regulatory overhaul (as is proposed for risk weights) can take years. In the Commission's view, swift action by APRA was appropriate.

Our criticism is not that action was taken, but rather that it is unclear the extent to which alternative interventions, that would have less anti-competitive consequences, were genuinely considered. And, if they were considered, it is unclear why they were dismissed. The concerted view of the CFR against considering predictable costs of an intervention is a matter that should be addressed, by it or by the Government. International experience shows that alternative interventions exist and have been implemented overseas.

International approaches to lending standards and systemic risks

With central banks around the world constrained to low interest rates during a slow GFC recovery, many countries have turned to novel prudential interventions to address the perverse incentives in lending from cheap credit and strong housing price growth. These interventions are sometimes referred to as 'macroprudential' as they seek to address the systemic risks banks can impose on the financial system.

In particular, sectoral capital and borrower-based tools can directly target lending to riskier segments through proxy indicators such as LVR or loan-to-income ratios. These types of interventions include:

- LVR restrictions (Canada and New Zealand)[26]
- Minimum amortisation requirements for high LVR loans (Norway and Sweden)

---

[25] For example, recent directions from APRA provide a means for ADIs to replace their investor growth limit with loan serviceability criteria among other general risk policies (APRA 2018g). These criteria specify rules for consideration of borrower income, interest rate buffers and collecting borrower expense data (in the context of comprehensive credit reporting) — all of which provide more targeted controls of lending standards without obstructing competition for safe investor lending.

[26] In New Zealand, the LVR limits were to restrict the extent of new lending to high LVR borrowers. These restrictions are tighter for loans secured by Auckland investment properties as part of the response to the growing housing market risks in that region.

- Maximum loan-to-income ratios (Norway)
- Caps on repayment-to-income ratios (Canada)

These policies do not have a long track record and, as a result, there is not a wide set of experiences upon which to draw. In addition, the RBA notes it is difficult to assess the effectiveness of these policies as their effects are hard to isolate and measure, especially as they are often implemented in combination with other policies (Orsmond and Price 2016). However, in each case, the policy intervention addressed the problem of new loans and would be likely to have less (if any) impact on existing mortgages, unlike APRA's benchmark approach.

APRA's experience in lending interventions and the actions of regulators overseas highlight the importance of selecting the right tool (or combination of tools) to address threats to systemic stability. It also illustrates the need for ongoing analysis of novel interventions and macroprudential policy outcomes, particularly on competition, to better understand the effectiveness of these policies, inform future policy decisions, and to clearly communicate policy objectives (chapter 19).

6.3 Government policy measures

In addition to the efforts of independent regulators, the Australian government may intervene in the banking sector to pursue stability objectives through budgetary policy or bespoke instruments. During the global financial crisis (GFC), the Australian government enacted three key policies to reinforce financial stability: the financial claims scheme; the wholesale funding guarantee; and residential mortgage backed security purchases.

Without these interventions, some Australian ADIs and their depositors may have faced heightened risk of failure during the GFC, for example, due to the inability to roll-over international wholesale funding without a government guarantee.

Though these policies are clear and intentional interventions, they reinforce the perception that government will support larger institutions and that they will bail out banks which are 'too big to fail' in times of stress (as their failure could cause a financial crisis, see box 6.3). This implied government support gives major banks (and some smaller banks) a rating uplift from credit ratings agencies and consequently lower costs of funds in debt markets. This section examines government interventions and where they may impact competition for banking services.

Box 6.3 Too big to fail and D-SIB

'Too big to fail' is the notion that some financial institutions are so large and interconnected with various parts of the economy that their failure would cause widespread economic disaster and a government should intervene to prevent any potential failure. A recent history of nationalisations and bailouts from the United Kingdom and United States governments during the global financial crisis suggests that in many circumstances, governments cannot make credible threats to not protect such institutions in crisis. Where a bank is deemed too big to fail, it may engage in excessive risk taking behaviour, taking profits when the risk pays off while letting the government bailout the bank if the risk does not pay off and the business fails.

Many countries have adopted the Basel committee's approach to identifying banking institutions that pose a systemic stability threat if they fail, known as systemically important banks. Systemically important banks attract greater regulation to internalise the extra risks they pose on the financial system by virtue of size. These can be globally systemically important banks (G-SIBs) or domestically systemically important banks (D-SIBs). There are no G-SIBs based in Australia.

APRA's framework for determining D-SIBs is based on four indicators: size, interconnectedness, substitutability and complexity. For some indicators, the assessment criteria are relatively straightforward. For example, the assessment of size is based on a bank's total resident assets. For other indicators, the assessment process is more complex. For example, the assessment of complexity draws on the extent of a bank's dealings in over-the-counter derivatives, its trading activities (and assets held in trading portfolios) and the assets on its balance sheet for which a fair value cannot be easily determined (APRA 2013b).

Implicit guarantee

While the ratings agencies each hold similar expectations on government intervention for 'too big to fail' institutions, they differ in their assessment of the associated ratings uplift from the expected support (table 6.2).

The ratings agencies also give Macquarie an uplift due to perceived government support. The uplift to smaller banks' ratings is smaller or zero (RBA 2015d).

Not all of the debt instruments issued by the major banks reflect the ratings uplift. For example, Moody's removed the uplift for government support from its ratings for subordinated debt in 2013 (RBA 2016c) and S&P's ratings on hybrid and subordinated debt instruments reflect the view that government support is unlikely to be extended to these instruments (S&P 2017). On the other hand, S&P's expectation that government support was highly likely for senior debt issued by the four major banks averted an otherwise likely downgrade of the rating for these instruments (S&P, pers. comm, 22 January 2018).

Table 6.2 **Impact of implied government support on credit ratings**

Rating uplift from government support

	Moody's[a]	*Standard and Poor's*[b]	*Fitch*[c]
ANZ	2 notches	3 notches	(1)
CBA	2 notches	3 notches	(1)
NAB	2 notches	3 notches	(1)
WBC	2 notches	3 notches	(1)

[a] Long-term rating compared with Baseline Credit Assessment. On 19 June 2017, Moody's lowered the ratings for various Australian banks, but retained the two notches of uplift for the four major banks, reflecting Moody's expectation of a "very high" probability of government support, in case of need. [b] Long-term issue rating compared with Stand-Alone Credit Profile (SACP). On 21 May 2017, S&P lowered the SACPs of almost all financial institutions operating in Australia, but affirmed the long-term issuer credit rating for the major banks, reflecting S&P's expectation of 'likely timely financial support from the Australian government, if needed'. This effectively increased the rating uplift by another notch. [c] Fitch rates support from 1 (extremely high probability of support) to 5 (cannot rely on support).

Source: RBA (2012c); S&P (2017)

The views of ratings agencies and capital markets persist despite the absence of direct policies or statements from the Australian Government to confirm support of any kind would be provided. However, the Australian Government's conduct in the wake of the GFC did little to disavow ratings agencies, capital markets and depositors of the notion that support would be supplied. Though ratings agencies' uplift for major banks partly reflects government actions, they nevertheless exacerbate perceptions of 'too big to fail'.

FINDING 6.1 BETTER RATINGS AND COST OF FUNDS FOR 'TOO BIG TO FAIL' BANKS

The major banks in Australia benefit from a 'too big to fail' status reflecting an expectation of government intervention if one or more of these banks were in financial difficulties. This status lowers the cost of funds for these banks.

By incorporating perceived government support in their relative ratings of Australia's banks, rating agencies further embed the major banks' 'too big to fail' status.

Quantifying the extent of any funding advantage from the uplift in credit ratings is a difficult task. The size of an ADI can affect perceptions of its creditworthiness but size is also part of the ratings agencies' belief that government support will be provided in a crisis. Disentangling these two effects on the funding cost of ADIs is difficult if not impossible. Notwithstanding this, the RBA estimated the size of this subsidy for Australia's four major banks at $1.9 billion a year. This represents the amount of interest major banks saved due to their lower funding rates (RBA 2016c).[27]

[27] The RBA found that the implicit guarantee lowered major banks' funding costs by about 20 – 40 basis points (RBA 2016c). Despite controlling for a number of ADI and bond specific variables (but not the size of the ADIs) within its model for bond spreads, the RBA placed a number of caveats on the model output and associated inferences for the extent of the major banks funding advantage.

The RBA's modelling and literature review strongly indicate that the funding advantage rises and falls over time. For example, the funding advantage was estimated to have fallen to reach close to zero in late 2014, a time of relative stability for financial markets and the financial sector. On the other hand, there are estimates in the literature of a 120 basis point advantage for the major banks in 2009, a time of heightened instability for financial markets and the financial sector.

The widening of the funding advantage in times of instability within the financial sector is the result of the decisions of many actors within capital markets. Some of the considerations in those decisions likely included a heightened expectation of government support for the major banks around the time of the GFC and an increase in investor risk aversion that reduces their appetite for the bonds of smaller ADIs.

APRA has increased the regulatory capital the major banks are required to hold (box 6.1) since the RBA modelling was undertaken. The increased capital requirements are aimed at making banks unquestionably strong. This should reduce the likelihood of the major banks ever requiring government support and so reduce the benefit inherent in any such implied support. As a result, the funding cost advantage of the major banks may have reduced from that modelled by the RBA.

The Financial Claims Scheme

In 2008, the Australian Government announced it would guarantee deposits of $1 million or less in locally-incorporated ADIs via the Financial Claims Scheme (FCS). This was part of the Government's response to the onset of the GFC. The upper limit on the size of deposits covered by this guarantee was eventually reduced to $250 000 per retail investor per ADI in March 2012. Government-backed depositor protection schemes (such as the FCS) reduce the likelihood that depositors will create a 'run' on a bank and are accepted around the world as a means of promoting financial stability. In addition, the RBA (sub. 29, p. 22) considered the FCS 'to have enhanced competition to the extent that it has reduced perceptions that deposits at some institutions are safer than others'.

The FCS works by having the Government repay depositors through a standing appropriation in the event of an ADI's failure. Once payments were made, the Government would receive a priority claim against the assets of the ADI in the liquidation process, to recover the cost of initial payments to depositors.

To date, no fee has been charged for provision of the Australian Government's guarantee. That is said to be because there is a very low probability that insufficient funds would be recovered from an ADI's liquidation to cover the deposits guaranteed due to a combination of three factors:

- the remote probability of an ADI being placed into liquidation
- the capital held by ADIs, and
- the priority ranking of depositors in liquidation under the *Banking Act 1959* (Cth) (Davis and Jenkinson 2013).

However, the FCS creates a 'timing' cost to the government. If the guarantee is invoked, the Government would pay protected depositors rapidly while it would have to wait for formal liquidation to recoup these funds.

Another argument for the lack of a fee might be that the fee would add to consumer costs while offering consumers no visible benefit (when the financial system is stable). However, this ignores the 'timing' benefit that depositors gain from the scheme — they do not have to wait for their funds or face any uncertainty if a bank fails.

The FCS does not extend to deposit-like products issued by non-ADIs to retail investors, such as debentures issued by finance companies. While this could be considered to place non-ADIs at a competitive disadvantage in sourcing retail funds, any such disadvantage needs to be balanced against the regulatory requirements (including capital requirements) and the associated burden applying to ADIs and through which access to the guarantee is facilitated. Further, the transparency of a capped, explicit guarantee better supports informed decision-making by investors compared to the implicit guarantee with an uncertain cap that was effectively in place prior to 2008.

Wholesale funding guarantee and RMBS support

The Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme) commenced in 2008 in response to deteriorating international wholesale funds markets during the GFC. As part of the scheme, the AAA-rated Australian Government guaranteed eligible wholesale funding securities. This lowered the perceived risk of Australian ADI funding instruments and enabled ADIs ongoing access to wholesale funds in the risk-averse international markets. The scheme required voluntary applications from ADIs of certain eligible securities, with fees charged as a portion of value guaranteed. The scheme ceased all new guarantees in 2010, though existing guaranteed securities were covered till maturity.

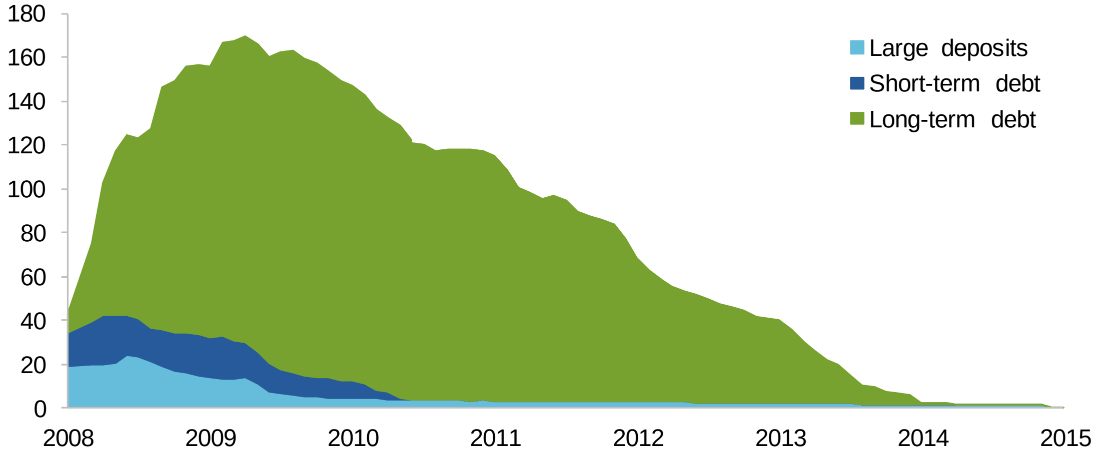
The Guarantee Scheme was enacted in response to a significant reduction in the availability of wholesale funding. That reduction was considered to have potentially serious implications for the liquidity and lending activities of Australia's ADIs. Prior to the Australian Government's announcement, other countries had begun guarantee schemes to support the funding of their financial systems and this left Australia little option but to follow as, in the then uncertain environment, it was untenable for unguaranteed banks to compete for funding against their guaranteed peers (Schwartz and Tan 2016).

Liabilities guaranteed under the Guarantee Scheme peaked at just under $170 billion in February 2010 and were dominated by long-term wholesale debt over the scheme's life (figure 6.1). The total fees paid to the Australian Government by ADIs using the facility were $4.5 billion (Schwartz and Tan 2016).

Major banks received relatively less assistance as a share of total liabilities from the Australian Government's support measures compared to other banks — 4.1% of major bank liabilities were guaranteed by the government compared to 11.7% for the non-major banks. However, they received greater assistance in terms of the dollar value of long-term debt (table 6.3) (Schwartz and Tan 2016). Non-ADIs received no support under the Guarantee Scheme.

Figure 6.1 **Government guaranteed wholesale banking liabilities**

$ billions, 2010–2015[a]



[a] Outstanding liabilities were guaranteed until October 2015 when the Guarantee Scheme ended.

Source: Australian Government (2017b)

Table 6.3 **Long-term debt guaranteed by the Australian Government**

March 2010

	Guaranteed long-term debt $b	*Share of total liabilities %*
Major banks	94.9	4.1
Non-major banks[a]	32.1	11.7

[a] Does not include foreign branches.

Source: Schwartz and Tan (2016)

In addition to the Guarantee Scheme, the Treasurer directed the Australian Office of Financial Management (AOFM) to invest up to $20 billion in residential mortgage-backed securities (RMBS). The directions were issued between October 2008 and April 2013 and intended to support competition in mortgage lending by ensuring funding for securitised mortgages remained available. The major banks did not sell any securities into the AOFM's program (AOFM 2016a). The Treasurer instructed the AOFM to begin divesting its RMBS portfolio in May 2015 (AOFM 2016b).

Dealing with expectations of government support

The GFC demonstrated that, as competent as regulators and policy makers may be in addressing local risks and issues, offshore events are beyond their control. The timing and effects of offshore events are unpredictable and this makes them difficult to plan for.

History also shows that a government cannot credibly assert that a large institution will be allowed to fail. Moreover, many would argue that it would be troubling were it to do so.[28]

Governments can draw on local and overseas experience to see the forms of assistance that may be required in a crisis. Governments and central banks have long been recognised as lenders of last resort to the banking sector. Guaranteeing the debt of ADIs to allow them continued access to capital markets is an indirect way of fulfilling this role, and the precise nature of the guarantee does not need to be determined until the time it is needed, when the risk can be better judged.

Making this role explicit would improve transparency around the extent of future government support, and might assist capital markets to more accurately price debt issued by ADIs, although some uncertainty would inevitably remain.

ADIs should pay for any support they receive from taxpayers via the Australian Government. This simply reflects commercial reality in the finance sector — banks levy a fee to guarantee the financial and contractual obligations of their customers. Unpriced support would also deter prudent risk management (as the ADI will not bear the cost of its actions) and distort competition (as some ADIs will benefit more from government assistance than others).

The fee for ADIs accessing the Australian Government's wholesale funding guarantee (table 6.4) was based on their credit rating. This reflected standard commercial practice of basing the cost of financial accommodation on the risk profile of the counterparty.

Table 6.4 **Fee for the Guarantee Scheme for Large Deposits and Wholesale Funding**
2008–2012

Institution credit rating[a]	*Fee charged on the balance of guaranteed liabilities*[b]
AAA to AA-	0.7% per annum
A+ to A-	1.0% per annum
BBB+ and below	1.5% per annum

[a] Standard and Poor's issuer rating (or equivalent). [b] Fees were charged monthly in arrears.

Source: Australian Government (2012); Schwartz and Tan (2016)

28 For example, Nobel laureate economist Paul Krugman is a key proponent of 'too big to fail' banks. Krugman suggests that very large and well-regulated banks are beneficial to an economy due to their scale advantages.

However, fees based on the credit ratings should be adjusted to remove any uplift reflecting potential government support, particularly in the current circumstances where the major banks have an advantage based on the perception that they are more likely to receive government capital support (as shown in table 6.2). Of course, if the arrangements were available to all ADIs, the difference in the ratings for this reason would gradually disappear.

An alternative approach might be to pre-fund government support through some form of insurance scheme. This has the advantage of spreading the cost across all industry participants who benefit from the protection even if they do not use it. However, the uncertain nature of the events to be insured and the scale of the likely support options mean that modelling would be difficult and might lead to the establishment of a fund larger than required. Such over-insurance would inevitably cost both the industry and its customers.

The major bank levy

The major bank levy has been put forward by the Australian Government as part of its effort to level the playing field between the major banks and others, among other justifications. This approach has been endorsed as a step in the right direction by the Regional Banks (sub. 37, p. 53).

The levy was introduced on the 1 July 2017 for ADIs with liabilities over $100 billion. Currently, five banks meet this criteria — ANZ, CBA, Macquarie, NAB and Westpac. All eligible banks use IRB systems and all except Macquarie are domestically systemically important banks.

The levy is an annual tax of 6 basis points on major banks' liabilities including corporate bonds, commercial paper, certificates of deposit, and tier two capital instruments (but does not apply to tier one capital or deposits covered by the Financial Claims Scheme). The levy is charged quarterly on liabilities reported to APRA.

Government documentation variously justifies the levy as a fix for competitive neutrality issues in funding costs for major banks, budget repair and externalities arising from the systemic risks major banks pose on the Australian financial system (Australian Government 2017g; Joye 2017).

6.4 Ownership restrictions

There are two main restrictions on financial institution ownership in Australia; the Four Pillars policy and the *Financial Sector (Shareholdings) Act 1998* (Cth) (Shareholdings Act). The Four Pillars policy restricts the four major banks of Australia from merging while the Shareholdings Act requires permission from the Treasurer before anyone can acquire more than 15% of an a prudentially regulated institution's voting shares.

Though similar in effect, the two ownership restrictions target different policy outcomes. The Four Pillars policy is intended to ensure competitive outcomes (that is, a sufficient number of large competitors) and the Shareholdings Act aims to increase financial stability by limiting the ties between an institution and the finances of any particular investor and their associates.

Loosening the ownership cap on banks

The Shareholdings Act was enacted for prudential reasons in response to the 1997 Wallis Financial System Inquiry (FSI), to create a diversity of ownership. It is intended to reduce the probability that the financial health of a prudentially regulated financial institution is dependent on the fortunes of an individual person and/or their associates (House of Representatives 1998). Financial institutions may apply for an exemption from the Treasurer (on national interest grounds) or from APRA if the ADI has less than $1 billion in residential assets (HoRSCE 2016e).

In its first report of a review of the four major banks, the House of Representatives Standing Committee on Economics (2016e) suggested that there are reports of this requirement limiting bank start-ups where a small number of individuals hold the majority of shares. The Committee recommended that the Australian Government review, by 2017, whether the 15% threshold is an undue barrier to entry.

As of April 2018, the Australian government has released draft legislation to increase the ownership cap to 20% (Morrison, S. (Treasurer) 2018b).[29] In addition, the draft legislation provides simplified means to exempt new ADIs and insurers with limited assets from the cap.

These adjustments to the ownership cap are an important step in alleviating barriers to entry for small start-up financial firms. As noted by Xinja, small ADIs will often rely on venture capital providers or large equity contributions from interested parties for initial capital needs — more than would be allowed under the 15% cap (PC transcript, 2018, p. 64). The Commission welcomes both the cap increase and greater consideration of new ADIs and insurers which will decrease the regulatory burden and encourage new entry. Alleviating barriers to entry is especially important considering there has only been one new domestic ADI entrant over the past 15 years.[30]

---

29 The Government released exposure draft legislation in April 2018 that includes an increase in the general ownership cap from 15% to 20%, in line with the requirements of the *Foreign Acquisitions and Takeovers Act 1975* (Cth), and to allow owners of domestically incorporated companies to hold more than 20% of a financial sector institution under certain conditions. Once the new firm passes an asset threshold, any shareholders holding more than 20% must provide notification to the Treasurer.

30 This excludes credit unions, building societies, foreign banks and 'other' category ADIs as defined by APRA. As discussed in chapter 4, the one new domestic ADI entrant is Tyro — although volt bank has now been approved as a restricted ADI.

Four pillars

The Four Pillars policy (box 6.4), as it is known today, came into effect with the Australian Government's response to the Wallis FSI (1997).

> The Government has further decided that mergers among the four major banks will not be permitted at this time. This will be reviewed when the Government is satisfied that competition from new and established participants in the financial industry, particularly in respect of small business lending, has increased sufficiently to allow such mergers to be considered (Costello, P. (Treasurer) 1997).

Box 6.4 **Four Pillars policy**

The Four Pillars policy dates back to 1990 when it was introduced as the 'six pillars policy' to prevent a merger between any of the four largest banks and the two major life insurance companies of the time (Keating 1990). In 1997, the policy was narrowed to prevent a merger between the four major banks only and became known as the Four Pillars policy. Successive Australian Governments, including the current one, have maintained the policy (Crowe 2014; Murray et al. 2014a).

The Four Pillars policy is not reflected in any legislation. In practice, it would be given effect through the Treasurer's power under one of the following statutes:

- the *Banking Act 1959* (Cth) which requires the Treasurer's approval for any sale of an ADI's business by amalgamation. In making a decision, the Treasurer is required to take into account the national interest and not unreasonably withhold approval.
- the *Financial Sector (Shareholdings) Act 1998* (Cth), which requires the Treasurer to approve any person holding a stake (effectively voting power) of over 15% in a financial sector company (draft legislation was released in April 2018 to increase this threshold to 20%).

There have been a mix of findings and recommendations across those reviews of the financial sector that have considered the policy. The Wallis FSI (1997) recommended that the then 'Six Pillars' policy should be removed. It concluded that the predecessor to the *Competition and Consumer Act 2010* (Cth) and the merger review role of the Australian Competition and Consumer Commission (ACCC) were sufficient to prevent acquisitions that would have detrimental effects on the community.

In contrast, the Senate Economic References Committee (2009b, p. 56) recommended the policy be retained as 'the Act sets such a high bar that the ACCC may not have grounds to prevent such a merger, which the Committee would regard as not being in the national interest'. Similarly, the Murray FSI (Murray et al. 2014a) saw the policy as providing necessary protection to consumers in addition to the general competition law, and made no proposals to change it.

In prohibiting these specific mergers, the Four Pillars policy is viewed as more prescriptive than the *Competition and Consumer Act 2010* (Cth) — which prohibits any merger or acquisition that would be likely to result in a 'substantial lessening of competition', unless it is found likely to deliver a public benefit.[31]

[31] Section 50, section 95AN.

It is important to recognise that the merger restrictions under Four Pillars are a policy, not a legislated obligation. Despite that, it has become a core element of thinking in the banking industry. This has some possible unintended costs to competitive behaviour.

Laws strong enough to protect competition

While noting the longstanding acceptance of the Four Pillars policy, the Commission considers that the policy duplicates strong competition and prudential protections available elsewhere.

Australia's competition laws already prohibit acquisitions that have, or would be likely to have, the effect of 'substantially lessening' competition in any market under section 50 of the Competition and Consumer Act. As the acquisition of any of the four largest banks by one of the others is likely to result in a substantial lessening of competition, such an acquisition would effectively be prohibited under the Act, unless a public benefit that more than outweighs the detriment to competition could be demonstrated.

The mergers approval processes under the Competition and Consumer Act have been strengthened and streamlined, while remaining subject to the 'substantial lessening of competition' test. Further, the strengthening of section 46 of the Act now provides strong protection against conduct that has the purpose, effect or likely effect of 'substantially lessening' competition. As a result of these changes and the strength of the Act tself, the ACCC is capable of managing the competition consequences of any prospective or mooted merger.

Moreover, an approval of a major bank merger need not result in a single bank that is the sum of the merger partners. The ACCC has powers under the Competition and Consumer Act to consider structural undertakings (for example, divestment of specific functions) when considering whether to grant approval for a merger. The Treasurer can also place conditions on approvals granted under the *Banking Act 1959* (Cth) and *Financial Sector (Shareholdings) Act 1998* (Cth) as occurred in Westpac's acquisition of St. George (Swan 2008b) and CBA's acquisition of BankWest (Swan 2008a).

In some circumstances, such as when a bank is failing, there can be a strong public benefit from bank mergers. A merger can limit taxpayers' exposure to a potential bailout. For example, while the CBA/BankWest merger led to consolidation in the market, it was nevertheless assessed as being both in the public interest and in the interests of longer term competition as, due to the GFC, Bankwest's UK-based parent had failed (ACCC 2008b).[32]

Similarly, a major bank merger that is inconsistent with the Four Pillars policy may be in the public interest in the future (for example, in the event of a financial crisis) but the Four Pillars policy would suggest it should not occur. Regulators or political leaders may thus have very strong incentives to try other interventions in order to avoid confronting such a long-standing policy.

[32] Additionally, the recent resolution of failing Spanish bank Banco Popular via merger has been praised as a swift and successful policy response with minimal cost to taxpayers (Council of the European Union 2017).

It was only in 2013 that Australia's largest airline sought Government guarantees in order to avoid a market crisis. More recently, a large steel-maker was rescued with government support. Policies that emphasise claimed national priorities can become dangerous points of leverage when market crises occur.

The broader effects of the Four Pillars policy

While protecting competition may have been the stated objective of the Four Pillars policy, in practice it has protected a specific market structure above all else — one dominated by four domestic banks. It has thus had the scope to weaken the four major banks' ability to pose a credible competitive threat to each other. The subsequent lack of takeover threat (posed by the major banks) to discipline board performance would normally be expected to depress competitive pressure.

Even so, in the Australian banking system, other prudential and regulatory settings (discussed in chapter 7) are likely to more significantly reduce the competitive pressure the major banks would otherwise face and outweigh any supposed advantages that the Four Pillars policy may confer.

The threat of takeover is an important regulator of both firm and board performance. In a typical market when a firm is underperforming, inefficient or poorly directed, it is particularly susceptible to takeover — the acquiring firm will often terminate board members and restructure until the purchased firm delivers better results (Lel and Miller 2014). These consequences of inefficiency or poor management serve as strong performance motivators.

The Four Pillars policy dulls the regulating effects and motivators of takeover threat. When there is little personal risk to senior management of simply extracting the benefits of monopolistic power rather than actively competing and managing, they will often do so. For example, the recent APRA review of CBA found there was little personal consequence to management for poor customer outcomes or bad risks in addition to a complacent governance culture (APRA 2018o).

One success claimed in the policy's name is that it helped Australia's banking sector survive the GFC by in fact deterring competition. The then Treasurer, Wayne Swan, said in June 2008:

> I take our experience over the last year as a demonstration of the soundness of the four pillars policy. These are banks which have performed as well as or better than any banks in the world during an exceptionally difficult period. Quite apart from the need to sustain competition in the banking market, I would not be at all comfortable if the soundness of our banking system depended not on the strength and risk management skills of four banks but on the strength and risk management skills of a lesser number. (House of Representatives, 2 June 2008)

Former RBA Governor Macfarlane (2009, p. 44) agreed that the Four Pillars policy had improved stability, and suggested that the policy does more to suppress competition than to advance it:

> The most curious thing about the four pillars policy is that its aim has always been to maintain or increase competition, it being felt that the present four major banks would provide more competition than the two that would be implied by the abolition of the policy. So the quiet irony in my view is that the policy has made a positive contribution to improving the stability of our financial system, but not because it increased competition, but because it reduced it to manageable levels.

Despite these reflections, we note that the government also introduced a range of policies during the GFC aimed at reducing the risk of failure for Australian ADIs including the banks covered by the Four Pillars policy. It is wrong, but indicative of the misleading nature of the policy many years after its inception, to suggest that the Four Pillars policy, rather than the prudential regime, existing banking laws and specific government interventions, created systemic stability during the GFC. In this sense, the Four Pillars policy reduces competition but without any clear offsetting stability benefits.

International practice would suggest that the Four Pillars policy is unnecessary for stability of banking. Like Australia, Canada did not need to call on taxpayers to bail out banks during the GFC. Yet there is no Canadian Government policy similar to the Four Pillars (Davis 2007). Instead, Canada has legislated similar controls on bank ownership to those set out in the Financial Sector (Shareholdings) Act (Government of Canada 2016) and has blocked mergers between the major banks in the past (most notably in 1998) based on prudential (rather than competition) concerns (Macfarlane 2009).

Given the scope to address any transaction-specific and prudential concerns via the approvals processes within the Banking Act and the Financial Sector (Shareholdings) Act, any bank merger would not proceed if it adversely affected prudential outcomes, such as by introducing additional systemic risk, unless (in the case of the Banking Act) it was otherwise in the national interest.

Under the Four Pillars policy, a full takeover of a major bank is currently only possible by a large foreign institution, but it is not clear as to whether this threat of takeover is sufficient to drive competitive behaviour or effective corporate governance. Despite management stumbles in most of the big four banks in the last decade, this source of market discipline has not arisen.

A key condition to which a foreign (or indeed any) takeover would be subject is under the Financial Sector (Shareholdings) Act — the Treasurer must approve any person holding a stake (effectively voting power) of over 15% in a financial sector company (soon to be 20%). The Act also allows additional conditions to be imposed as part of the takeover approval. In addition to complying with APRA requirements under the Banking Act, Foreign Investment Review Board approval for foreign investment is required under the *Foreign Acquisitions and Takeovers Act 1975* (Cth), including on national interest grounds.

Conclusion

The Four Pillars policy is unnecessary as a means of ensuring either competitive or prudential outcomes given the strong existing laws in place.

Effective prudential policy and banking-specific legislation appear to be more relevant to avoiding excesses of behaviour that led to the GFC than the special standard of the Four Pillars policy. And the Competition and Consumer Act is fully able to deal with the adverse competition effects of any proposed takeover, provided its powers are exercised.

In our view, retention of the Four Pillars policy potentially erodes competition. It also removes the potential threat of discipline by the market on the management of the four banks covered by it, undermining effective corporate governance.

At best, it is a redundant policy that does not achieve its stated objectives.

FINDING 6.2 THE FOUR PILLARS POLICY IS REDUNDANT

The Four Pillars policy is a redundant convention.

There are sufficient provisions within the *Competition and Consumer Act 2010* (Cth), the *Banking Act 1959* (Cth) and the *Financial Sector (Shareholdings) Act 1998* (Cth) that give the government or the designated regulators power to intervene to ensure competition, prudential outcomes and the broader public interest are protected.

There is no evidence that the Four Pillars policy has enhanced competition; and far more reasons to conclude that it may have dissuaded it by embedding a fixed market structure.

7 Banks’ responses to pervasive regulatory action

Key points

- Regulatory actions influence nearly every aspect of operations in the banking system — from the cost and source of funding, to the specific types and amounts of capital that authorised deposit-taking institutions (ADIs) are required to hold, and permitted growth rates in some product lines.
  - Regulatory influences on cost, including the cash rate, prudential standards and targeted interventions in specific parts of the banking system have a significant effect over ADIs’ willingness and ability to compete on price.
- To comply with regulatory requirements, ADIs must adapt their business models and strategies, and price is often directly affected. In some cases, intervention means ADIs may stop operating in certain market segments temporarily.
- A reduction in competition is often an intentional action on the part of regulators, who seek to reduce risky practices. However, regulators can and should consider all probable costs, including scope for anti-competitive activities (including tacit collusion).
- Recent intervention by APRA in home loan provision has resulted in a higher than necessary cost on investors and taxpayers via tax deductible interest payments (up to $500 million a year, depending on various permutations of tax treatment). Regulators targeted only *new* loan growth, but *all* investor loans were re-priced upwards by banks.
- Explicit government measures to support confidence in ADIs were particularly prominent during the global financial crisis, but have since been wound back. These measures generally did not impede competition, even though smaller ADIs suffered in that period.
- Currently, the main support mechanisms are the Financial Claims Scheme that provides guarantees to retail depositors, and the Committed Liquidity Facility (CLF). The CLF is provided by the RBA to enable banks to comply with regulatory requirements around liquidity.
- It is essential that, as each new assurance mechanism is put in place by government, both the individual <u>and</u> the collective impact on scope for exercise of market power by larger banks is assessed and actively minimised.
- Correct or not, markets assume that some banks are too big to fail. This assumption influences credit ratings and, in turn, the cost of funding for these banks, and gives them a competitive advantage.
- It is unwise for the Australian Government to attempt to impose additional costs on those banks that benefit from being considered too big to fail. Actions that lift cost in a market where *price* competition is weak simply mean consumers ultimately pay more.

Since the global financial crisis (GFC), Australia's authorised deposit-taking institutions (ADIs) have adapted their competitive strategies to fit in with changes in international and domestic financial market conditions as well as a new regulatory paradigm. These changes affect nearly every aspect of ADIs' operations, from the interest rates offered on home loans and term deposits to their profitability.

Over the past decade, prudential regulators and central banks in developed countries have worked to build a more resilient global banking system, based on stable funding models. The Australian Prudential Regulation Authority (APRA) tightened the capital and liquidity requirements that all ADIs must comply with, and in many cases, chose to take a conservative approach to the global guidelines (chapter 6). At the same time, the Australian Government and the Reserve Bank (RBA) have put in place various measures to support the banks in their new operating environment.

Alongside prudential standards, regulators have also taken more targeted steps to tackle ADI behaviours that they believed 'if left unchallenged, would have the potential to threaten the stability of the financial system' (APRA, sub. 22, p. 21). Regulators believe these interventions have succeeded in achieving their intended objectives (The Treasury, sub. DR126).

However, in the longer term, banks are likely to adjust their competitive strategies to their new environment:

> [I]n the prudential realm, … lender and borrowers have incentives to find a mutual agreeable contract that is not restricted by regulatory constraints … Faced with a macro need for low interest rates, but worries about a home lending boom, prudential regulators can take supervisory and regulatory steps to retard lending aggressiveness for targeted sectors. We are confident that such steps will work in the short to medium term. It is unclear if tighter prudential regulation can permanently offset lower rates in the long term. (Ellis and Littrell 2017, p. 150)

This chapter presents the changes ADIs have made, and continue to make, in response to their changing prudential regulatory environment, and analyses their effect on competition. Other types of regulation — for example, the responsible lending obligations enforced by Australian Securities and Investments Commission (ASIC) — also have a bearing on how ADIs operate. However, prudential regulation has undergone the most significant change in recent years and has expanded its reach, both in terms of the institutions it applies to and the areas of their activity that it affects (chapters 6, 18). Therefore, the discussion concentrates on prudential regulation, including the broad requirements that apply to capital and liquidity and the more targeted interventions in specific markets.

7.1 The prudential regulatory landscape is changing — and ADIs are changing along with it

In keeping with global trends, APRA is implementing the Basel III regulatory framework. This implementation has mandated an increase in the amount and quality of capital held by ADIs (Atkin and Cheung 2017).

In addition, APRA has been putting in place prudential standards that are unique to Australia. The Murray Financial System Inquiry (FSI) recommended adjustments in capital ratios such that Australia's ADIs are 'unquestionably strong' and able to absorb possible losses without support from public funds (Murray et al. 2014a). These recommendations are being implemented progressively, with 'unquestionably strong' ratios to become compulsory in 2021 (APRA 2017v).

The objective of these reforms is to further strengthen the resilience of Australia's ADIs, by improving their capital and liquidity positions, and fundamentally altering their balance sheets in favour of assets that regulators view as more stable. These changes have been gradually implemented over a number of years, and many Australian ADIs were compliant with the new ratios long before they became official standards (Atkin and Cheung 2017).

Increasing the amounts of capital ADIs must hold, as well as their reliance on equity as a source of funding, has raised their costs. The Treasury (sub. DR126) argued that the capital requirements should reduce costs, as investors view banks as safer and therefore expect lower risk premiums. Although capital requirements have been rising since the GFC across all advanced economies, such a reduction in risk premiums has not generally been observed. In fact, in numerous cases, risk premiums have increased, due to greater volatility in banks' earnings and the uncertainty around the effects of future regulatory intervention (BIS 2018). The experience of the Australian banking sector echoes global trends — as Westpac's CFO explained in this Inquiry's public hearings:

> [T]here is the argument that because we are safer organisations investors should lower their returns, whether they be debt or equity. A lot have not. In some cases they've said actually the risks might be a bit bigger than what we were pricing pre the experience of the last ten years. (PC transcript, 2018, p. 41)

The extent of the cost rise for each institution depends on its specific business and risk models, but across the sector — as occurs in every industry — higher costs can erode profitability and result in higher prices for customers (table 7.1).

ADIs and market analysts primarily use two measures to assess bank profitability: net interest margins (NIM) and return on equity (ROE). From managers' and shareholders' perspective, an ongoing erosion in these measures would be of concern. Profits are important not only to maintain returns for investors, but also in order to retain high credit ratings and raise funds overseas (Westpac, sub. DR125).

Table 7.1 **How ADIs have responded to the shifting prudential regulatory environment**

All ADIs are required to hold more high quality capital	
Steps taken by the ADIs	*Effects on ADIs' profitability*
Increase their capital base through: • accumulation of retained earnings • dividend reinvestment plans • new equity issuance	Profitability (measured by ROE) has declined as more equity was issued and profit growth stalled – and is expected to continue falling as capital requirements increase further
Limiting the amounts of capital they are required to hold by reducing the average risk weighting of their assets[a]	The continued shift towards housing lending, which is considered less risky than other types of credit, has a positive effect on ROE
Large ADIs are required to hold more stable assets and more high quality liquid assets[b]	
Steps taken by the ADIs	*Effects on ADIs' profitability*
Increase the use of funding from stable sources – deposits, equity and long term wholesale debt, leading to: • increased competition to attract stable deposits[c] • changes to the maturity terms of some deposit products and wholesale debt issuance	This funding mix has higher costs for ADIs and can erode profitability. ADIs passed on higher costs to borrowers
Increase their holdings of high quality liquid assets (HQLA) to comply with the liquidity coverage ratio and respond to shocks	Lower returns on HQLA, compared to other investment options, may further erode profitability

[a] Prudential regulation assigns a risk weighting to each type of lending activity, and this weighting determines the amount of capital an ADI has to hold against its lending activity. Residential mortgages, for example, are considered less risky than small to medium enterprise (SME) term loans, and therefore are assigned a lower risk rating — and require ADIs to hold less capital. [b] The net stable funding ratio (NSFR) and the liquidity coverage ratio only apply to large and complex banks, as determined by APRA. There are 15 institutions that fall in this category, including the four major banks, the large regional banks and a number of foreign institutions (APRA 2016d). [c] Deposits that are considered most stable for the purposes of the NSFR include term deposits; transaction accounts, which are seen as more stable since depositors use them to make and receive day-to-day payments; and deposits from households or SMEs that have multiple products with the same bank (Atkin and Cheung 2017).

Source: Atkin and Cheung (2017)

As regulators raised capital and liquidity requirements for ADIs, they anticipated that institutions may increase loan interest rates in order to offset their higher funding costs and maintain profitability (see, for example, APRA 2012). And indeed, loan interest rates have been rising, relative to the cash rate, although not all institutions have increased their rates to the same extent. In addition to increasing interest rates, some ADIs chose to exit product areas that offered lower returns, such as wealth management (Norman 2017).

But not all ADIs are affected by prudential regulations in the same way. For example, the four major banks are required to hold more capital as they have been designated as domestic systemically important banks. At the same time, the big four banks, as well as Macquarie Bank and ING, benefit from operating internal ratings-based (IRB) risk models, which allow them to determine the amount of capital they hold based on their own models, as approved by APRA. All other ADIs use APRA's standardised risk weighting. This is likely to place the smaller banks at a pricing disadvantage, although changes planned by APRA may narrow this gap and reduce the funding benefits achieved through IRB accreditation[33] (chapters 6 and 8 discuss prudential standards in detail).

This new regulatory environment has had substantial implications for competition across the banking system. For example, the regulatory shift that followed the GFC supported increased demand for certain types of deposits that are seen by regulators as more stable (RBA, sub. 29). This is likely to have prompted additional competition in some segments of the market. However, more recently competition for deposits has eased, as banks have achieved compliance with required ratios (Atkin and Cheung 2017; RBA, sub. 29).

More housing lending — at a higher price

Prompted in part by regulatory change, the composition of banks' lending portfolios has shifted. Over time, housing lending has become the key component of ADIs' credit activities, at the expense of business lending (figure 7.1).

Figure 7.1 **Shift over time in banks' lending portfolios[a]**

a 2018 figures refer to data from January to March.

Source: RBA (2018h)

33 In 2017, the average risk weight on the residential mortgages of the IRB banks was 26%, compared with the average risk weight of 39% applying to residential mortgages across all other ADIs that are required to use the standardised approach (chapter 8). In 2018, APRA released a discussion paper as part of its work towards revising the capital framework, which included proposed changes to standardised risk weights. For example, APRA proposes to reduce the minimum risk weight on home loans to 20%. Overall, the changes to the capital framework may reduce the cost advantages achieved through IRB accreditation, although the final set of risk weights and other capital components are yet to be finalised (chapter 6).

This has been driven by a number of factors.

First, housing lending imposes lower operating costs on ADIs due the way it is treated under prudential regulation. Prudential standards treat housing loans (in particular owner-occupier mortgages) as less risky than unsecured small business loans, and require less capital to be held against them. This lowers operating costs for ADIs. It also means housing credit generates higher ROEs for a given amount of capital, compared with other types of lending, making it an attractive line of business for ADIs.

Second, general economic conditions have affected demand for credit in different parts of the economy, with demand for business lending remaining relatively subdued compared with very strong and prolonged growth in demand for housing credit (RBA 2017x). Further, competition from foreign banks has contributed to lowering the share of domestically-owned banks in the market for large business lending, while they remained the dominant providers of housing credit. Foreign banks' lending to large corporations has grown faster than lending by Australian-owned banks (RBA 2017q).

ADIs are concentrating on home loans — but competition remains constrained

A number of Inquiry participants suggested that recent years have seen significant competition in the home loan market. In principle, ADIs can compete both on home loan price and loan features. In practice, margins are healthy and if competition were strong, it would be the norm to see substantial rivalry, particularly where unanticipated shocks or innovations affect business strategies. Margins should contract under this pressure. Such competition could be expected to lead to lower prices, innovative products, and reduced profits over time.

But innovation has been limited in recent years. Banks have increasingly moved towards bundling products in home loan 'packages' that also include transaction accounts and credit cards, for example. This can be convenient to the consumer, but is also beneficial for institutions. Bundling is likely to increase customer lock-in (consumers are less likely to switch if they hold multiple products (chapter 5)) and offer institutions opportunities to cross-subsidise (chapter 9). Moreover, there is very little differentiation in some of the key features of home loans. For example, consumers can often only choose between variable and fixed interest rates on their loans.

Tracker mortgages, which offer a variable interest rate that follows the RBA's cash rate by adding to it a fixed margin, combine some of the features of fixed and variable rates, and have the potential to offer consumers more transparency on pricing. Such mortgages are popular in other countries,[34] but attempts to introduce these loans into the Australian market have been largely unsuccessful. Only one ADI, AusWide Bank, is currently offering such a loan. Other ADIs have offered them in the past but no longer do so (Corderoy 2016). In 2016, the issue was raised by the House of Representatives Standing Committee on

[34] Examples include the United States, Canada, France, Korea and Japan (ACCC 2018).

Economics, in the course of its inquiry into the four major banks. All banks testified that while tracker mortgages could be offered on the Australian market, they were likely to be expensive and consumer demand was expected to be limited (HoRSCE 2016b).

One of the big four banks revealed that it had considered offering these mortgages, but decided against it:

> We also looked hard at the launching of tracker mortgages, but our research showed that only 10 per cent of variable-rate customers today would think about switching to a tracker. In part, that reflects price. We cannot fund the bank with tracker deposits, and this risk needs to be priced for. Launching trackers would therefore be commercially unattractive in our view and make us even more complex. That said, we will continue to assess demand. (Elliott 2017, sec. Standing Committee on Economics)

This apparent inability to fund tracker mortgages, as suggested above, is somewhat surprising. Offering one additional type of mortgage, which would only appeal to a subset of borrowers, is unlikely to materially alter banks' lending portfolios in the short term. In addition, banks *do* raise funds via bond issues that in effect track the cash rate plus a margin.[35] While the purpose of such funding might be different, the outcome is the same: investors *are* willing to offer funds that essentially track an index plus a margin. Thus the case against tracker mortgages does not seem to be one where the constraint lies with investors.

Regulators have inconsistent views in regards to tracker mortgages: while ASIC has stated it would encourage lenders to offer such a product, APRA has been far more cautious. APRA noted that these mortgages are likely to be risky for providers given the uncertainty around funding costs and interest rates over the term of the loan, and as a result, cost households more than existing products (ASIC 2016b; HoRSCE 2016a). Of course, if this were the outcome, the product would languish, as there would be very low demand. The tone of regulatory ambiguity has the potential to stifle innovation in the market.

Nonetheless, there is no regulatory *barrier* that prevents lenders from offering tracker mortgages. It may well be the case that weak competitive pressure limits the need for lenders to innovate and offer a wider range of products, including tracker mortgages. There are a range of loan features, such as flexible terms, available in markets overseas, that are not on offer in Australia (ACCC 2018).

Is price competition possible?

Even in the absence of strong competition based on product features, ADIs could potentially engage in price-based competition. Not only is this desirable from a consumer perspective,

[35] Banks issue floating rate bonds, which make interest payments tied to current interest rates. A common benchmark rate is the bank bill swap rate (ASX Group 2018). The bank bill swap rate tends to mirror movements in the cash rate (Atkin and La Cava 2017).

but it is behaviour that should induce better quality managerial decisions and reward well-judged risk-taking.

Institutions argue that they set their prices at a level that allows them to expand their market share (see, for example, ANZ, sub. DR74). But the ACCC (2018), in its inquiry into mortgage pricing, did not find evidence of pricing that is intended to attract a larger share of the market.[36] Significant competitive price shifts between institutions are not evident in the financial system's primary loan products.

Regulators appear to play a notable part in flattening the prospects for risk-taking and use of price to shift market shares. This does not occur through direct regulatory intervention in the way interest rates are set. Rather, monetary and prudential policy exert substantial influence over banks' costs and operations, which result in banks being significantly constrained in any price competition scenario.

The RBA influences interest rates through its cash rate decisions, which affect ADI funding costs (chapter 8). Although the relationship is far from direct, and the responsiveness of the market to the cash rate changes over time, the cash rate still has a 'strong influence over the lending and deposit rates that households and businesses face' (Atkin and La Cava 2017, p. 3). Banks are a conduit of monetary policy, and their expected pricing decisions are taken into account in the RBA's cash rate decisions 'to ensure that the structure of interest rates in the economy is consistent with the desired stance of monetary policy' (Deputy RBA Governor Guy Debelle quoted in SERC 2012, p. 59).

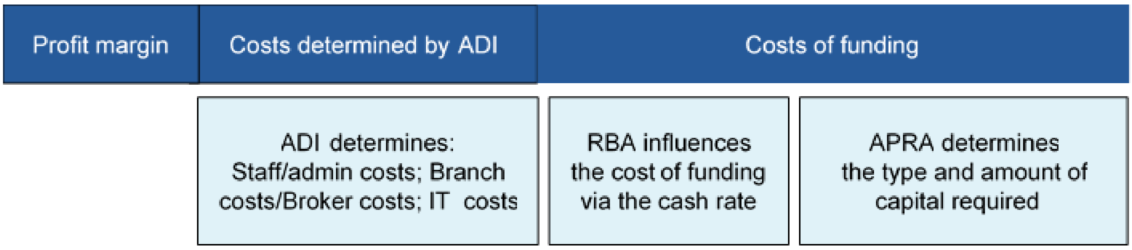
The effect of APRA's interventions is indirect but in a structural sense possibly far stronger than the RBA's. The prudential regulator requires ADIs to hold specific amounts of capital against their lending (chapter 6). The cost of this capital and its maturity rate are reflected in product pricing in an ongoing way. Regulators dictate to a large extent the types of capital allowable, which means ADIs cannot readily optimise their capital holdings based on price alone.

In effect, when any ADI determines the pricing of its loans, it examines its cost and sources of funds and their timing to maturity, as well as the operating costs it needs to pay (for example, staff and branch costs). It then adds on to these components a profit margin, such that the overall price is set at a level where the ADI is able to maintain its market share (figure 7.2). These numbers are mostly well known to all competitors and, in the case of cost of funds, are broadcast and deeply analysed by regulators and analysts alike. Thus a form of price leading that is not evident in many industries is managed by the financial system regulators.

In this environment of regulated price signals; regulatory concern over signs of risk-taking behaviour by larger institutions (extending to smaller ADIs where they are active competitors); and intense market scrutiny of profitability, there is little scope to expect aggressive price competition for lending.

[36] The inquiry reviewed pricing decisions for residential mortgages undertaken by the four major banks and Macquarie Bank (ACCC 2018).

Figure 7.2 Components of home loan pricing — illustrative example[a]



[a] The cost of funds comprises the cost of deposits, wholesale funding and equity, as well as other costs incurred by ADIs (such as liquidity and hedging premiums) (ACCC 2018). Chapter 8 discusses funding costs in detail.

In its submission to the Inquiry Draft Report, the RBA argued that:

> … the cash rate is a significant influence on funding costs but does not determine them, nor does it determine banks' margins. The Bank believes this neither constrains price competition nor facilitates price coordination and the experience in other countries supports this conclusion.
>
> … in the same way that the cash rate does not constrain banks' ability to compete by adjusting margins, capital requirements and risk weights [set by APRA] do not constrain the return on capital that each bank seeks, and it is this that contributes to the competitiveness of a market. There is no regulatory constraint that prevents banks from undercutting their competitors by accepting lower returns on equity. (sub. DR82, pp. 3–4)

While it is true that there is no regulatory obligation for banks to cluster around a particular level of returns or interest rates, their observed ability to do so is a persistent feature of the market. Banks often argue that price shifts are tied to a shift in costs. It is invariably the case after a rise in the cash rate, and often the case with rises in other wholesale funds costs, that prices will rise — and profits will be maintained. The ability to maintain prices and profitability in all market conditions is a very clear sign of market power (chapter 3). In such a market, regulators price-lead, whether it is intentional or not.

The purpose of this Inquiry in observing this is not to criticise regulators but to note that if this behaviour is indeed unavoidable, then we simply do not have the conditions for a robust competitive market.

In such circumstances, as we argue later in this report, regulators can and should do their utmost to recognise that their actions can have serious consequences for competition. Therefore, when designing macroprudential interventions — interventions that do not increase costs directly, and therefore do not lend themselves easily to being used as a reason for price increases by banks — regulators should ensure that they frame their interventions to openly oppose use of the intervention as a vehicle to profit enhancement.

The ACCC (2018, p. 6) has observed the same behaviour as we have — banks using pricing strategies based around the cash rate 'to accommodate, rather than challenge, their rivals'.

Accepting lower returns on equity, an alternative that the RBA and Treasury have suggested, is uncommon. It appears that achieving ROE targets is an important factor in major banks' interest rate decisions, and one that has tended to lead to higher rates charged to existing borrowers, rather than aggressive discounting intended to expand market shares. The ACCC has concluded that:

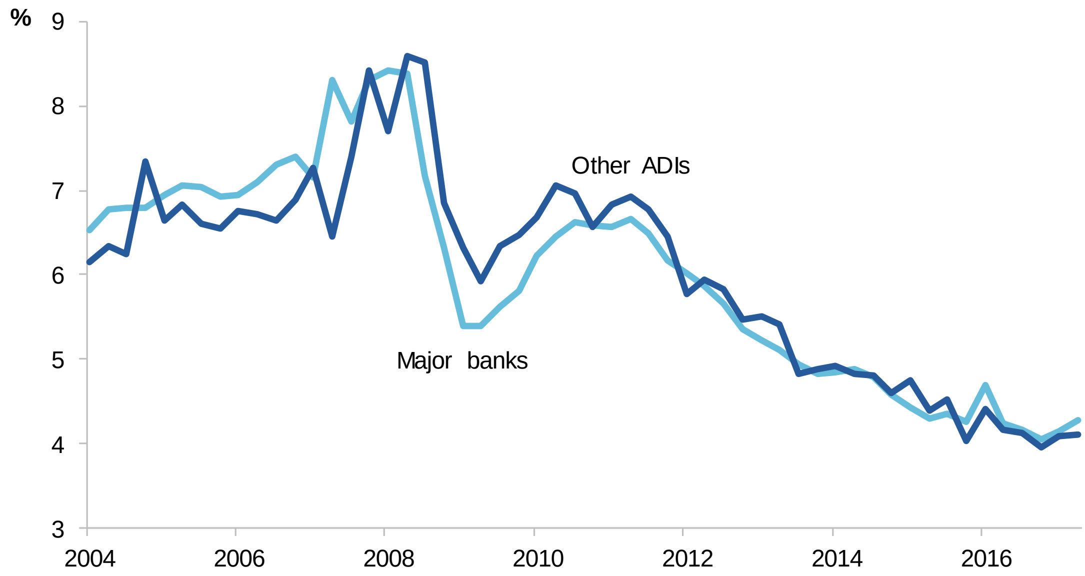
> The Inquiry Banks [CBA, NAB, ANZ, Westpac and Macquarie Bank] generally would need to win a significant number (and value) of additional new borrowers to achieve the same revenue as they can generate by increasing their headline variable interest rates. … We consider that this is an important part of the reason why individual Inquiry Banks have chosen to increase headline variable interest rates in response to shortfalls to their internal performance targets, in preference to lowering interest rates to attract new borrowers and thus build volume (and revenue). (ACCC 2018, p. 28)

This reflects the fact that the major banks appear to have sufficient market power to allow them to adjust prices when individual costs shift, such that their profit margins are maintained (chapter 3). ADIs tend to follow each other's lead in setting interest rates (ACCC 2018). The data shows generally that smaller institutions in turn tend to follow the rate decisions of the major banks. Therefore, over time there has been little variation in housing interest rates between different types of lenders (figure 7.3). Limited price variation in itself does not necessarily mean there is no competition, if the price is set at the marginal cost of provision. However, this is not the case in home loans.

APRA (2017v) suggests that competitive pressures can prevent lenders from passing on increased costs as a result of regulatory changes, but the evidence is that this has not eventuated. The bulk of these costs *have* been passed on to new and existing borrowers — resulting in a widening of the spread between the cash rate and interest rates charged. So while individual lenders may jostle to attract new borrowers with hints of slightly different (discounted) interest rates, consumers overall are unable to make effective use of this. Increasingly, they rely on the advice of brokers just to narrow down the options into assessable input to their decision.

In recent years, despite the cash rate remaining at record low levels and the decline in the cost of wholesale funds, ADIs have widened the spread between the cash rate and their housing lending rates (figure 7.4). This enabled them to maintain relatively stable profit margins, even when changes to prudential regulation increased their costs and eroded ROE.

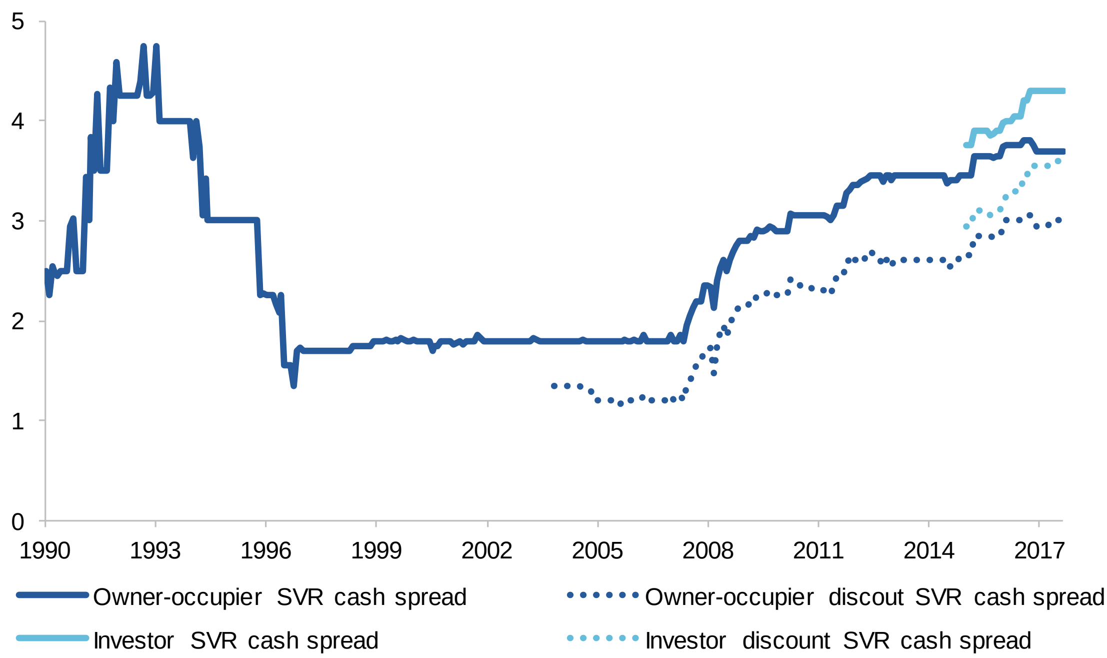
Figure 7.3 There is limited variation in housing interest rates between different types of institutions



Source: APRA (2017t)

Figure 7.4 Banks' housing lending rates

Percentage point spread relative to the cash rate



Source: RBA (2018f)

7.2 Targeted interventions by regulators can have dramatic effects on competition

Apart from the overarching changes to the regulatory environment that are intended to alter the way ADIs operate, regulators also intervene in specific markets. At times, these interventions are carried out specifically to weaken competitive activity. A well-publicised example of such an intervention is APRA and the RBA's concerted effort to intervene in housing lending markets from 2002 to 2005 and again from 2014 to 2017, as result of what they saw as increasing competition leading to declining lending standards and higher systemic risk (chapter 6).

> *The erosion in [lending] standards has been driven, first and foremost, by the competitive instincts of the banking system.* Many housing lenders have been all too tempted to trade-off a marginal level of prudence in favour of a marginal increase in market share. That temptation has, unfortunately, been widespread and not limited to a few isolated institutions – the competitive market pushes towards the lowest common denominator. *The measures that [APRA has] put in place in recent years have been designed, unapologetically, to temper competition playing out through weak credit underwriting standards.* (Byres 2017a, p. 8, emphasis added)

What APRA says — and how the banks implement it

Unlike prudential standards, which are legislative instruments, the targeted interventions of regulators in the financial system have been delivered in more informal ways. Interventions in the housing loan markets in 2014 and 2017 exemplify this approach (chapter 6).

APRA's 2014 intervention — a growth benchmark of 10% for investor lending (APRA 2014c) — was explicitly stated to <u>not</u> be a hard limit, but it was clear that growth beyond it would induce adverse consequences for the relevant ADI.[37] Senior executives at APRA and the RBA reported that the announcement of the benchmark was followed by 'a comprehensive increase in supervisory pressure to meet these suggestions' (Ellis and Littrell 2017, p. 147).[38]

When first announced, ADIs treated the suggested benchmark as a <u>hard limit</u> on investor and interest only lending. In fact, numerous media reports as well as submissions to this Inquiry refer to it as a 'growth cap' (for example, Australian Bankers' Association, sub. 11; COBA, sub. 21; NAB, sub. 31; Regional Banks, sub. 37).

[37] APRA's letter stated that '[t]he benchmark is not intended as a hard limit, but ADIs should be mindful that investor loan growth materially above this rate will likely result in a supervisory response' (APRA 2014c).

[38] All CFR agencies (ASIC, APRA, the RBA and Treasury) held discussions on expanding supervisory activities in the housing credit market (RBA 2015e). ASIC took enforcement action against mortgage brokers who produced fraudulent loan applications while the RBA repeatedly communicated their concerns about the housing market (Ellis and Littrell 2017).

APRA's 2017 intervention in the housing loan market included a statement that it expected ADIs to:

> - limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending, and …
> - manage lending to investors in such a manner so as to comfortably remain below the previously advised benchmark of 10 per cent growth;
>
> … APRA views a higher proportion of interest-only lending in the current environment to be indicative of a higher risk profile. *APRA supervisors will therefore be monitoring the share of interest-only lending within total new mortgage lending for each ADI, and will likely impose additional requirements on an ADI if the proportion of new lending on interest-only terms exceeds 30 per cent of total new mortgage lending, over the course of each quarterly period*. For ADIs currently above this benchmark, APRA will be discussing their plans to bring the share of interest-only lending down as quickly as possible. ADIs with levels of interest-only lending below this benchmark are expected to remain below it and not increase the share of new interest-only loans materially from current levels. (APRA 2017h, pp. 1–2, emphasis added)

ADIs faced similar options and made similar choices

In order to implement APRA's benchmarks, ADIs could choose between a number of strategies to limit further demand for investor loans:

- stop lending across their portfolio, or in specific postcodes where there has been stronger demand growth than in other areas
- tighten lending standards, which would lead to fewer loans being approved
- stop offering discounted interest rates to new borrowers, or limit discounting. This would increase interest rates on new loans and limit further demand growth
- raise standard variable interest rates on investor loans, which would increase interest rates for existing and new loans.[39] While this would limit demand, it offers banks the benefit of increasing interest income across their entire portfolio of investment lending.

According to the CBA, each of these steps was taken, but market dynamics left them with little choice other than to raise rates:

> CommBank's first step in response to the APRA limit was to change its lending policies and to reduce discretionary discounts on new interest only lending. CommBank reduced these to the lowest level possible, while leaving its headline rates unchanged. Subsequently, CommBank's competitors announced increases in their headline interest only rates. Consequently, CommBank's interest only product was the cheapest of all of Australia's Major Banks. If this situation had continued, CommBank anticipated breaching the APRA cap as CommBank would have attracted more volume. Because CommBank had already reduced its discretionary discounts, the only option left was to change its headline interest only rates to avoid breaching

[39] This is due to the structure of standard home loans contracts, which specify the interest in relation to an indicator rate (Lowe 1995). As a result, when the standard variable interest rate changes, all interest rates change at the same rate. This feature of mortgage contracts is not common overseas (Lea 2010).

> the APRA 30% limit. As the headline rate is the same ‘reference rate’ for both new and existing customers, raising CommBank’s headline rate impacted both new and existing customers (CBA, sub. DR79, p. 31).

This suggests that there can only ever be one ‘reference rate’. However, CBA itself advertises no fewer than 23 different reference rates for investment home loans alone, and according to the terms and conditions of its loans, it can change, replace or introduce new reference rates at any time (CBA 2017d, 2018c). In other words, there is no rule of business or regulation imposing an obligation for an immutable rate.

Undoubtedly, loan *contracts* allow banks to unilaterally alter rates but that is quite a different proposition to suggesting there can only ever be one reference rate. So to have additional rates for investor loans does not breach any apparent business standard. If banks were to introduce new reference rates, this is likely to have allowed them to comply with APRA’s benchmark for new loans, without repricing existing loans. However, they chose not to pursue this strategy, but increase rates across the board.

The effect of common price moves was clearly observable. While each institution may well have reacted in accordance with its specific business model and performance, the overall result in the market was a nearly uniform increase in price. According to the ACCC:

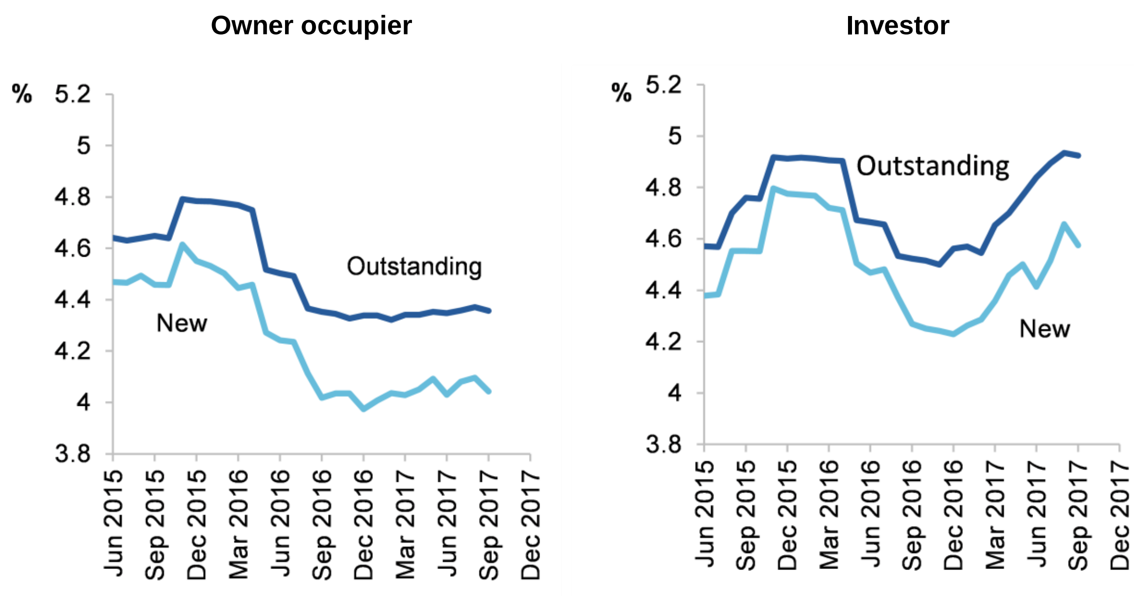
> APRA’s prudential benchmarks have impacted the scope for ADIs to compete on price for residential mortgages for investor and interest only borrowers as any offer of interest rates below those available from other lenders may attract too many new borrowers and put the ADI at risk of non-compliance. (ACCC 2018, p. 41)

Across the banking industry, rates on investment loans and interest-only loans increased in 2017 (figure 7.5). Rates increased for existing and new loans, although APRA specifically stated that it intended to influence the flow of credit, not the stock. The increase in interest rates stemmed the expansion in investor and interest-only lending, which policy makers interpreted as evidence that the measures ‘have been broadly effective in achieving their desired outcomes’ (Treasury, sub. DR126, p. 9).

At the same time, because interest rates increased across *all* investor loans, this has had a positive effect on net interest margins for institutions (RBA, sub. 29).

Figure 7.5 **APRA's intervention in investor loans led to higher interest rates for both new and existing customers**

Balance-weighted average rate on securitised housing loans[a]



[a] New loans originated over the past three months.

Source: RBA, Securitisation System

The effect on profits and competition

The regional banks (sub. 37) submitted that both APRA policies were blunt tools, and that they had detrimental effects on competition. On the other hand, the Australian Banking Association (sub. DR119) argued that it was only the 2014 APRA benchmark that restricted competition, while the 2017 intervention, which targeted the flow of credit rather than its growth, did not have a similar effect. Regardless, from consumers' point of view, institutions responded to both regulatory actions in ways that reflect weak competitive pressures.

In both cases, ADIs, seemingly almost in unison, responded to the regulatory intervention by choosing the path that would ensure their compliance while also boosting their profits. Unsurprising as this is, the serious question is whether more targeted interventions could have avoided creating such a windfall profit opportunity.

Rate hikes were predictable — and profitable

The changes to interest rates have drawn criticism, in particular from members of Parliament (HoRSCE 2017).

But from the ADIs' point of view, it was the logical choice, as new lending was restricted, and if all institutions raised interest rates, there was little risk that existing borrowers would move to a competitor and refinance. Therefore, institutions took the opportunity to safely extract additional returns. According to Morgan Stanley, ROE on interest-only investor loans doubled, to reach over 40%, after APRA's latest round of intervention (Yeates 2017d).

The potential for regulatory intervention to result in ADIs raising rates to both new and existing customers was predictable. Any intervention that essentially restricts supply is likely to lead to pressure on future prices. The growth benchmark also meant a very limited ability for existing interest-only borrowers to move to an alternative supplier while preserving interest-only status. ADIs thus had additional market power over these existing borrowers.

The adverse consequences reflect the structure of the Australian banking market. If there were more diversity in the major banks, in terms of business strategies, then institutions may have varied significantly in how they implemented the regulator's instructions. The resulting net cost to the economy may have been lower (and to achieve the regulatory objective all rates *need not* have risen); yet investor growth still would have cooled (as new loans were now clearly constrained); and competitive alternative strategies could have emerged. Instead, the outcome closely resembled a rise in the cash rate, but only for one class of customer.

While APRA did not specify which steps ADIs should take to ensure they comply with the growth benchmarks (Byres 2017b), as long as all ADIs are covered by the directive and a rise in rates would achieve it, ADIs had no incentive to maintain lower interest rates for their existing customers. Profits could increase and market shares could, for the most part, remain unaffected.

The RBA (subs. 29, DR82) believes that although regulatory actions played a role in ADIs' decisions, banks decided to increase interest rates and change lending standards as their risk appetite had changed.

> Banks individually took the decision to also reprice their 'back books'. This should be seen as a commercial decision by each bank rather than a direct consequence of regulation (RBA, sub. DR82, p. 5).

While each major bank made its pricing decision separately, the ACCC presents clear evidence that banks' decisions were heavily influenced by the timing and movements of other major banks (ACCC 2018). These dynamics are also described in the submission made to this Inquiry by the CBA (none of the other major banks discussed this issue in their submissions).

Further, regulators themselves acknowledged in the past that changes to interest rates were a response to regulatory intervention:

> Based on what I know — and the ACCC will obviously have a much deeper look at these issues — the bank, and a number of banks made similar statements, so I could probably say the banks, would not have made these interest rate changes were it not for the regulatory initiatives. So I think a literal interpretation of what has been said is that it is a response to regulatory

> requirements. *I don't think those changes would have happened, when they did and as they did, had it not been for the range of regulatory initiatives that APRA has taken* (Byres 2017b, p. 3, emphasis added).

Banks responding to this APRA intervention have logically used price to ensure compliance while also enhancing revenues — yet point to another party (the regulator) as being responsible. In effect, the industry has found profit in a regulatory intervention that had no direct influence on its costs.

But there is no tool available to regulators to ensure that, when removing the APRA-imposed benchmarks, price premiums induced by the regulatory intervention will also disappear. In a robustly competitive market, any price increases that had resulted from this temporary measure would likely be rapidly competed away over time, but this is unlikely to be the case here, given what we have established about major bank market power.

An opportunity for smaller lenders?

The RBA (sub. 29) suggests that the changes in the markets presented an opportunity for other lenders that have regained some market share.

This may leave the impression of equating improvement in smaller lenders' market share with a competitive outcome. Growth in parts of the market was impeded by the regulators — and if unregulated entities benefited from this, it is not necessarily because they developed a better product or service, as could be expected in a competitive market — but primarily as a consequence of regulatory intervention. Competition — be it on price or conditions — is not enhanced by an increase in an institution's market share if it comes solely as the result of a regulatory intervention. It is, at best, a coincidence; and simply leaves the impression of a competitive response.

Only some smaller lenders saw their market shares increase. Despite the RBA's observation, some smaller ADIs decided to temporarily stop offering investor loans (Heritage Bank 2017a; O'Dowd 2017). Some have seen the regulatory moves as a barrier to competition:

> The design of this blunt instrument benefits banks that expanded their investor lending most aggressively before the cap was applied and banks who already had large investor lending portfolios in actual and proportionate terms. It had the effect of freezing market shares and rewarding banks whose behaviour led to the intervention. (COBA, sub. 21, p. 32)

Non-ADIs, which are not subject to APRA's regulation, might have treated the regulatory intervention as an opportunity to expand their market share. However, they faced two significant constraints. First, the major banks dominate the market. Non-ADIs are small and face capacity constraints in order to increase loans. The RBA has noted that 'non-major lenders are running up against constraints in their capacity to process the increased volume of applications in a timely manner', suggesting limits to the competitive response by smaller lenders (RBA 2017x, p. 50).

Second, non-ADIs are, to a significant extent, dependent on ADIs to participate in warehouse funding as a source of funds (chapter 8). Put simply, non-ADIs would (to some degree) need the cooperation of the major banks if they were to gain the warehouse funding needed to materially increase competition against those same major banks.

Impact on borrowers — and tax payers

It is not only the individual borrowers who are affected by these decisions. Interest paid on loans used to purchase investment properties is tax deductible — therefore, part of the bill for the higher interest rates charged by ADIs is paid by the community through reduced tax revenues. We estimate that ADIs benefited from an additional $1 billion a year in interest income from investor loans following the repricing in early 2017. Between $300 and $500 million could have been claimed by investors as income tax deductions.[40]

The cost to the tax payer would be offset to some extent by the tax ADIs pay on their income; however, this is unpredictable and will never make the impact of a price rise zero — either economically or commercially.

FINDING 7.1 COST OF APRA INTERVENTIONS IN THE HOME LOAN MARKET

APRA's actions to slow interest-only lending on residential property in early 2017 resulted in banks imposing higher interest rates on both new <u>and</u> existing residential investment loans, despite the regulatory objective being to slow only new lending.

This led to a windfall gain for the banking sector.

Up to half of this gain is in effect being paid for by taxpayers, as interest on investment loans is tax deductible. The Commission estimates that the cost borne by taxpayers as a result of APRA's intervention was up to $500 million a year, depending on various tax permutations.

Competition between lenders was restricted, and there was limited competitive variation in lenders' responses to the regulatory intervention.

7.3 Explicit inducements and their effect on competition

At various times, governments and regulators have put in place a range of supports for ADIs, in response to financial crises or other regulatory changes. Regardless of the motivation,

40 Between March and July 2017, interest rates on investment loans increased by 0.2 percentage points. On the total amount of investment lending ($533 billion in June 2017), such an increase in interest rates would generate an additional $1 billion in interest payments. These payments are tax deductible. Depending on the individual marginal tax rates of property investors (between 30% and 49%), the overall amount of additional interest rate deductions can vary between $300 million and $500 million.

such interventions can affect competition, by giving certain institutions a competitive advantage over others, or leading them to invest in assets that carry higher risks (knowing that the government is likely to support them if things go wrong). While regulators have taken steps to limit the effect of the guarantees on ADIs, this is still work in progress.

Impact of regulatory measures introduced during and after the GFC

The GFC saw the introduction of deposit guarantees, both at the retail and the wholesale levels, and a range of other measures, such as the Australian Government's purchase program for residential mortgage backed securities (chapter 6). These measures were put in place to shore up depositors' confidence in ADIs, and enable the institutions to continue to use capital markets. On both counts, the RBA and APRA (2009) consider that the interventions have been successful.

Following the GFC, when the Senate Standing Committee on Economics investigated the guarantees put in place by the Government, it raised concerns about their effect on a range of competitors that did not benefit from them, such as non-ADIs, investment funds and foreign bank branches. Further, the Committee questioned whether competition has been seriously considered by regulators:

> The Committee believes that close consideration needs to be given to shifting the balance between stability and competition back toward the latter as conditions improve (as they already are) to ensure any medium- to long-term impact on competition is minimised. (SERC 2009a, p. 41)

Since the Committee's report, some of the supports put in place during the GFC have been wound back (chapter 6). However, the ACCC (sub. 17, p. 13) argued that some of the policies implemented in response to the GFC 'are now potentially in conflict with the objectives of competition policy and regulation'.

While this may well be the case for implicit guarantees (see below), the Financial Claims Scheme — the only support policy instigated in response to the GFC that continues to operate — was designed to minimise detrimental effects on competition (chapter 6). The scheme protects retail deposits of up to $250 000 in the case an institution fails, and operates alongside other protections to depositors, which are included in the *Banking Act 1959* (Cth) (Turner 2011).

When it was first introduced, the guarantee stabilised confidence in all ADIs and stemmed the outflow of deposits from smaller institutions. Since the GFC, the Australian Government confirmed the scheme will remain as a permanent feature of the financial system, bringing Australia in line with other developed countries (Turner 2011).

The RBA believes that the Financial Claims Scheme (FCS) has had a positive effect on the competition for deposits. The fact that it applies to nearly all ADIs reduces the perception that some are safer than others, and allows institutions to compete for deposits on a relatively level playing field (RBA, sub. 29). The scheme covers all licensed banks, building societies and credit unions incorporated in Australia, but excludes foreign bank branches. The RBA has argued that this exclusion gives additional protection to small depositors, by ensuring their funds are backed by capital held in Australia. Most other countries have not chosen to impose a similar restriction (Turner 2011). Under legislation, foreign banks branches must inform depositors that their funds will not be covered by the depositor protections contained in the Banking Act.[41]

In effect, this means that in order to compete in the retail deposit market segment, foreign banks need to consider setting up a subsidiary, rather than a branch, which will make them eligible for the FCS. This is a higher barrier to entry, compared to other segments of the market such as lending. This does in principle affect the competitive landscape, and may have constrained the ability of additional foreign banks to enter into the retail banking market and potentially increase competition. Nonetheless, there are other factors that affect the rate of entry by foreign banks, and their expansion the Australian market (chapter 4), and while this specific aspect of the regulatory system played a role, it is unlikely to have been the deciding factor.

Enabling ADIs to comply with regulatory change

More recently, in response to the implementation of more restrictive liquidity requirements by APRA, the RBA introduced the Committed Liquidity Facility (CLF) — a different type of tool to support parts of the banking system.

As part of the Basel III liquidity reforms, institutions that are considered by APRA to be relatively large and complex are required to comply with the Liquidity Coverage Ratio (LCR). To comply, they need to hold sufficient high quality liquid assets (HQLA) to cover potential cash outflows for 30 days in case of market-wide crisis (APRA 2017q).[42] Only 15 institutions in the banking system have been deemed large and complex enough to require LCR compliance (APRA 2016d).

The challenge for these institutions is that only a very small subset of assets are designated by APRA as HQLA, and there is insufficient supply to allow all ADIs to comply with the LCR (APRA 2012d).[43] As with other choices APRA made in implementing the Basel III reforms, it is difficult to evaluate the reasons for this decision. There has been very limited information provided publicly about the assessment conducted by APRA to determine which assets can be considered as HQLA (APRA 2016a). This is despite the fact that this decision has significant implications for the institutions affected and the RBA (for further discussion on transparency in the design and implementation of prudential regulation, see chapter 18).

41 Foreign bank branches are also precluded from accepting retail deposits of less than $250 000 (chapter 4).

42 Other institutions need to comply with a minimum liquidity holdings (MLH) regime, and hold a minimum of 9% of their liability base in liquid assets (APRA 2017q).

43 Only deposits held with the RBA, Commonwealth Government securities and semi-government securities are designated as HQLA (APRA 2016a).

The CLF is the solution to this problem, designed by the RBA and APRA. Through the CLF, the RBA guarantees eligible ADIs that they will have access to liquid funding in a crisis (and in effect, that they comply with the LCR). APRA must approve all applications for the CLF, and the amounts requested. In considering these applications, APRA examines institutions' balance sheets and whether any improvements can be made that will lower their need for the CLF (Debelle 2015).

In addition, institutions must pay an annual fee of 0.15% of their facility limit and offer substantial amounts of collateral (Debelle 2015). In the year to 30 June 2017, the CLF taken up by institutions totalled $217 billion (though APRA approved an overall limit of $223 billion). The fee income received by the RBA was $347 million (RBA 2017f). For 2018, APRA approved an overall limit of $248 billion for the CLF, although institutions may choose to apply for lower amounts (APRA 2017j).

For the institutions that are required to comply with the LCR, this has meant a possible impact on profitability. These institutions now hold substantial amounts of HQLA, which offer relatively low returns, and put additional pressure on ROE. From banks' perspective, the HQLA requirement, even with the CLF, will lead to higher costs and result in higher prices to consumers. But other regulatory changes since the GFC have potentially worked in the other direction too (chapter 6).

Implicit inducements give larger ADIs a competitive advantage

Aside from explicit guarantees, a broader concern raised by many stakeholders in this Inquiry is the effect of implicit guarantees on banks' market power. Across banking systems in the developed world, large banks benefit from an implicit guarantee — shareholders and credit agencies believe these banks are 'too big to fail' and governments will step in to support them if they run into serious trouble:

> It is just not credible for a government or regulator to promise not to step in and prevent large scale bank failure in a financial crisis. The public know they will, and no amount of words will dispel this expectation. (Macfarlane 2014, p. 4)

In theory, banks that are 'too big to fail' can increase risk across the financial system:

> [T]he moral hazard associated with implicit guarantees derived from the perceived expectation of government support can encourage [systemically important financial institutions] to take excessive risks, reduces market discipline and creates competitive distortions, further increasing the probability of distress in the future. As a result, the direct cost of support associated with moral hazard is borne by taxpayers, representing a large and unacceptable implicit public subsidy of private enterprise. (APRA 2013b, p. 5)

In practice, these type of risks from the 'too big to fail' advantage in Australia are partly or fully offset by the heavy involvement of regulators in limiting risk-taking by ADIs. The question for an inquiry of this nature is whether in doing so, competition is suppressed.

The ‘too big to fail’ perception affects the cost of wholesale funding — as credit ratings agencies and investors see such institutions as safer due to the prospect of government support, and therefore ascribe higher credit ratings to them and, in turn, lend them money at lower rates or on less strict terms (chapter 8).

A range of policy responses have been put in place to address this issue.

- Australia’s four major banks have been designated as domestic systemically important banks by APRA, which increases their capital requirements over and above those imposed on other banks (APRA 2013b). Some stakeholders argue that this designation works in favour of the major banks and reinforces their ‘too big to fail’ status (Regional Banks, sub. 37).
- The RBA considered that the FCS reduces the implicit guarantee and any possible liability for tax payers. In case an institution failed, the cost of the scheme will be covered by its assets and, if necessary, an industry levy (RBA 2016c).
- The recently introduced major bank levy has been said to reduce the costing advantages of the big banks, and also indirectly, the benefits of implicit guarantees. It is expected to raise $1.6 billion in 2018-19, rising to $1.9 billion by 2021-22 (Australian Government 2018a).

Policy makers appear to expect that these policies may erode some of the major banks’ market power. For example, in its review of the four major banks, the House of Representatives Standing Committee on Economics (2016e, p. 33) concluded that:

> The committee expects that, over time, the size of the major banks’ cost advantages will decline due to:
>
> - the Government’s commitment to clarify and strengthen APRA’s crisis management powers;
> - APRA’s commitment to introduce a domestic loss-absorbing capacity framework in line with international developments (both of which will reduce the perception that the major banks are [too big to fail]); and
> - work by the Basel Committee on Banking Supervision (that APRA expects to adopt) to address excessive variability between the capital requirements for banks using IRB and standardised models.

None of these measures are individually ill-advised, but all need to be considered for their individual and collective burden on competitive markets. Despite the Committee’s interest in bank cost advantages one over the other, these are flaws in a system, but structurally the system remains: being a systemically important institution with assured funding in times of crisis, and protection from takeover, gives a consequent embedded ability to set prices to recover additional regulatory costs.

Cost advantage is one source of the major banks’ market power, and it can be tempting to respond crudely to that by lifting costs for them. But as we have shown in other chapters, where there is no change to the market power of the affected institutions, this does not benefit consumers nor the economy. It merely lifts costs.

It is unfortunately easier for policy-makers to add cost to the major banks than it is to guide regulators towards minimising the effects on competition, or avoid unintended opportunities to exploit re-pricing.

The overall effect on competition

The net effect of these policies on *price* competition is unlikely to be positive. Costs are being driven up and innovation suppressed. The offsetting benefit to security of the system may be significant, but as the costs accrue, they should be more clearly quantified by regulators, including in more sophisticated design and practice of interventions.

The implications of regulation for competition can be stark — for example, when ADIs have temporarily withdrawn from certain product segments in response to regulatory changes. This suggests that the intention to keep these changes competitively neutral has been unsuccessful (at least in the short term).

Before intervening in markets, a regulator should undertake a structured assessment of how the proposed change to designated risky activity is likely to play out, and whether the costs to competitive behaviour can be significantly mitigated by more precision.

8 Funding models and their effect on competition

Key points

- The cost at which banks and non-bank lenders source their funds has a substantial influence on their competitive position — those that benefit from lower cost of funds can offer customers loans at lower interest rates or boost their returns to shareholders.
- Different types of institutions use different funding sources.
  - Deposits: Over the past decade, the banking system has increased its reliance on deposits. Major banks' incumbency and pricing power have given them cheaper access to deposit funds than competitors, and allowed them to determine whether the benefits of a higher cash rate were passed on to depositors.
  - Wholesale funds: Australia's major banks do not have similar pricing power in overseas capital markets, but are relatively advantaged by ratings agencies when they seek to go offshore. Offshore wholesale funds comprise a relatively small portion of major ADIs' total funds. This should mean that consumer prices should not inevitably rise by the same rate overall if offshore funding prices increase.
  - Equity: In response to regulatory changes, banks have been increasing their use of equity issuance to broaden their capital base. In the new regulatory environment, return on equity has fallen (albeit remaining at high levels), but banks have been able to recoup some of the cost by raising interest rates to borrowers.
  - Securitisation: Smaller institutions that rely on securitisation incur higher costs when raising funds, partly because they use warehouse funding provided by the major banks. Recent changes in securitisation rules have disproportionately increased costs for non-ADIs in particular.
- Banks that invest in an internal risk management model approved by APRA – primarily the largest banks — gain a cost advantage in terms of the capital held against loans made. This investment is significant and ongoing.
  - The Commission estimates that the collective cost saving for the four major banks from using their own risk models is well in excess of $1 billion a year.
- Institutions that have not invested in development of these risk models must follow APRA's standardised risk weights. APRA's approach to risk weights has increased the cost disadvantage for smaller institutions and reduced the scope for price competition, potentially harming consumers.
- The Australian Government and APRA have taken a range of steps that alter risk weights, which has had the effect of adding cost to the major banks. The language that is used to explain these shifts should be clear and not attack cost advantage as a fault.

The cost of sourcing funds to provide credit to borrowers is the single largest expense for all lenders in the Australian financial system. In the year to December 2017, authorised deposit-taking institutions (ADIs) paid close to $80 billion — more than half their interest income and about three times more than the cost of staff — in interest payments for their funding (APRA 2018). The cost of funds accordingly affects institutions' ability to compete in the market for lending; those that face lower costs of funds are in a better position to either attract more customers by charging less for credit, or increase their profits.

8.1 Mix and cost of funding for different types of lenders

Australia's lenders use a range of sources to fund their operations (figure 8.1):

- deposits — primarily current accounts (including no-interest accounts); savings accounts (bonus and online savers); term deposits and cash management accounts
- short-term and long-term debt (raised on wholesale bond markets)
- equity that can absorb loss (including share issuance, retained earnings and dividend reinvestment plans).
- securitisation — the process of using short term funds (often wholesale or 'warehouse' funds) to accumulate a group of illiquid assets (such as residential mortgages) and, then bundling those assets as separate financial products and reselling them.

The broad mix of funding sources varies between lenders (and types of lenders) and changes over time with market conditions that affect cost and availability, as well as regulatory settings. Regulatory settings determine the regulatory capital that financial institutions must hold — a key driver of cost.

Variation in the funding mix between lender types and over time

Not all types of lenders can use the entire range of funding sources (table 8.1) — only ADIs (including foreign bank subsidiaries) can take retail deposits; non-ADIs must fund their operations without taking deposits and may have limited access to short-term debt funding (Gishkariany et al. 2017). Mutually-owned ADIs (including mutual banks, credit unions and building societies) are restricted in their use of equity — although these institutions are now (uniquely) able to raise funds by issuing mutual equity interests.[44]

Limits on allowable funding sources can affect institutions' ability to compete, for example, if they cannot raise sufficient funds to expand their lending portfolios (COBA, sub. 21).

[44] The limitation on mutuals is a result of the way Australia's prudential regulation has treated the mutual ownership structure since 2012 (COBA, sub. 21). However, from January 2018 mutual institutions are able to issue mutual equity interests (MEI). The amount of MEI that institutions are able to issue was set by APRA following consultation with industry, and this amount will be reviewed in future (APRA 2017d).

Table 8.1 Sources of funding for lenders

Source of funding	*External factors that affect the price institutions pay*	*Which type of institution can use this funding source?*				
		Major banks	**Other domestic banks**	**Mutual banks and credit unions & building societies (CUBS)**	**Non-ADIs**	**Foreign banks**
Deposits	Price affected by cash rate and regulatory requirements on liquidity	✓	✓	✓	✗	✓ Foreign bank subsidiaries only for retail deposits
Short-term debt	On domestic markets — price driven by cash rate, and influenced by the institution's credit rating. On foreign markets — price determined by supply and demand in foreign markets and influenced by institution's credit rating	✓	✓	✓	✓	Funds may be raised in the bank's country of origin or on international markets – using any of these sources
Long term debt		✓	✓	✓	✓	
Equity issuance	Determined by a range of market factors at the time of issuance	✓	✓	Only limited types of equity can be issued	✓	
Securitisation	Determined by a range of market factors at the time of issuance	✓	✓	✓	✓	

The mix of funding sources used changes over time, with notable changes since the lobal Financial Crisis (GFC, see figure 8.1). Broadly, this has been because of a dramatic change in the relative risk profiles of the different funding sources, regulatory changes and subsequent changes in costs.

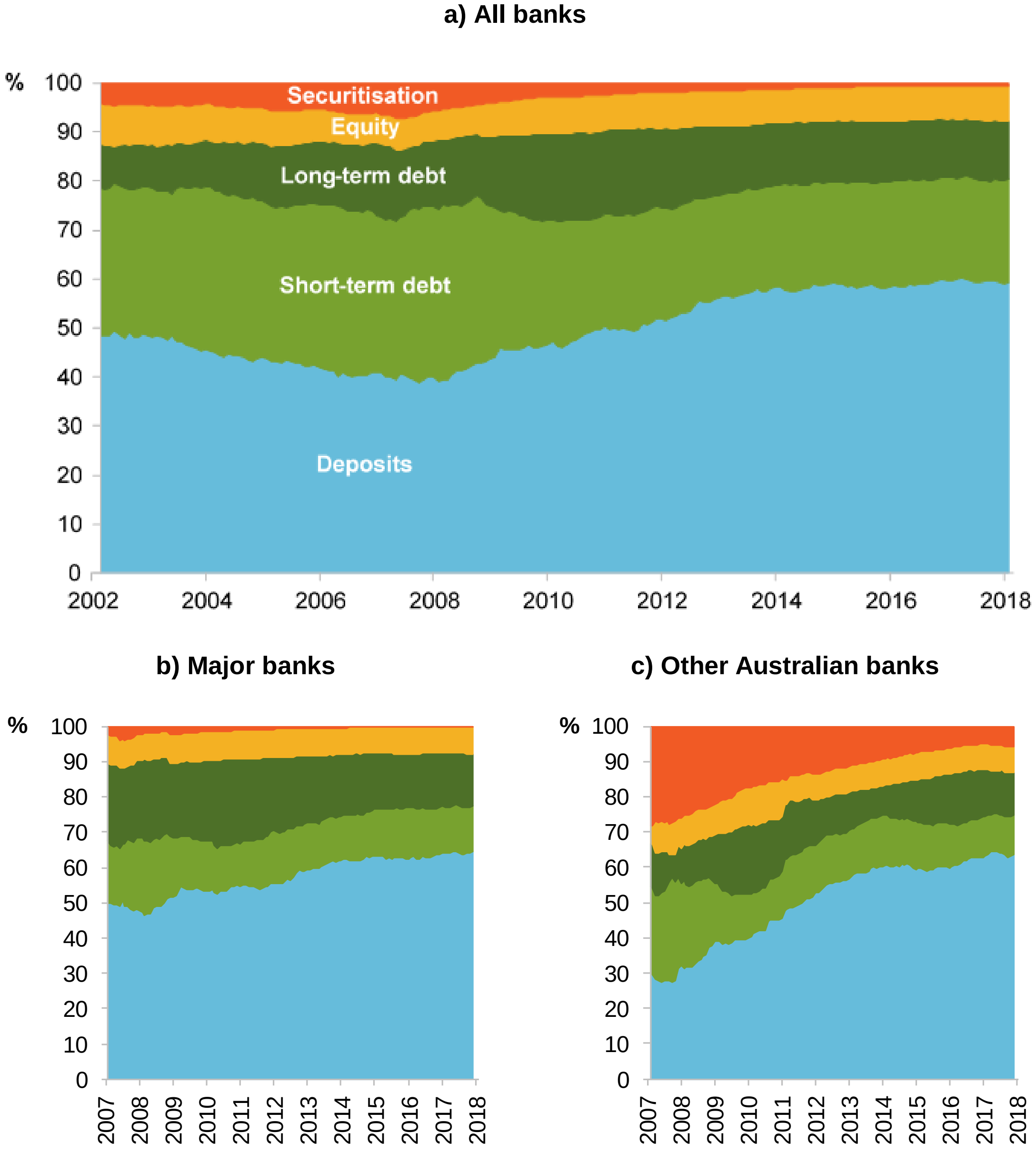
Deposits relied on as a stable funding source

The majority of bank funding comes from deposits, covering approximately 59% of total ADI funding in early 2018.

During the GFC, all ADIs increased their reliance on deposits as other funding sources were withdrawn or became more expensive (discussed below). Following the crisis, funding markets recovered, but changes to prudential regulation maintained the increased reliance on deposits, which are considered a more stable funding source.

As a consequence, the share of funding sourced from deposits has increased for all Australian-owned ADIs since the GFC, but the most significant increase (more than double the share at GFC) has been for small Australian-owned banks. Even so, the major banks' share in the deposit market increased significantly with the earlier mergers of Bankwest with Commonwealth Bank and St George with Westpac, and along with the 'flight to safety' to major banks in the GFC's wake.

Figure 8.1 **Funding composition of Australia's ADIs**



Source: Reproduced from RBA (McKinnon 2018); Unpublished RBA data (2018)

Reliance on equity to manage risks

Since 2008, Australia's banks have also increased their reliance on equity. This occurred in response to prudential standards set by the Australian Prudential Regulation Authority (APRA) that require ADIs to hold more equity in order to lower their risk of instability (Atkin and Cheung 2017). As equity is generally a more expensive source of funding than debt, increasing the share of funding that a bank sources from equity tends to reduce its profitability and its return on equity (ROE) (chapter 6). As the RBA explains:

> This increase in capital has had a direct effect on banks' [ROE]. Australian banks' ROE remains high by international standards, but the rise in bank capital since 2008, combined with lower profit growth, has reduced ROE to below its pre-crisis levels ... While this increase in capital has reduced banks' leverage and should make them more resilient, this does not appear to have been reflected in a lower implied risk premium demanded by investors. (Atkin and Cheung 2017, p. 43)

Major bank ROE remains strong, despite regulatory changes (chapter 3).

Debt composition varies substantially between lenders

Lenders typically hold a mix of short-term and long-term debt, sourced from both domestic and off-shore markets.

Major bank reliance on debt funding had been declining for a number of years (given their increased use of deposit funding post GFC), as was reliance on short-term debt by other ADIs, until 2017, when the cost of issuing debt declined (McKinnon 2018).

In comparison, foreign banks in Australia (branches and subsidiaries) hold substantially more short-term debt, with a substantial portion of this sourced from their offshore head office (McKinnon 2018). This is to be expected as most foreign banks in Australia are branches (rather than subsidiaries), which limits their ability to take deposits (chapter 4), increasing their reliance on alternative funding sources. This potentially reduces the extent to which foreign banks compete with domestic banks to secure deposits. But it also means they are more vulnerable to global macroeconomic conditions and global wholesale funding risks, such as a rapid withdrawal of liquidity (as had occurred during the GFC).

Securitisation a minor, but slowly recovering, source of funds

Securitisation is a comparatively minor source of funding for most ADIs (1% of funds) but is of more significance for smaller ADIs and non-ADIs (given the latter cannot take deposits). Since the mid-1990s, the most significant assets securitised in Australia have been residential mortgages (Aylmer 2016).

The GFC had a dramatic impact on securitisation — the total value of Australian residential mortgage backed securities (RMBS) dropped about 70% in 2008 (box 8.1). However, there has been a gradual recovery since then. 2017 had the highest rate of issuance since the GFC.

In many cases, non-ADIs use interim funding from major banks (warehouse funding) to extend credit to their customers, and once they have a sufficient number of loans on their books, they are able to issue securities. Warehouse facilities are temporary, or in practice revolving, lines of credit provided to (usually smaller) lenders.

Box 8.1 **Securitisation in Australia: the ebb and flow**

In the 1990s, securitisation was a critical force in driving competition for residential mortgages. Relatively significant volumes of residential mortgage backed securities (RMBS) were issued by Macquarie's PUMA program, which backed Aussie Home Loans, and other new entrants. During this period, competition from new lenders led to a substantial decline in home loan interest rates (chapter 7, figure 7.4).

The GFC had a dramatic effect on securitisation, with total issuance of Australian RMBS — which had been rising very rapidly since the mid-1990s — dropping about 70% in 2008 (Aylmer 2016). This resulted in very limited access to funds for institutions that relied on short-term debt and securitisation, particularly non-ADIs (Ellis 2009).

As the securitisation market shrank, the stock of RMBS outstanding halved between mid-2007 and mid-2010 and the share of housing loans funded by securitisation fell from almost 25% in mid-2007 to around 10% in early 2010 (Aylmer 2016; Debelle 2012). In the period since the financial crisis, issuance had been entirely into the domestic market, with the Australian Office of Financial Management (AOFM) being a major investor in some issues.

The Treasurer directed the AOFM to invest up to $20 billion in RMBS between 2008 and 2013 with the stated objective of supporting competition in mortgage lending. The AOFM invested $15.4 billion of this in securities issued by 16 ADIs ($10.4 billion) and 4 non-ADIs ($4 billion)(AOFM 2018). The major banks did not sell any securities into the AOFM's program.

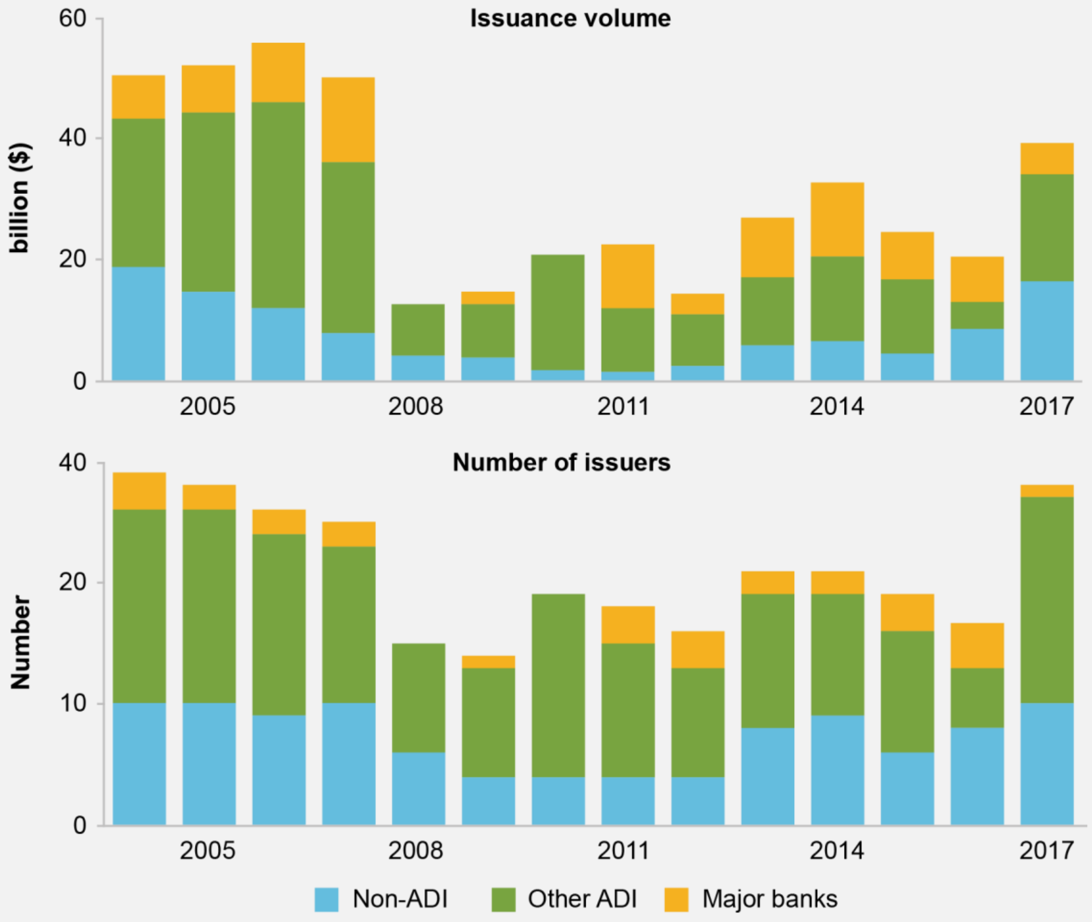
Security issuance remained below pre-crisis levels until recently. With investors regaining confidence in securitisation markets and Australian issuances in particular, securitisation activity has started to pick up, raising scope for securitisation to become a cost-effective source of funds to banks and non-banks alike (Kent 2018). 2017 had the highest issuance rates since the GFC. The AOFM also divested its entire portfolio in early 2018 (AOFM 2018).

The recent low spreads (lower costs of risk) have encouraged some smaller competitors to re-enter the securitisation market and has driven some growth. Major banks only accounted for 13% of the total volume of issuance in 2017, the lowest since 2010. Even with the decline in RMBS spreads, alternative sources of funds — such as unsecured wholesale markets — have remained attractive because spreads in those markets have also narrowed (Kent 2018).

(continued next page)

Box 8.1 (continued)

Australian RMBS issuance



Source: Reproduced from RBA (Kent 2018)

In effect, for some lenders their largest competitors (the major banks) may be the source of funding via warehousing (thus pricing their input), and also a prospective buyer of their final product (via securitisation). Domestic warehouse facilities that are overwhelmingly provided by the major banks represent close to a quarter of smaller lenders' assets in aggregate, and facilitate what is estimated to be about half of non-banks' lending through securitisation (Gishkariany et al. 2017; RBA 2017q, 2017v).[45] The non-banks currently have access to about $18 billion in warehouse facilities from major banks (although alternative sources estimate this to be $22 billion), of which $11 billion was drawn as at December 2017 (APRA 2018).

45 Evidence on the extent of warehousing activity in Australia is patchy at best. As at June 2017, APRA had instituted one ad-hoc data collection on warehouse funding, and the Commission has also gathered an incomplete dataset through direct reporting from key ADIs. The RBA also infers the extent of warehousing activity based on the ABS's securitisation dataset (RBA 2017v). We understand that APRA has recently issued notices to ADIs to collect quarterly data on the extent of warehousing activity.

Funding, but at what cost?

The relative costs of deposits, debt, securitisation and equity affect a bank's profitability: where costs rise, profits will decline if banks absorb some of the higher costs rather than pass through in full to loan rates. Alternatively, banks may choose to pass on some or all of an increase in funding costs to borrowers by raising the rates charged on lending. Where banks exercise choice in this matter, they also exercise market power, and their decisions carry economy-wide implications.

Deposits are the lowest-cost source of funds for ADIs

There are two important factors that have kept the cost of deposits low, relative to other funding sources: the decline in the RBA's cash rate (box 8.2) and the major banks' market power, which has allowed them to dictate deposit pricing (chapter 3).

Commonly referred to as the 'risk-free rate', the cash rate is the short run marginal cost of funds for banks, which would pay the cash rate as interest on unsecured funds in the overnight money market. The cash rate and other interest rates have on average moved in broadly similar ways since at least the early 1990s (box 8.2). While the movements have been similar, pricing across various deposit products has differed as ADIs have vied for the most stable and cheapest funds — a competition driven by both the availability of other funding sources and new regulatory settings.

Box 8.2 **How the cash rate influences the cost of funds**

The cash rate is the interest that financial institutions pay each other on overnight funds. These funds are used by financial institutions to balance their books each day.

The cash rate is generally the lowest rate at which banks borrow from each other and serves as a benchmark rate for other interest rates in Australia.

When the cash rate changes, wholesale funding costs change, as the cash rate affects the interest rates paid on short-term and long-term bonds. However, while the changes occur in the same direction, they are rarely of the same magnitude and can take time to feed through. This is because bond yields also take into account market expectations about a range of economic factors in Australia and overseas, in addition to the cash rate.

Interest rates paid on deposits can be affected by the cash rate, particularly for longer term deposits and cash management trusts. In this case, interest rates tend to rise by less than the changes in the cash rate, reflecting the management expenses and profit margins of banks.

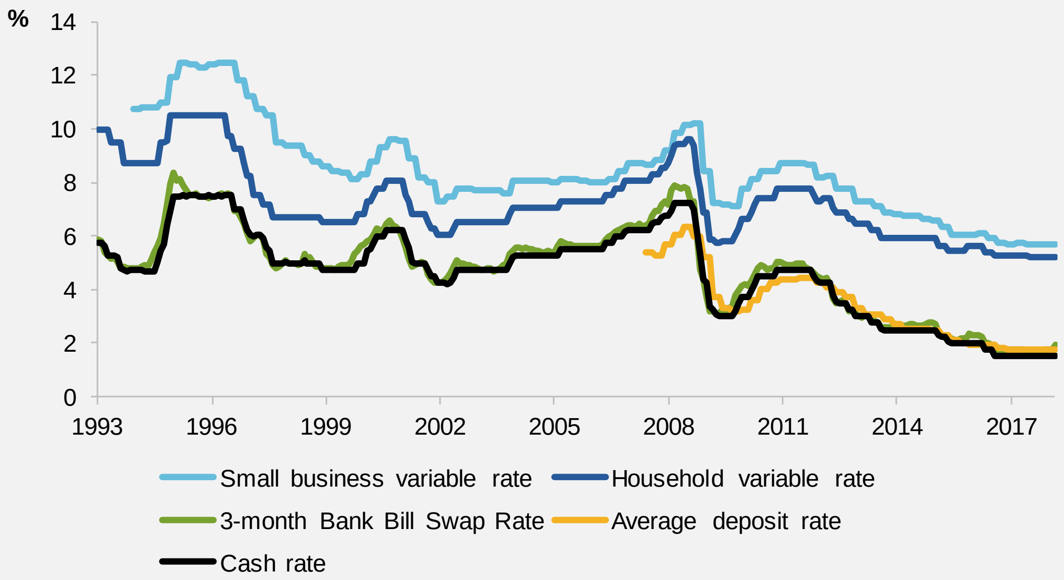
(continued next page)

Box 8.2 (continued)

When the cash rate declines, banks' cost of funding declines, although not necessarily by the same amount. The RBA has found that historically, changes in the cash rate were not passed through fully to loan rates. A number of factors affect the 'pass-through' decisions of banks:

- changes in the deposit structure, and to what extent customers use relatively high-interest products
- the level of risk in lending, with interest rates tending to rise more when the probability of default rises
- the level of banking competition
- and the characteristics of the home loan market, such as the rate of refinancing.

Australian interest rates following the cash rate

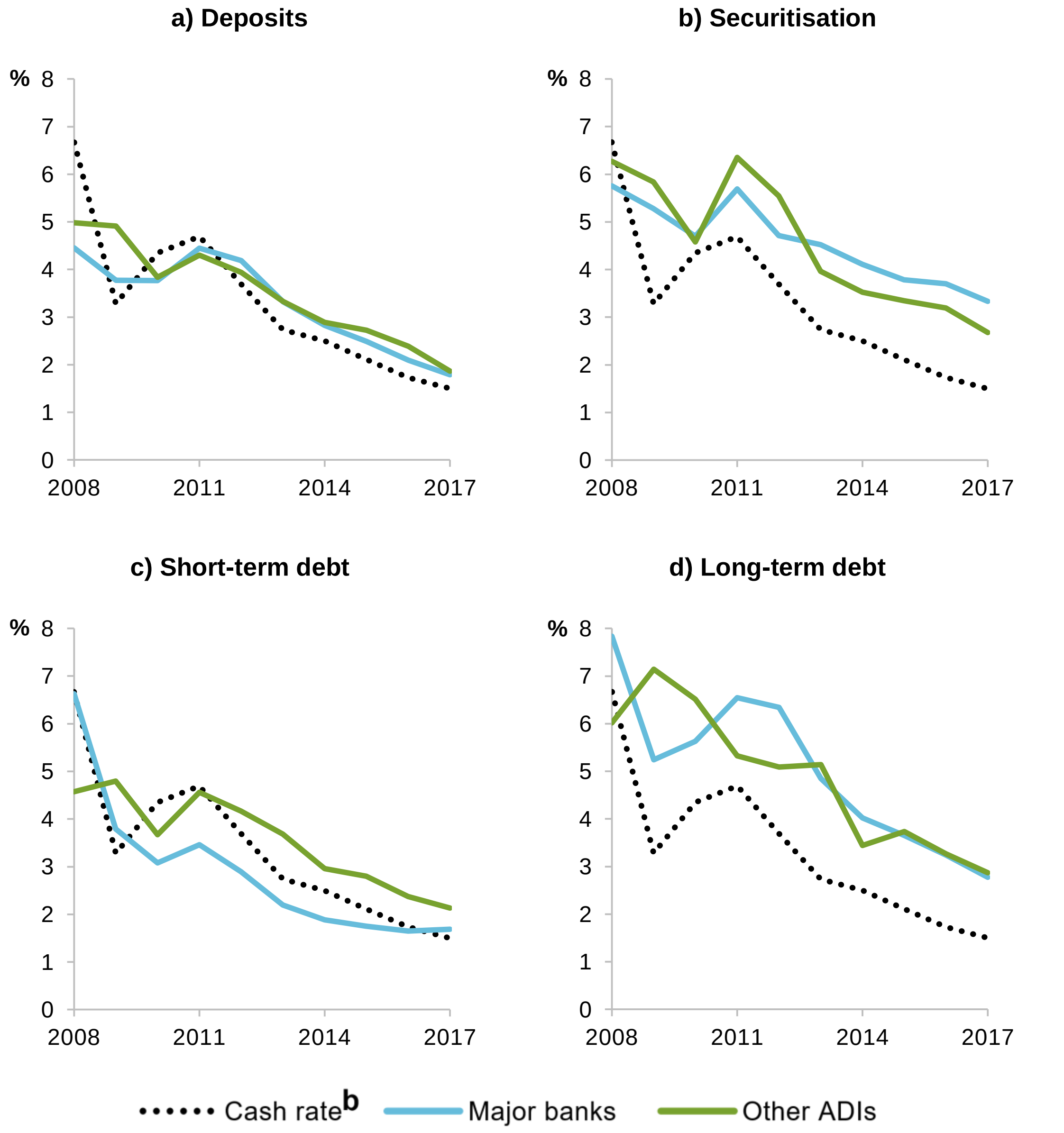


Source: Lowe (1995); Atkin and La Cava (2017); RBA (Statistical tables D8, F1 and F5); APRA (2018) unpublished data

Deposits remain one of the cheapest sources of bank funding. Increasing their share in the overall funding composition benefits ADIs (and ultimately consumers), as it lowers their overall cost of funds (figure 8.2, panel a).

As funding markets recovered from the GFC, banks no longer needed to compete as strongly for deposits, as they could again access alternative sources of funding — therefore interest rates offered to consumers have been relatively stable, or declining (figure 8.3).

Figure 8.2 **Cost of different funding sources**[a]

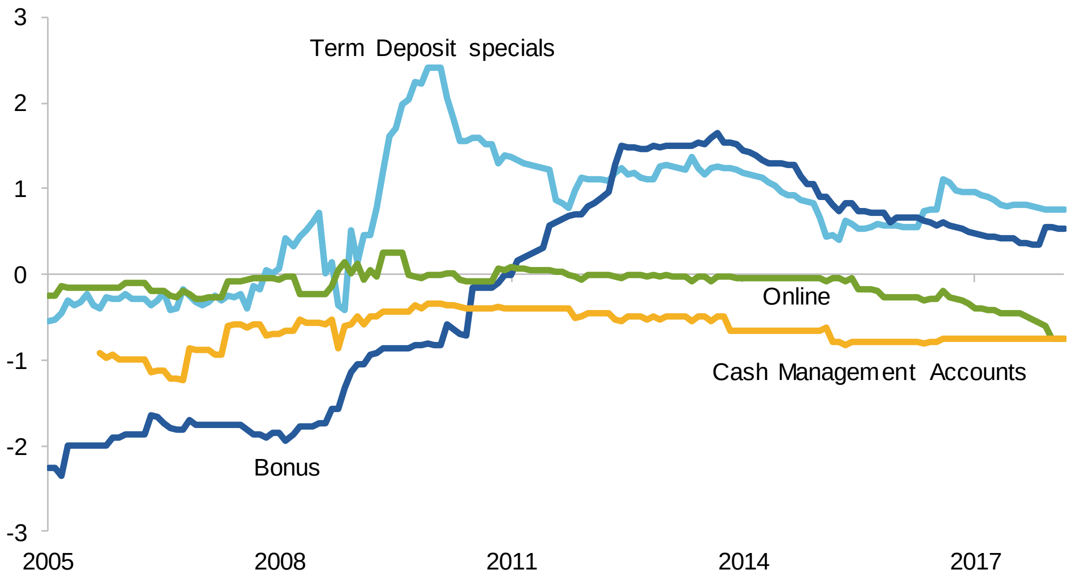


[a] Costs expressed as an annual percentage premium paid on the principal funding amount. [b] The daily cash rate series is weighted to arrive at a weighted average annual cash rate.

Source: Data provided by ADIs; RBA (2018b)

Figure 8.3 **ADIs' deposit rates[a]**

Percentage point spread of deposit rates to the cash rate



[a] Term deposit specials are an average of 1-12, 24, 36, and 60-month terms. The rate for cash management accounts is for deposits above $250 000. The rate for online saver accounts is the base rate and therefore excludes any temporary bonus rates.

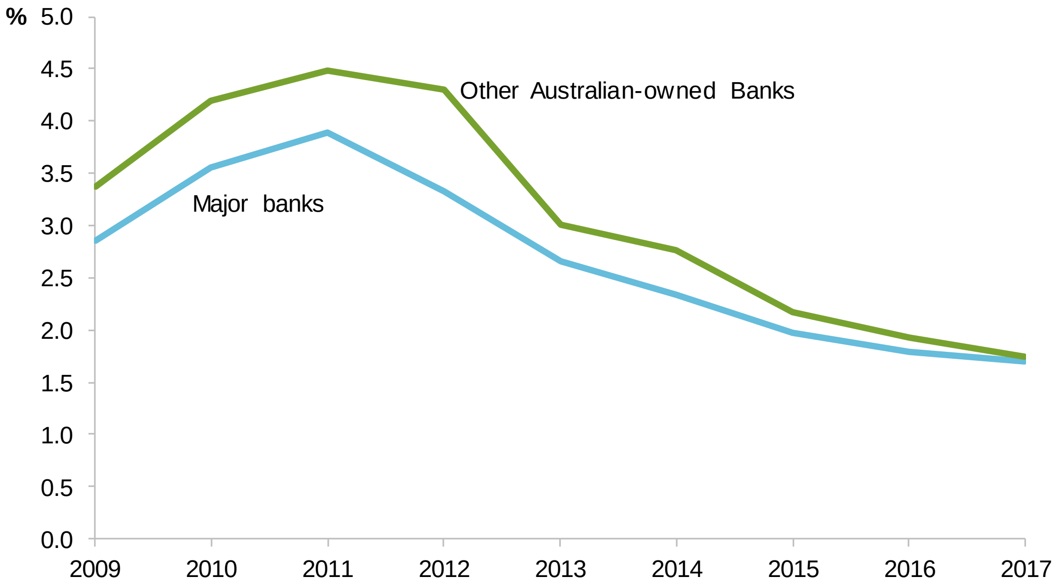
Source: Unpublished RBA data (2018)

There is little difference in the interest rates paid on similar types of deposits, particularly by major institutions (see, for example, Davies 2016). Some smaller institutions have consistently offered better rates to reduce their reliance on expensive short-term debt and meet regulatory obligations (COBA, sub. 21 and figure 8.2). But their ability to attract more deposits is dampened by the major banks' market dominance, the 'flight to safety' during the GFC and the generally low levels of customer switching (chapters 3, 5). The major banks' incumbency advantage and size have enabled them to reduce their deposit expense relative to smaller institutions, increasing their cost advantage (figure 8.4).

More recently, smaller banks' deposit interest expenses have also reduced relative to their deposit balances as they too reduce the rates on offer for consumers, effectively following the majors' lead (figure 8.4).

Figure 8.4 **Major versus other banks' deposit expense premium**

Deposit interest expense as a percentage of total deposits by bank type



Source: Unpublished APRA data (2018)

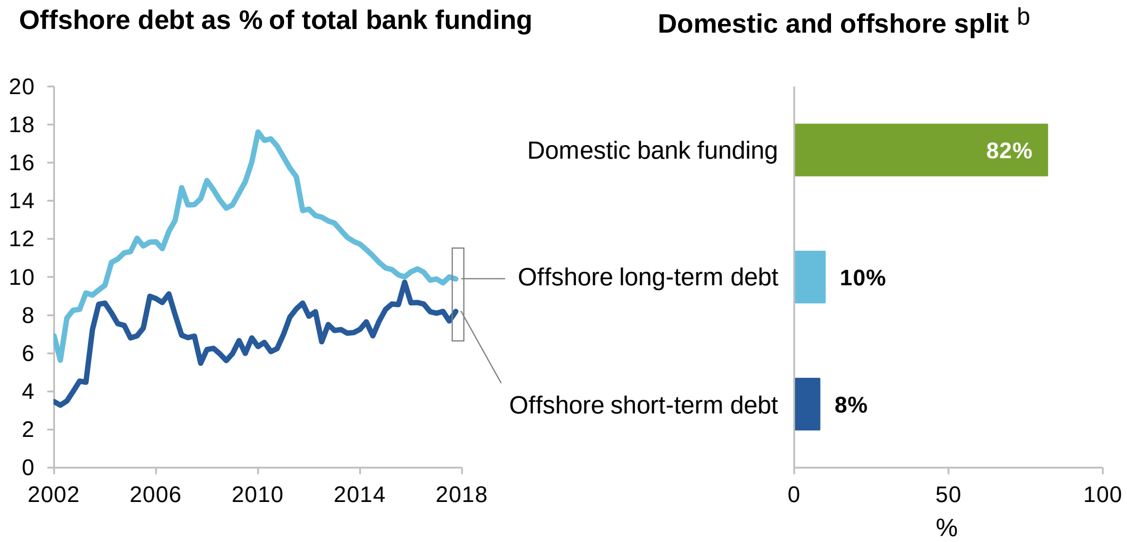
Wholesale funds are more expensive, but majors have easier access

Unlike domestic markets, where the major banks have substantial pricing power, they have very limited influence over global funding markets, from which banks source most of their wholesale funds. In 2017, the major banks sourced about 18% of their funding from overseas as short- and long-term debt (figure 8.5, McKinnon 2018). The major banks are more reliant on offshore wholesale markets compared with other Australian-owned banks (McKinnon 2018). The cost of raising funds overseas depends to a large extent on individual institutions' credit ratings, which are set by global ratings agencies. These ratings, along with institutions' financial performance and general economic conditions, determine the price at which global investors are willing to lend to Australian banks.

As a consequence, if the cost of wholesale funds was to rise, the lower proportion of offshore funds should mean that retail loan costs in Australia should not necessarily rise by the same rate overall.

The major banks have higher credit ratings than other Australian institutions. This is a reflection of their profitability and substantial market share, and their 'too big to fail' status (RBA, sub. 29). The ratings agencies may implicitly believe that the Australian Government will intervene to support the major banks to prevent them failing and triggering a financial crisis.[46] Therefore, investment in these institutions is considered safer, compared to smaller operators in the financial system, and their ratings are higher. In turn, investors may be more likely to accept a lower yield on the debt securities issued by the major banks compared to smaller institutions (chapter 6). The difference in credit ratings means that larger institutions pay less to raise funds — most evident in the cost of short-term debt (figure 8.2, panel c).

Figure 8.5 **Major banks' domestic versus offshore funding[a]**



[a] Debt (wholesale) funding makes up the vast majority of total offshore funding, a very small proportion of securitisation funding may come from offshore. [b] Offshore and domestic split of total major bank funding as at 31 December 2017.

Source: McKinnon (2018)

Wholesale term deposit markets are an alternative source of funding for smaller ADIs, particularly mutual ADIs that cannot access other forms of wholesale funding or retail funding (Laminar Capital, sub. DR137). Local councils, charitable organisations, universities, corporates and smaller super funds have investment funds held in term deposits. This 'middle market' of smaller institutional investors enables the smaller ADIs to access funding without a credit rating.

We are told that the major banks are also highly active in this market and have for the past decade crowded out smaller institutions (Laminar Capital, sub. DR137).

46 There is a history of governments from around the world using taxpayer funds to support (or 'bailout') distressed or failing financial institutions. Governments are most likely to make such interventions where the failure of an institution would cause significant damage to the financial system and broader economy. This is most likely to be the case for large financial institutions and has given rise to the notion that such institutions can become too big to fail.

Smaller institutions are not only affected by their lower credit ratings; they also often pay the major banks to arrange and manage their debt and other issuance, as the major banks have the required skills available in-house. The cost of these services raises the overall cost of funds for smaller institutions.

Long-term debt is typically more costly than short-term debt and deposits because of the greater risk and opportunity cost investors carry. Most recently, the cost of issuing new debt decreased over 2017 for both long-term and short-term debt issuances. But increases in the average tenor (length till maturity) of bank debt and interest rate risk have partially offset the cost reductions.

As result of their ratings advantage and the recently declining cost of debt securities, the major banks have been able to obtain a larger share of funding from offshore wholesale markets compared with other Australian ADIs and non-ADIs.

Recently, the smaller ADIs have further reduced their use of domestic short-term debt and funding from offshore debt markets as they have shifted toward more deposit funding.

Non-ADIs still have relatively limited access to short-term wholesale markets as a result of the GFC.

Securitisation is a main funding source for non-ADIs, not the major banks

Non-ADIs rely on a mix of long-term debt and securitisation (and short-term debt to a lesser extent) to fund their activities. Securitisation accounts for 25-100% of non-ADIs' funding (Gishkariany et al. 2017). Pepper Money, for example, derive 100% of their funding from securitisation.

The current gradual recovery of the Australian securitisation market means that securitisation still offers scope to enable potential competitive forces in the financial sector. Securitisation can provide a re-emerging viable source of funding for smaller players to offer loans at competitive rates.[47]

Regulators are understandably cautious in how they treat securitised assets. But securitisation remains a viable way in which institutions can reduce risk on their balance sheet and expand credit. By moving loans off their balance sheets, securitisation can shift

[47] Laminar Capital (sub. DR137) called for a stand-by government-backed liquidity facility as a securitisation vehicle specifically targeted at lowering the costs for the mutual ADI sector. Such a stand-by liquidity facility carries the risk of embedding contingent government liabilities or deteriorating lending standards where investors expect government guarantees for purchasing particular security tranches. Further, it is expected that enabling the sector to issue mutual equity interests will lower its funding costs.

risks from institutions and improve their stability — that is, they can undertake capital relief securitisation.[48]

On balance, majors have a significant cost advantage in funds markets

Overall, there is a distinct difference in the cost of funds faced by larger and smaller players. Major banks are generally able to set the price on deposits, and they benefit from higher credit ratings, which lower the cost of their funds raised in wholesale funding markets. Even when funding costs decline, major banks' market power allows them to decide whether they pass on the savings to their borrowers (chapter 3).

Smaller banks often need to pay slightly more to attract deposits and convince customers to switch away from major banks. Their cost of funds is higher overall and this makes it difficult for them to lower interest rates for borrowers while maintaining their profit margins. Non-ADIs face the greatest funding constraints.

Some small institutions (such as mutuals) can benefit from relatively low cost funds sourced from communities of common interest. In their case, however, the limitations of size, regulatory restrictions (such as mutuals' inability to issue some types of equity) and relatively high operating costs have eroded profit margins (Byres 2017a). This makes it difficult for them to lower lending interest rates to attract more customers and compete vigorously against the major institutions.

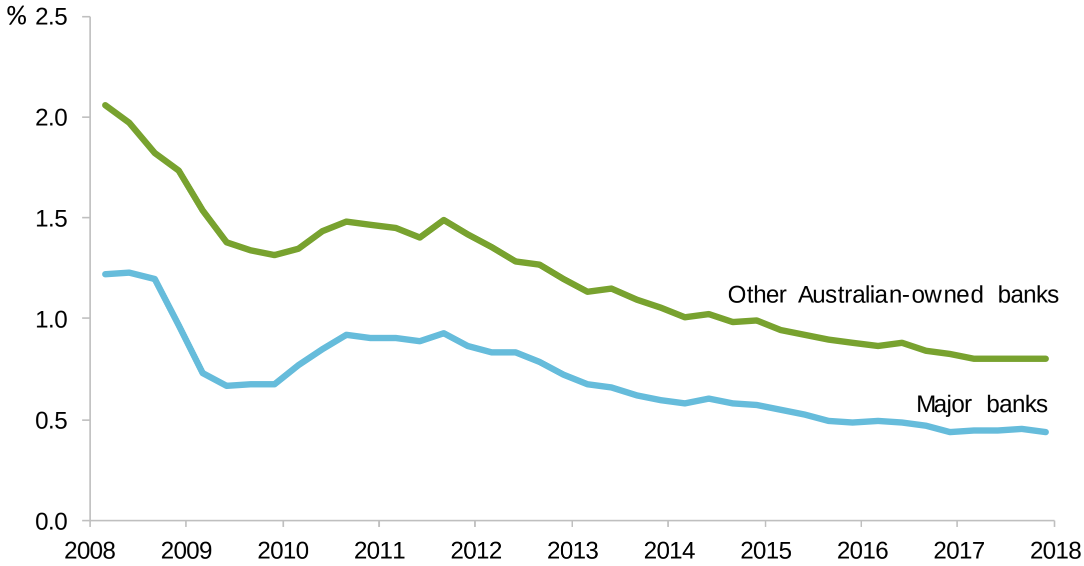
The cost advantages that major banks have when raising funds, both domestically and overseas, translate into a lower marginal cost for them compared with other institutions (figure 8.6). Other costs, such as labour, property and equipment and technology, are relatively fixed and to this end do not drive the banks' marginal costs.

The RBA estimated that overall funding costs for the major banks declined by around 4 basis points over 2017, given the lower deposit costs and shifts towards cheaper types of deposits. Yet despite these funding advantages, the Commission has not found evidence of a pass-through of these efficiencies to consumers. Even as funding costs declined in 2017, lending rates remained stable overall. The effect of the pricing power the major banks exert is considered in depth at chapters 3 and 7.

48 Securitisation was originally conceived as a tool to enable ADIs to achieve both capital benefits (capital relief securitisation) and funding benefits. Capital relief securitisation is where ADIs may be able to reduce the amount of regulatory capital APRA requires them to hold against the securitised bundle of loans by removing them from their balance sheets (a 'significant credit risk transfer'). Funding only securitisation is where ADIs and non-ADIs sell the securitised bundle of loans to raise funds, but retain some component of the bundle of loans on their books as an indemnity for the buyer (in the form of a 'first loss piece', the lowest rated part of the security).

Figure 8.6 **Marginal cost of major versus other banks**

Average cost a bank incurs for an additional unit of lending[a]



[a] Uses a transcendental logarithmic cost function estimation as detailed in Demirguc-Kunt, Peria & Soledad (2010). The model uses labour, fixed capital and funding as factor inputs to derive a total cost function. This is derived with respect to quantity to arrive at marginal cost, which eliminates the banks' fixed cost elements (such as labour, property and equipment and technology). The model uses unpublished APRA data on Australian-owned bank costs (excludes foreign banks, credit unions and building societies).

Source: Productivity Commission estimates based on unpublished APRA data (2018)

8.2 Regulatory influences on funding models

Prudential regulation has a very strong influence on the mix and cost of funding sources used by ADIs. This is because APRA requires ADIs to hold regulatory capital and meet liquidity requirements, so that the risk of loss is managed and possible losses from their loan portfolios (and other assets and activities) can be absorbed without affecting depositors or the government (chapter 6 explains this issue in detail). This affects ADIs' overall cost of funds, as they are unable to optimise their funding mix purely in response to market conditions. Holding more regulatory capital also leads to lower returns as the regulatory capital cannot be put towards revenue-generating activities. Prudential regulation can also affect non-ADIs.

The effect on major versus smaller ADIs

… of liquidity and stable funding rules

As noted above, the regulatory shift that followed the GFC encouraged banks to seek deposits, and for a time likely prompted additional competition in the deposit market. Major banks have increased their overall deposit market share given their incumbency and funding advantages as discussed earlier (chapter 3, appendix C). More recently, these competitive pressures in the deposit market have eased as other sources and tenors of funds have been available and banks reached the capital ratios required by regulation (in some cases, reached these before the deadlines).

Regulation has had a stronger effect on some segments of the deposit market:

> The relative interest rates on deposits have also recently been influenced by liquidity regulations, which treat retail (households, small businesses and self-managed superannuation funds) and longer maturity deposits as more stable than other deposit types…These regulations will tend to lead to differentiation in pricing across deposit types. Offsetting this to some degree is the fact that there appears to have been less price differentiation within some deposit categories since the financial crisis. (RBA, sub. 29, p. 21)

Two new funding standards – the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR)[49] – create a preference against online deposits and deposits that attract rate-driven customers (that is, those more inclined to switch), in favour of deposits from customers with existing ADI relationships and longer term deposits.

These regulatory settings are likely to have encouraged a preference for more stable, longer term deposits.

For example, before the NSFR was introduced, transaction and savings deposits grew strongly. Competition for term deposits intensified in late 2016 as the NSFR came into effect because they are considered more stable funding under the NSFR. More recently, growth in term deposits has slowed as banks lowered the rates on these products, consistent with an expectation that they would remain comfortably above the regulatory minimum. Existing term deposit customers are penalised for their ostensible loyalty that ultimately benefits the banks themselves, which have lowered the rates for renewed term deposits (chapter 5).[50]

The funding standards may also have had unintended consequences on deposit product design. Both the LCR and NSFR, for example, may encourage bundling by ADIs to retain their existing or long-standing customers (chapters 5 and 9). The LCR may have led to the development of term deposits that require 31 days' notice for early withdrawal from the consumer, as deposits that cannot be accessed for 30 day days are more favourable under the LCR 30-day stress test (RBA 2014, ASIC 2014).

---

[49] The LCR is a stress test that requires banks to hold at least 100% of their net cash flow requirements in high quality liquid assets for 30 days. High quality liquid assets include: cash; high quality sovereign marketable instruments; and certain qualified corporate bonds. The NSFR mandates that available stable funding is always greater than stable funding requirements.

[50] For term deposits, ASIC (sub. 40, p. 58) found that 'ADIs promoted their term deposits by advertising the high rates available on a limited number of term deposit periods, while maintaining significantly lower rates for all other deposit periods ('dual pricing'). This resulted in many customers receiving significantly lower rates if they stayed with their provider through automatic rollover of their deposit.'

…of regulatory capital

ADIs use risk weights to calculate the amount of regulatory capital that needs to be held against each loan. The major banks have developed internal risk-based (IRB) models, which have been approved by APRA, to determine their risk weights. All other ADIs must use APRA's standardised weights. Prudential regulation sets the proportion of risk-weighted assets to be held as regulatory capital, and the specific types of capital to be held.[51]

A number of Inquiry participants were concerned that the difference between standardised and IRB approaches to risk weights impacted on competition, particularly for home loans. Some participants consider residential mortgages to have a similar risk profile across all ADIs and therefore suggest that ADIs should hold similar amounts of capital against these loans (for example, BOQ, sub. 35). Alternatively, some have argued that IRB banks have made a substantial investment in their risk models, which have been approved by APRA, and the models' performance to date has matched the confidence placed in them by the regulator (although they remain untested in times of crisis). Thus it is suggested there is no case for depriving them of lower provision against loss. One of the reasons for introducing IRB models into prudential regulation was to create incentives for banks to improve their risk models (Murray et al. 2014a).

In practice, the majority of ADIs uses the standardised approach and so need to hold more regulatory capital against these home loans than those authorised to use the IRB approach — ANZ, CBA, Macquarie Bank, ING, NAB and Westpac. The requirement to hold more capital translates to a higher cost of funding home loans for standardised ADIs compared to the six IRB banks. A similar but separate concern was also raised about lending to small and medium size businesses (chapter 16).

APRA is currently in the process of developing a new capital framework, including revised standardised risk weights, which is expected to come into effect in 2021 (see below).

Different risk weights applied to residential mortgages benefit the larger banks

Risk weights on residential mortgages were identical across all ADIs before the Basel II reforms introduced the concept of IRB models in 2008. The reasoning for allowing banks to develop their own risk models was that it would develop a banking system where regulatory capital was better aligned with risk, and that institutions would have an incentive to invest in better risk models, to benefit from lower risk weights, while at the same time improving their risk management capabilities (Murray et al. 2014a).

---

[51] The minimum level of regulatory capital ADIs are required to hold include a Common Equity Tier 1 Capital ratio of 4.5% of risk-weighted assets; a Tier 1 Capital ratio of 6.0% of risk-weighted assets; and a Total Capital ratio of 8.0% of risk-weighted assets. APRA can require ADIs to hold additional capital to the minimum requirements (APRA 2012c). Chapter 6 discusses these issues in detail.

As expected, the implementation of IRB models resulted in lower risk weights for those institutions that made the substantial investment required to develop models that were approved by APRA. In 2014, the Murray FSI (2014a, p. 61) found that:

> The average mortgage risk weight for an ADI using the standardised model is 39 per cent — more than twice the size of the average mortgage risk weight for banks using IRB models, which is 18 per cent.

Following Murray FSI recommendations, APRA increased the regulatory capital IRB banks are required to hold against their residential mortgage loan portfolios (APRA 2015b, 2016b).[52] From July 2016, the average risk weight across the portfolio of residential mortgage loans of the IRB banks was to increase to *at least* 25% (from about 16% previously), narrowing the difference in regulatory capital costs between IRB and standardised banks. By 30 June 2017, the average risk weight on the residential mortgages of the IRB banks was just above the minimum set by APRA, at 26% (APRA, sub. 22). However, this is still well below the average risk weight of 39% applying to residential mortgages across all other ADIs that are required to use the standardised approach (Regional Banks, sub. 37).

Given its greater granularity, IRB risk weights are not always lower than the standard weights that APRA sets. The maximum risk weight an IRB bank applies for a residential mortgage that is not in default is 137% compared to 100% for a standardised ADI (table 8.2). Risk weights can be even higher for IRB banks when mortgages are in default – increasing to up to almost 220% whereas standardised ADIs usually retain a risk weight of 100% (ANZ 2017b; APRA 2012a; CBA 2017b; NAB 2017d; Westpac 2017a).

However, this is the exception rather than the rule. Less risky loans — those where the borrower has a low probability of defaulting or a low loan-to-valuation ratio (or both) — represent the vast majority of loans in banks' portfolios (chapter 13). It is on these loans that the risk weights applied by the IRB banks fall below the minimum applying under the standardised approach, and the benefit of the IRB approach becomes apparent.

For otherwise identical ADIs, the advantage of a 25% average risk weight (APRA's minimum for IRB banks) compared to the 39% average risk weight of standardised ADIs is a reduction of approximately 0.14 percentage points in the cost of funding the loan portfolio (table 8.3). This difference translates into an annual funding cost advantage of almost $750 on a residential mortgage of $500 000, or about $15 000 over the 30 year life of a residential mortgage (assuming an average interest rate of 7% over that period)[53].

---

52 This change also reflected the direction of work that was then underway at the Basel Committee on Banking Supervision on revised regulatory capital requirements (BCBS 2015). The increase was implemented as an interim measure pending the finalisation of the Committee's work on a revised regulatory capital framework.

53 $15 000 estimate based on amortising $500 000 loan over 360 months at 7% annual interest, of which the IRB ADIs have a 0.14 percentage point cost advantage over standardised ADIs.

Table 8.2 **2018 risk weights for eligible mortgages that are not in default**[a]

	Standardised risk weights				
	Standard eligible mortgages[b]		*Non-standard eligible mortgages*[b]		*IRB risk weights*
	No LMI	*LMI covering ≥ 40% of the loan*	*No LMI*	*LMI covering ≥ 40% of the loan*	
LVR	%	%	%	%	• Average risk weight across all portfolios of 26%. • Risk weights on individual loans range from 5% to 137% as at 30 September 2017.
Less than 60%	35	35	50	35	
60% < LVR ≤ 80%	35	35	75	50	
80% < LVR ≤ 90%	50	35	100	75	
90% < LVR ≤ 100%	75	50	100	75	
Over 100%	100	75	100	100	

[a] **LMI** - lenders mortgage insurance. **LVR** - loan to valuation ratio. [b] A standard eligible mortgage is one where the ADI has confirmed and documented the ability of the borrower to make the contracted repayments; valued the residential property offered as security and established the marketability of that property.

Source: ANZ (2017b); APRA (sub. 22; 2012a); CBA (2017b); NAB (2017d); Westpac (2017a)

Table 8.3 **Composition of the cost advantage from current risk weighting**

Based on a residential mortgage of $500 000

	Standardised ADI	*IRB ADI*
Common equity tier 1 (CET1) required	9%	9%
Risk weight	39%	25%
Equity funding (based on CET1 and risk weight)	$17 550	$11 250
Deposit and debt funding	$482 450	$488 750
Cost of equity	$2 507	$1 607
Cost of deposits and debt	$12 061	$12 219
Total funding cost	$14 569	$13 826
Cost of funds	**2.91%**	**2.77%**

Assumptions: the standardised and IRB ADI have: an average cost of debt and deposits of 2.50%; a 10% post-tax cost of regulatory capital; a 30% tax rate; and equal operating costs and impairment charges. These assumptions are informed by the ABA (sub. 11); BOQ (sub. 35) and APRA (2014b). The same assumptions were applied to the standardised ADI and IRB bank to isolate the cost advantage from different risk weights.

APRA's review of the capital framework may shift the balance

APRA has recently begun consultation on proposals for key revisions to its capital framework (chapter 6). The revisions cover the calculation of credit, market and operational risks. Key proposals of relevance to ADI funding include:

- revisions to the capital treatment of residential mortgage portfolios under the standardised and IRB approaches, with higher capital requirements for higher-risk segments
- amendments to the treatment of other exposures to improve the risk sensitivity of risk-weighted asset outcomes
- additional constraints on the use of ADIs' own risk parameter estimates under IRB approaches to determine capital requirements for credit risks and introducing an overall floor to risk weighted assets for ADIs using the standardised approach
- introducing a single methodology for the current advanced and standardised approaches to operational risks
- introducing a simpler approach for small, less complex ADIs to reduce the regulatory burden without compromising prudential soundness.

Most significantly, the revisions propose a more granular approach for determining the regulatory capital requirement for residential mortgage exposures under the standardised approach (table 8.4). This includes capital requirements for exposures with a loan to valuation ratio (LVR) of less than 80%, which better align with those of the Basel III framework.

Table 8.4 **APRA's proposed risk weights for residential mortgage exposures under the standardised approach**

Percentage of the loan to be held as regulatory capital

For loans with LVR of…	≤ 50%	≤ 60%	≤ 80%	≤ 90%	≤ 100%	> 100%
Where the loan is a principal and interest owner-occupier mortgage	20	25	30	40	50	70
For other residential mortgages	30	35	45	60	75	85

Source: APRA (sub. DR116)

The closer alignment of capital to risk for residential mortgages will come from increases in risk weights on several higher-risk loan segments. APRA proposes increased risk weights for mortgages used for investment purposes, those with interest-only features and those with higher LVRs. At the same time, risk weights for some lower-risk segments are proposed to drop. For example, under the standardised approach, mortgages with LVRs lower than 80% will require risk weights of only 20%-30%, down from the 35% currently required.

The higher capital charges on investment loans are expected to better reflect their greater sensitivity to economic cycles.

The new capital framework is intended to be implemented by 2021. While the standards have not been finalised, they are expected to affect funding costs and narrow the gap between the IRB and standardised approach (chapter 6).

The major banks have an overall advantage

In addition to the IRB advantage illustrated in table 8.3, major banks benefit from lower costs of debt and deposits, and lower operating costs (as discussed above and outlined at table 8.5). Therefore, the overall advantage for the major banks is likely to be larger.

The collective cost saving for the four major banks is still well in excess of $1 billion, based on their combined residential mortgage portfolio of $1.24 trillion and under the regulatory capital requirements and risk weights currently in place (APRA 2017u).[54] However, under the proposed risk weights, the difference would likely be smaller, holding all else constant and assuming an owner-occupier mortgage portfolio.

Table 8.5 **Factors that affect the cost of funds for IRB and other banks**

	IRB banks	*Other ADIs*
Factors that *lower* the cost of funds for IRB banks		
Average risk weight applied to residential mortgages as a result of IRB models	25%	39%
Wholesale funding advantage[a]	-0.14 percentage points	nil
Factors that *raise* the cost of funds for IRB banks		
CET1 requirement[b]	10.5%	8.5%
Higher capital requirements for domestic systemically important banks (D-SIB)	Yes	No
Capital for IRRBB[c]	Yes	No

[a] A negative number indicates a reduction in funding costs. The number used is based on that used by the RBA (2015d). No funding cost advantage was assumed for deposits as the depositor preference provisions and scope of the FCS are consistent across ADIs. [b] This is the capital requirement that will apply once the implementation of the 'unquestionably strong' framework is completed, in 2020 (BOQ, sub. 35, APRA 2017c). [c] IRRBB - interest rate risk on the banking book.

Risk weights should be set with a focus on risk only, not relative cost advantage

While the major banks receive an advantage in their funding costs from certain regulations and the attitude of ratings agencies, they also face regulation (and related costs) that increases their funding costs relative to rivals (table 8.5).

For example:

- APRA has designated the major banks as domestic systemically important banks (D-SIBs) and, as a result, they are required to hold additional Common Equity Tier 1

54 This estimate assumes the cost differentials demonstrated in table 8.3 apply across the residential mortgage portfolio. This refers only to the cost advantages created through the use of IRB models.

capital equivalent to 1% of their risk-weighted assets to cover the systemic risk they present (APRA 2013a).

- To meet APRA's unquestionably strong capital benchmark, the four major banks need to hold approximately 1% more regulatory capital (relative to their risk-weighted assets) compared to their rivals (APRA 2017c).
- IRB banks are required to hold regulatory capital against the interest rate risk in the banking book whereas standardised ADIs face no such requirement (APRA 2008b).[55]

In some cases, the regulator may need to impose additional costs, for example through higher risk weights to address past miscalculations of risk.[56] Market power may mean that this cost is passed on by those affected institutions, but to the extent that prices may have been distorted by a previous regulatory decision, addressing this is in the public interest.

But some policy shifts that have increased costs for the major banks have been characterised as being more about reducing their competitive advantages than about addressing a public interest objective (such as better-judged risk weights, or perhaps in the case of the bank levy, fiscal imperatives). Due to their market power, the major banks have the capacity to pass such additional costs on, despite the best efforts of monitoring.

Well designed and implemented regulation, including prudential regulation and other government interventions, should thus seek not to damage markets (and, as a result, harm competition and consumers) more than is essential to the public interest purpose.

But equally, the language used to explain interventions is itself particularly sensitive in the world of finance, where altering expectations through comment is a recognised art.[57] The language that is used to explain these shifts should be clear on the motivations and objectives of policy interventions, and not attack as a fault cost advantages that arise through features such as economies of scale.

---

55 Prudential regulation requires IRB banks to estimate the effect of movements in interest rates on their banking book items, including interest and non-interest income. IRB banks must hold additional capital that reflects the risk to returns posed by interest rate movements (APRA 2008b).

56 For example, the Murray FSI (2014a) identified substantial gaps between the risk weights used by IRB and non-IRB banks, which were not reflective of the underlying riskiness of the relevant loans. It recommended raising the minimum risk weight used by IRB banks, a recommendation that was implemented by APRA.

57 The public communication strategies commonly employed by central bankers and other regulators to influence markets can carry significant weight for investors (Cecchetti and Schoenholtz 2015).

FINDING 8.1 COST OF FUNDS FOR DIFFERENT SIZE BANKS

Larger banks benefit from lower costs of funding, compared with smaller institutions. Size, scope and incumbency have enabled them to increase their share of the deposit market, retain better access to offshore funding markets and raise funds at relatively cheaper rates due to their higher credit ratings, which in part reflect an expectation of government support.

Risk weights determined by the prudential framework have a substantial impact on the cost of funds. The major banks have invested in approved internal risk management models, gaining a further cost advantage from being allowed to use risk weights that are generally lower than APRA's standard requirements.

Cost interventions (such as changes to risk weights) have been presented as targeting both stability and competition. While such interventions may have achieved stability objectives, they have had adverse consequences for competition. Interventions that raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and will harm consumers.

The effect of regulatory measures on non-ADI funding

Regulators should be careful not to stymie the opportunity for competition that securitisation and possibly other innovative funding models offer, with blanket 'one size fits all' prudential regulations that increase costs for major banks, which are then passed through to smaller players.

Under APRA's revised prudential standard for securitisation (APS 120), which came into effect on 1 January 2018, banks and other financial institutions providing warehouse funds now need to hold more capital against their securities than they had previously, driving up warehouse costs (box 8.3).[58] Under the revised rules, smaller ADIs subject to the standardised risk weights can no longer access funds through a major bank warehouse and apply a lower capital requirement to their credit exposures under the major banks' internal risk models. The revised rules close a gap that allowed regulatory arbitrage by smaller ADIs up until now.

The APS 120 changes not only ensure standard ADIs still face standardised risk weights on warehouse loans, but go further in affecting the funding costs of non-ADIs. Non-ADIs —

58 Industry practice has evolved to create a class of ADIs which is only interested in funding, not capital, benefits. The revised APS 120 now explicitly recognises securitisation for funding only purposes.

The revised APS 120 also requires that securities be either externally rated by a ratings agency (the 'external ratings-based approach') or otherwise be assigned the standard risk weights (the 'standardised approach'). Depending on the approach, different risk weights, and therefore capital requirements, apply. Securities generated through warehousing will also be subject to these revised capital requirements. Previously, the major ADIs providing warehousing facilities had applied internal risk models (under the 'internal ratings-based approach') for their securitisation exposures, with lower risk weights.

reliant primarily on warehousing from the majors to fund their lending portfolios — are now indirectly subject to the standardised risk weighting model. For warehouse funding providers, the capital that they are now required to hold against securities has more than doubled under the new rules.[59] Three of the four major banks that are currently providing warehouse lines of credit have indicated that mortgage-backed security issuance will become an increasingly expensive exercise for them (ADI responses 2017), which they would quite reasonably be expected to pass on as higher funding costs to non-ADIs.

Despite the impacts of the change claimed by both warehouse lenders and users, APRA submitted in its 2017 regulation impact statement that the regulatory capital costs would be ‘moderate’ and that net costs would be ‘low to moderate’ overall, noting that regulatory capital only directly applies to ADIs (APRA 2017p, p. 120).

In theory, the non-ADI lenders might weaken APRA’s efforts by writing more high-risk loans than the banks. However, their market share is very small (4% of the home lending market) and their scope to grow (outside niches) is clearly constrained by the presence of dominant competitors. Non-ADIs do not appear to have the ability to create a systemic threat. APRA has suggested that regulatory arbitrage to evade risk weightings by standard ADIs rather than limits on non-ADI activity was the target of the rule changes (APRA, sub. DR116).

Competition impacts of APS 120 should be assessed

The Commission recommended in its Inquiry Draft Report a pausing of the most recent changes to the securitisation rules. A range of Inquiry participants have advised us that while the changes have directly increased the cost of funding and reduced funding and competitive efficiency of those non-ADIs using warehouses, it is now too late for any carve-outs in APS 120 for non-ADIs (box 8.3).

Specifically, investments that non-ADIs have made to adjust to the changed warehouse capital requirements under APS 120 are now ‘sunk’, meaning that reversing APS 120 for non-ADIs is no longer feasible (Australian Securitisation Forum, sub. DR 133).

It is unfortunate, if this is the case, as the arbitrage could have been addressed with more direct mechanisms. Costs have been raised unnecessarily and consumers, on first principles, could be worse off.

[59] For warehouses with securities for which they will now seek an external senior AAA rating (the security ranks before all others if a company falls into liquidation or bankruptcy), the risk weighting for capital will increase from around 7% to around 20% under the ‘External Ratings-based Approach’ (APRA 2017p). For warehouses that do not have an external credit rating, the risk weighting will increase from about 7% to at least 15% as per the standardised risk weighting formula.

Box 8.3 The effects of APS 120 on cost and competition

The Australian Securitisation Forum (sub. DR133) describes the costs of implementing the changes as having been 'material' for many of the non-ADIs given:

- The **direct costs of more regulatory capital required** (capital enhancement) for warehouse funding both mortgages and non-mortgage assets. Capital enhancement for mortgages was previously in the range of 2 to 3%, but this has now more than doubled to between 6.25 and 7%, and is even higher for non-mortgage assets.
- The **direct costs of needing to replace some of ADI-provided warehouses** with more expensive funding from mezzanine financiers. Non-ADIs have had to secure mezzanine funding from a relatively small and at times inexperienced investor pool.
- The **risks associated with offshore funding,** noting that foreign institutions were the first to retreat from the Australian market during and after the GFC.
- The **administrative (such as legal) and labour costs** required to effect the changes. For some non-ADIs, legal fees were estimated to comprise more than 50% of the entity's annual legal fees.

Moreover, the higher capital requirements could impose barriers to entry and expansion. New entrants would need to be significantly well-capitalised as a result of the regulatory changes in order to sustain a funding model with a significant securitisation component, which 'might preclude smaller and more innovative organisations, such as fintechs or mortgage managers.' The Commission was told that the pool of investors willing to invest in warehouses is also relatively small, leaving fewer funding options available for potential new players. And external investors are less likely to provide capital without a demonstrated track record in lending performance and accessing securities markets to refinance warehouses. Such regulatory interventions are accordingly likely to impose capacity constraints on existing non-banks, which may then decide to either merge to gain some scale or exit.

Source: Australian Securitisation Forum (sub. DR133)

It is also representative of the damage that can occur when intervention does not consider competitive effects. Non-ADIs have proposed that future policy and regulation affecting securitisation should give greater consideration to the impact of competition' (Australian Securitisation Forum, sub. DR133).

The APS 120 consultation process, while extensive, overlooked the impact on smaller lenders' ability to compete. Future changes that seek to restrict small but particularly non-ADI lenders' already limited funding options, and diminish their capacity to pose any competitive threat in the Australian retail banking market, need more careful and documented consideration.

FINDING 8.2 NEW WAREHOUSING RULES COSTLY FOR NON-ADIS

Prudential regulations (Prudential Standard APS 120) affecting warehousing activities (temporary lines of credit provided by larger banks to other lenders) that came into effect on 1 January 2018 take a one-size-fits-all approach to risk ratings for smaller authorised deposit-taking institutions (ADIs) and non-ADIs. These have increased the costs of warehousing and reduced the competitiveness of those (generally small) institutions that rely on warehouse funding.

RECOMMENDATION 8.1 COMPETITION IMPACTS OF APS 120 SHOULD BE ASSESSED

Consistent with recommendation 19.3, APRA should conduct a post-implementation review on how the changes in Prudential Standard APS 120 have affected the costs of funds and competitiveness of non-authorised deposit-taking institutions.

9 Integration in the financial system

Key points

- The financial system has varying degrees of vertical, horizontal and conglomerate integration across its segments.
  - Major banks, insurance and investment firms have entered multiple market segments, integrating horizontally and bundling products (such as credit cards, insurance and home loans).
  - ADIs and non-ADIs have also vertically integrated (up and down the supply chain), particularly in retail banking and wealth management.
- Integration is not a problem per se, and is a common commercial decision. As a result of integration, consumers can benefit from greater choice; and scale and scope economies mean production and delivery can become more efficient.
- But some argue that integration in the financial system has raised barriers to entry and expansion for competitors and harmed consumers.
- Evidence on the competition effects of integration in mortgages and wealth management is mixed.
  - While there are poor consumer outcomes in some parts of these sectors, these relate to issues of transparency and incentives that arise for both integrated and separated businesses.
- The weight of evidence across the different parts of the financial system suggests that forced structural separation would do little to improve consumer outcomes or increase competition.
- Structural separation would not remove the information asymmetries that currently plague the financial system and undermine consumer outcomes. And incentives towards poor behaviour are better dealt with directly, by credibly enforcing standards, than indirectly by hoping new management behaves better.
- Understanding the longer term market implications of integration is an important component of promoting competition in the financial system. The ACCC should undertake regular market studies of financial system integration, including *ex post* reviews of past merger decisions.
  - As existing data to analyse the competitive effects of integration is piecemeal and often only assembled when a specific merger raises competition concerns, a key part of such reviews is likely to be the collection of information on integration activities.
- To hold bank boards to account for the consumer consequences of conflicted remuneration structures, a Principal Integrity Officer should be appointed by each ADI. This Officer would be tasked with ensuring that reward structures do not conflict with customer interests on an ongoing basis, including ongoing evaluation of the impact of integrated supply chains on the delivery of consumer best interests.

Businesses, including banks and other financial institutions, integrate through mergers and acquisitions. This can take the form of:

- horizontal integration — acquiring a business in the same part of the supply chain (such as the integration of a building society with a small ADI)
- vertical integration — acquiring a business 'up' or 'down' the supply chain (such as the integration of a lender with a mortgage aggregator)
- conglomerate integration — acquiring a business that is part of a different supply chain (such as the integration of a large bank with a large insurer).

Integration creates new and varying pathways through which products reach the consumer (figure 9.1). It can also alter the product possibilities and costs for both the integrator and competitors.

For example, vertical integration can give economies of scale or scope that may improve efficiency and lower costs where downstream suppliers or upstream marketers present otherwise unmanageable risks to product managers. Alternatively, it may provide one producer with the ability to control a key input or channel to market, to the detriment of competitors and competition.

Horizontal integration directly reduces both the number of competitors and degree of competition. Integration, more broadly, can also affect the number or viability of competitors. However, this need not reduce competition. For example, integrating to establish effective changes to marketing or distribution that alter how consumers view a product (such as bundling) or improve the incentives in the supply chain (such as rebates) may reduce the market share of competitors but *increase* competition.

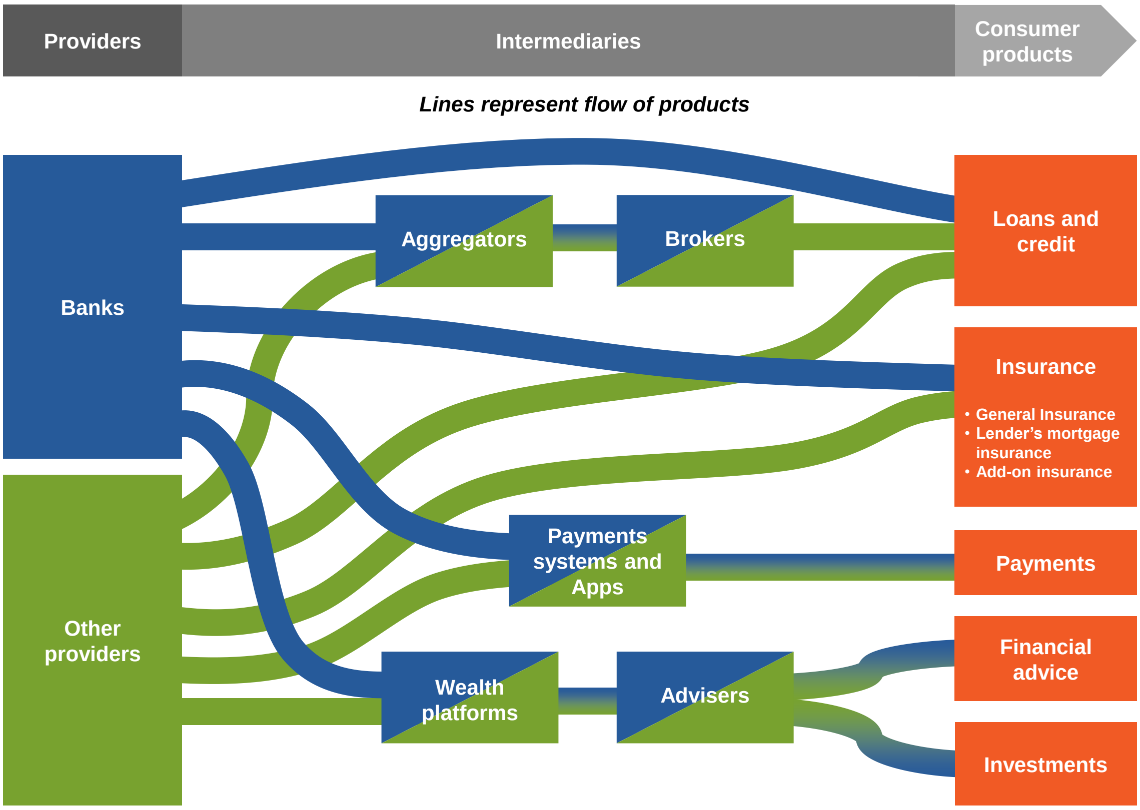
Integration that lowers costs can benefit consumers, to the degree that these cost savings are 'passed through'. But integration that reduces competition below the point of effective rivalry can reduce innovation, raise prices and harm consumers.

If markets are unable to moderate any power created by integration, then regulatory intervention may be required. But the choice of both target and tool can be fraught. Because integration can create either consumer benefit or detriment, regulations that restrict integration or subsidies that create new competitors need to carefully evaluate the potential for consumer harm.

This chapter analyses the extent to which integration has occurred in Australia's financial system and its impact on competition, and considers what more could be done to understand the longer term impacts of integration on market outcomes and address potential adverse impacts on consumers.

Figure 9.1 **Integrated pathways**

A stylised depiction of the pathways integration creates for banks



9.1 How integrated is the Australian financial system?

Banks have extended their traditional reach

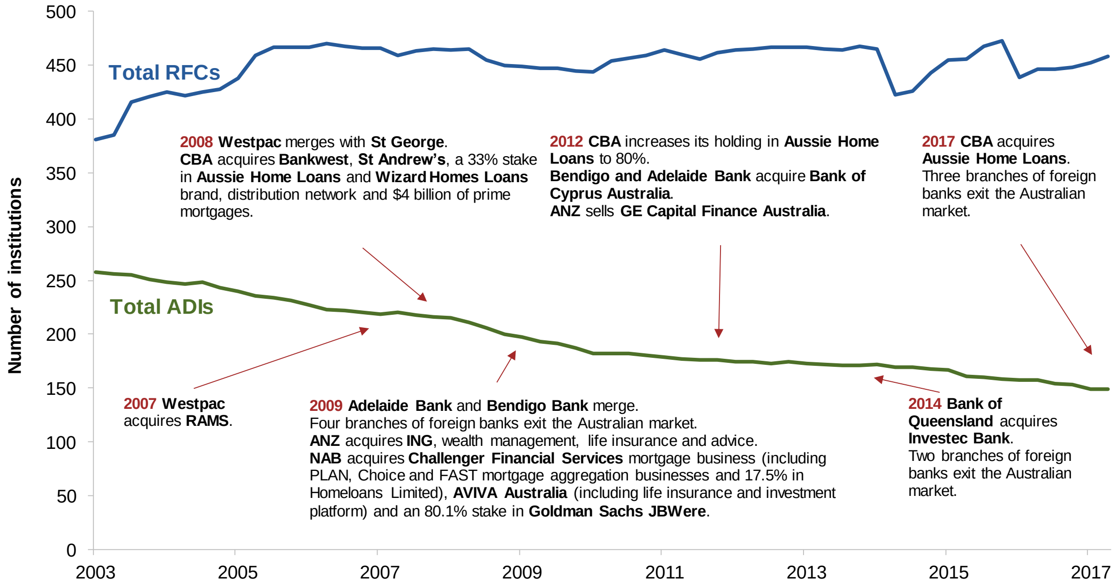
Over the past two decades, horizontal mergers and acquisitions combined with exits from the financial system have led to an overall decline in the number of institutions (despite an increase in the number of institutions now being called banks) (figure 9.2).

Consolidation has occurred throughout the banking sector, largely as a result of horizontal integration. The major banks have increased their market share by acquiring other ADIs. And (not-for-profit) credit unions and building societies — institutions that grew strongly in earlier decades — have merged with other minor ADIs and declined in market share in recent years (chapter 4) (APRA 2017t; Deloitte 2012).

The reasons for consolidation among smaller institutions vary, but in many cases they were driven by a need to improve efficiency by generating economies of scale to compete with larger banks. For example, larger banks can spread the fixed costs of new technology, such as that for online banking and real-time payments, over a larger revenue base (chapter 8). Further, consolidation may help meet a growing demand from customers for a broader range of financial services as well as managing ongoing regulatory obligations.

Figure 9.2 **Total authorised deposit-taking institutions (ADIs) and Registered Financial Corporations (non-ADIs)**

Number and rate of change in ADIs and RFCs per year[a]



[a] Registered financial companies (RFCs) are non-regulated and the responsibility to register lies with the entity. RFCs with assets less than $50 million are not required to report as per the *Financial Sector (Collection of Data) Act 2001* (Cth) (the Act). 45 RFCs exited the market in June 2014, and 39 in March 2016. These exits included de-registrations from the RFC database due to insolvencies, Australian Business Number cancellations, being incorporated into other companies, and no longer being required to report under the Act.

Source: APRA (Entries and exits, unpublished), APRA (2017s), ASIC (sub. 40)

Extending into new market segments

The major banks' dominance in their traditional bank product markets has provided them with a strong base to move into other related markets through conglomerate and vertical integration over the past two decades (figure 9.3).

Bank forays into insurance

Banks' entry and growth in the provision of insurance has enabled them to capture increasing shares of the general, life and lenders mortgage insurance markets.

In response to the Wallis Financial System Inquiry (FSI) and subsequent deregulation in a range of financial services, the banks entered the insurance market, adding insurance products to their retail bank product offerings; and some insurers looked to extend their own reach into retail banking. The Wallis FSI recommended an end to the blanket ban on any mergers between the major banks and the largest life insurance companies (the so-called 'six pillars' policy, before it eventually became the 'Four Pillars' policy — see chapter 6), which the Australian Government accepted at the time.

In this environment, Commonwealth Bank expanded its insurance operations to acquire life insurer Colonial Limited in 2002, rebranding Commonwealth Bank's insurance business as Comminsure.

And the Queensland Industry Development Corporation (QIDC), Suncorp (formerly a state-based insurer) and Metway Bank merged to form the fifth largest financial company in Australia in 1996. In 1997, Suncorp-Metway conducted a public offering, reducing the Queensland government's stake from 68% to 4%. The company completed the integration of Metway, QIDC and Suncorp operations in 1999 to create a single brand. Suncorp-Metway's conglomerate mergers continued into the early 2000s.

Combining retail banking with insurance has enabled banks as well as insurance firms to increase their customer bases and turnover in the immediate term. In more recent times, this model has faced competition from market players that specialise in insurance only. A number of banks have responded to the higher costs associated with tightening regulation of incentive structures and conduct by choosing to divest their insurance functions, particularly life insurance (discussed later).

Banks in wealth management

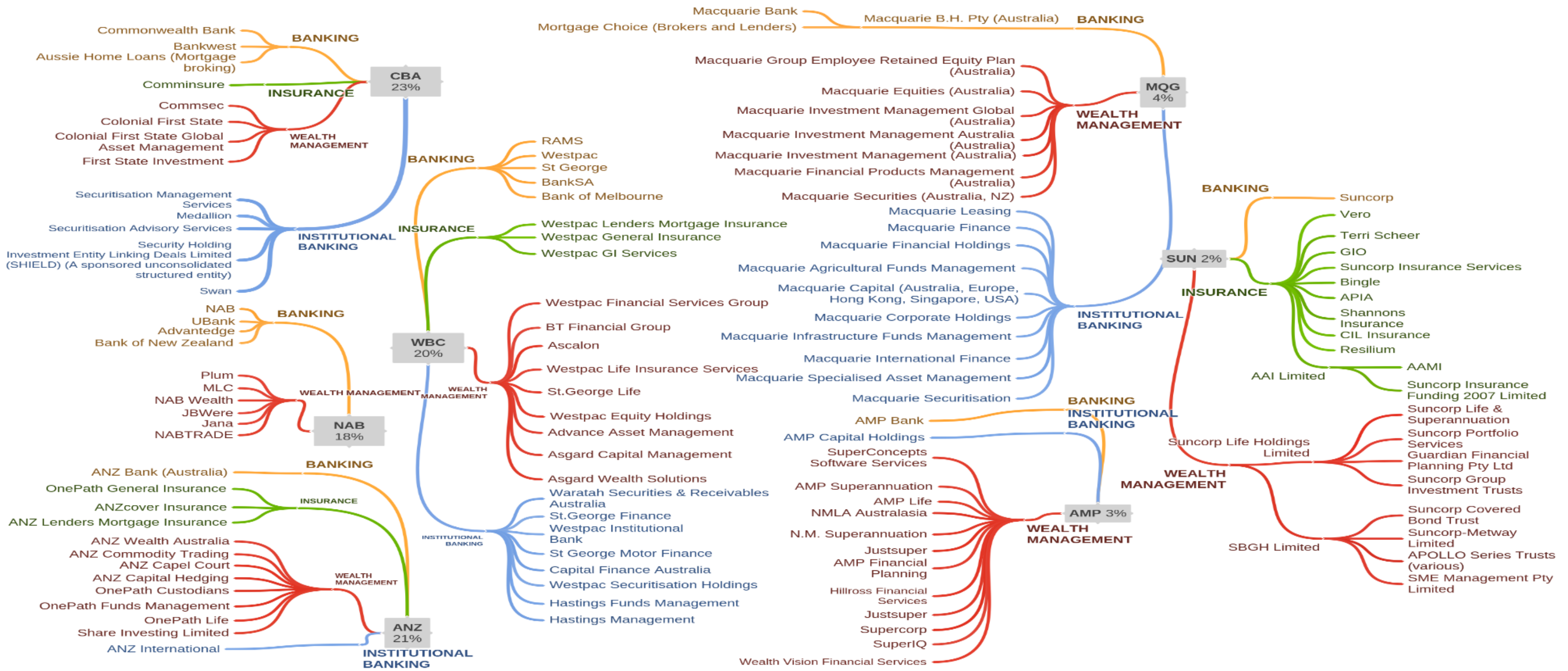
Conglomerate integration has also occurred in wealth management. Historically, wealth management services were largely provided by independent fund managers and life insurers such as AMP Limited (AMP), Colonial Group, BT Financial Group (BT) and MLC. Banks saw the growth in wealth management as an opportunity to cross-sell a broader range of financial services to their existing customer base and access the rapidly growing superannuation market.[60] This triggered a number of mergers and acquisitions. During the late 1990s and early 2000s, each of the major banks acquired or merged with a fund manager. Of the four fund managers listed above, only AMP remains independent.

The acquisitions resulted in the major banks' assets under management increasing from the equivalent of 13% of Australia's total wealth management in the late 1990s to about 20% (or $530 billion) in 2016 (Golat 2016).

[60] An employer-funded superannuation benefit in industry awards was introduced in 1986, followed by the introduction of compulsory superannuation in 1992.

Figure 9.3 **Network of some financial institutions[a,b]**

Select subsidiaries and other entities of some financial institutions



[a] Financial institutions include AMP Limited (AMP), Australia New Zealand Banking Group (ANZ), Commonwealth Bank Group (CBA), Macquarie Group (MQG), National Australia Bank Group (NAB), Suncorp Group (SUN), Westpac Banking Corporation (WBC). Total assets of group as % of total assets of all authorised deposit-taking institutions and registered financial corporations. [b] Entities listed may fall within more than one category. Entities listed as at latest financial reports, which may not capture any recent merger or divestment activity. The listed entities do not comprise an exhaustive list, do not show exclusive contracts, and are generally entities incorporated in Australia.

Source: AMP (2018), ANZ (2017c), CBA (2017a), Macquarie (2018), NAB (2017a), RBA (2018a), Suncorp (2017), Westpac (2017)

Integrating supply chains

Australia's major financial institutions have long been active in increasing vertical integration, competing for distribution channels as a way of increasing their number of customers, in addition to directly offering alternative products and prices. This in turn could have affected smaller players' market access (ACCC 2017f), as large institutions increasingly controlled the distribution channels used by these smaller players to access customers (box 9.1).

Box 9.1 **Benefits and costs of vertical integration**

Vertical integration can occur by internal growth or by merger/acquisition.

The benefits of vertical integration come from the greater capacity it gives firms to control access to their own and/or their competitors' inputs (and to control the cost, quality and delivery times of those inputs). In turn, this control can deliver consumer benefit in the form of convenience in choice and day-to-day operations.

Historically, firms vertically integrated in order to control access to scarce physical resources. Upstream producers (those further from final consumers) integrated with downstream distributors to secure a market for their output. More recently, firms have been participating in a variety of alliances and joint ventures and outsourcing even those activities normally regarded as core to improve efficiency (Stuckey and White 1993). Contracts may be used to align incentives between integrated firms and control conduct.

Vertical integration by investment in new productive assets usually expands markets, bringing in additional resources. In contrast, a vertical merger by asset acquisition or stock acquisition usually does not expand markets and can raise competition concerns. Regulating the conduct of vertically integrated firms might improve market performance (for example, in the case of monopoly or oligopoly) and minimise the risk of anti-competitive behaviour.

The competitive effects of vertical integration depend on the structure of upstream and downstream markets. Among the most important elements of market structure is the market power of firms in the relevant industries — evident in their the ability to raise price above cost without the loss of market share or to exclude competitors — and is brought about by factors such as industry concentration, product differentiation, or cost advantages. Vertical integration that increases market power (for example, by eliminating competitors or raising entry barriers) is more likely to have adverse consequences for consumers.

Vertical integration in retail banking

The residential mortgage market is highly vertically integrated. The main players in the consumer-facing residential mortgage supply chain are lenders, aggregators and brokers (the mortgage broker market is discussed in detail in chapter 11). Aggregators and brokers are both intermediaries that act between lenders and borrowers. Commissions on successful loans are paid by lenders to aggregators, who take a fee before passing on the remainder to brokers.

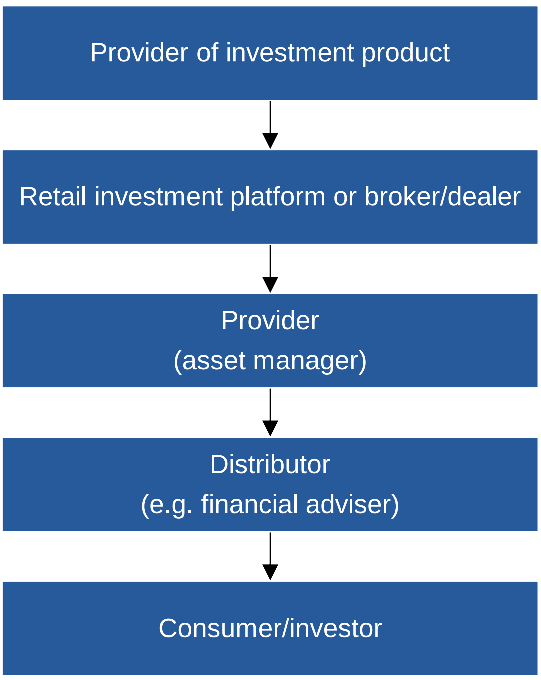
Vertical integration means that, currently, many mortgage aggregators are owned by lenders. Using data obtained from the Australian Securities and Investments Commission (ASIC), we estimate that the combined broker channel share of the CBA, NAB and Macquarie aggregators was just under 70% (based on loans by value) as at December 2015 (chapter 11). This does not account for Westpac's recently acquired majority stake in the online broker firm Uno Home Loans.[61] Some non-bank lenders also have ownership stakes in mortgage aggregators — for example, Liberty acquired the wholesale aggregator National Mortgage Brokers in 2017.

Vertical integration in asset management and financial advice

Some financial institutions have integrated part or all of the wealth management supply chain into a single business model (figure 9.4).

One common example of vertical integration occurs when a wealth management entity engages in both the delivery of personal financial advice services, as well as manufacturing financial products the clients invest in.

Figure 9.4 **A simplified wealth management supply chain**



Source: Adapted from FCA (UK) (2015a); Oxera (2016)

Such integration has not always resulted in a highly concentrated market. For example, the big four banks now hold approximately 21% of superannuation and fund manager assets under management (ASIC 2017f). And two of the major banks rank among the top five

[61] In June 2018, CBA announced it intends to spin off its mortgage broking businesses, including Aussie Home Loans (CBA 2018a).

superannuation funds. The industry structure is notably less concentrated than in most other areas of finance. Looking beyond superannuation, it is only two major banks (Commonwealth and Westpac), AMP and Macquarie that were among the ten largest providers of asset management services in Australia as at 2015 (table 9.1).[62]

The four major banks have a larger, but not dominant, presence in the financial advice market. The four major banks, AMP and IOOF (who manufacture their own financial investment products as well as provide advice) account for around 35% of the financial advice market, as measured by the number of (aligned and non-aligned) advisers (ASIC 2017f).

Another example of integration occurs between retail investment platforms, investment product provider and financial advisers.[63] The top five master fund administrators — controlled by BT Financial (Westpac), AMP, CBA/Colonial, NAB/MLC Group and Macquarie Group — accounted for about 76% of the total platform assets under management, and about 45% of the $16 billion total net flows to master fund administrators (ASIC, sub. 40, appendix C).[64] There has been relatively little movement in the market shares of the top five fund administrators between 2015 and 2017 (Plan For Life 2015, Strategic Insight 2017).

Table 9.1 **Largest 10 asset managers in Australia**

At 31 December 2015

Investment manager	*A$Billion*	*Rank*
State Street Global Advisors (Aus) Ltd	167.1	1
AMP Group	101.6	2
Commonwealth/Colonial Group[a]	94.0	3
Vanguard Investments Australia Ltd	88.3	4
IFM Investors Ltd	67.4	5
Macquarie Bank Group	65.7	6
BlackRock Investment Mgmt (AUS) Ltd	61.4	7
Schroder Investment Management Australia Ltd	50.7	8
UBS Asset Management (Australia) Ltd	44.4	9
BT Investment Management Ltd[b]	36.6	10

a In June 2018, CBA announced it intends to spin off its wealth management businesses, including Colonial First State **b** No longer a subsidiary of Westpac (as at June 2018).

Source: Morningstar (2016)

62 Asset management services are a major part of Australia's financial system. As at December 2017, resident asset managers held $2 trillion in assets under management, of which $1.2 trillion came from Australian superannuation and life insurance managed funds institutions (ABS 2018f). Managed funds institutions provide their funds to asset managers (also called investment managers) to invest and manage on their behalf (appendix C).

63 Platforms are typically online services allowing investors to buy funds from different asset managers and hold them together in one account or portfolio.

64 In June 2018, CBA announced it intends to spin off its wealth management businesses, including Colonial First State (CBA 2018a).

9.2 How has integration affected competition?

Integration is not a problem per se

Integration in the Australian financial system is not a problem in and of itself. It can have efficiency benefits — for smaller players in retail banking, for example (boxes 9.1 and 9.2). If integration leads to efficiency gains then this should ultimately prove beneficial for consumers. But even when leading to efficiency gains, integration can also raise market power and create conflicts of interest.

The emergence of 'financial supermarkets' means the effects of integration are not clear cut

Major banks have ventured into almost every part of the financial system; some operate like financial supermarkets, offering various financial products and services that can be bundled together and sold under one roof (ASIC, sub. 40). Product bundling has occurred across the retail banking, wealth management and financial advice and insurance sectors.

Bundling can give consumers choice but also be a strategic move against switching

While a persistent feature of the Australian financial market, the effectiveness and efficiency of product bundling is unclear. What is clear is that bundling by institutions that have a large market share can make it harder for other players to compete on a product-by-product basis and can raise consumers' switching costs (box 9.2).

In retail and consumer banking, many credit cards represent a bundle of products and services, including transaction and borrowing services, insurance products (travel, payment protection and extended warranties), and loyalty programs such as frequent flyer points or other rewards.

Housing credit growth over recent years has been accompanied by rapid growth in loan products that provide borrowers with access to offset accounts and credit cards (RBA 2015i). The residential mortgage acts as an 'anchor' for consumers to remain with one financial institution and consolidate other financial products with it. For example, according to CHOICE (sub. 42, p. 15), a survey of consumers found that about half of respondents had a transaction account and a credit card with their home loan provider. Similarly, data collected by the Productivity Commission indicates that, in 2015-16 and 2016-17, consumers who had a mortgage with a major bank typically held at least two other financial products with the same bank (chapter 5).

Box 9.2 Strategic bundling through horizontal and conglomerate integration

Through horizontal and conglomerate integration, firms can sell multiple products together, making use of their broad consumer base for one product to expand sales of other products, and increasing revenue opportunities possible from each consumer interaction. The products may be available only as a bundle or, if available separately, are offered as a bundle at a discount relative to their individual prices.

Bundling may be efficient. It can provide consumers with easy access to a number of products simultaneously, at lower cost (combined home building and contents insurance, for example).

But there are several aspects of bundling that give rise to potential competition concerns, including:

- *Leveraging market power and hiding true costs:* Firms can leverage their presence in one market into another by not only using their existing customer base, but by recovering the costs of one function from another. So, while a firm may not achieve economies of scale across all the market segments in which it operates, its scale in one market can help cover costs in another. For example, bundling more expensive products such as credit cards and other loans with transaction accounts may help to cover the bank's costs of providing transaction accounts. This can also hide the true cost of products and obscure prices. As a consequence, there may be distortions in price competition where there are large cross-subsidies that competitors cannot disentangle or compete against. Consumers may also be unable to purchase just one product from the bundle, reducing their ability to switch between products and exert demand-side pressure.
- *Protecting market power:* When an incumbent has market power in several product areas, it can use bundling as a way to reduce the scope for other firms to enter and capture market share. Bundling may restrict potential new entrants to pursue more limited markets of consumers with niche preferences and impede them from expanding into larger existing markets.
- *Raising a rival's costs or lowering a rival's benefits:* Bundling can be used to deny a rival or potential entrant access to a complementary market. For example, if bundling leads to the disappearance of an independent service market, then a potential entrant will have to enter with both a product and a service network. Similarly, bundling could lower the benefits that consumers anticipate from rivals' products — such as through loyalty programs.

Nonetheless the competition implications of many of these features of bundling are ambiguous. They may make it harder for individual competitors but benefit customers.

Insurance products are also commonly bundled or cross-sold with other financial and even non-financial products, with consumers often not given choice on product, price or timing. In add-on insurance, pressure-selling techniques used by some providers exacerbate information asymmetries and poor consumer outcomes (chapter 15). Most add-on insurance products are sold in a bundle through a product retailer, limiting the scope for competition by narrowing the field of options for consumers.

Vertical integration effects are not simple to unpack in retail banking

The evidence on the competition effects of vertical integration in the supply of mortgages and wealth management is mixed. While there are a range of competition problems in these industries (such as transparency and the incentives to offer appropriate advice) it is more assertion than evidence that indicates these problems are based on, or even exacerbated by, vertical integration (box 9.1).

In the retail banking sector, significant vertical integration was driven by the competitive threat posed by the growing mortgage broker channel in the 1990s and early 2000s. The degree of price competition posed by brokers has decreased in recent years. While this could be due simply to integration, it could equally be due to better awareness at the bank branch level of the services offered by brokers; and an effort to match them. Indeed, use of the broker channel for distribution appears to be very similar between the major banks regardless of whether or not they have vertically integrated into mortgage broking.

Major banks dominate the broker network — they accounted for 63% of total loans brokers generated by count and by value in 2015, even though brokers have not been a cheaper distribution channel for the major banks. The major banks' share of the market increases to 77% when their subsidiaries are accounted for. Further, they have been able to use their white label loans to take a disproportionate share of the activity generated through at least some of those aggregators that they have an ownership stake in (chapter 11).[65]

This would suggest that smaller lenders (and other lenders that do not have an ownership stake in an aggregator) may have been disadvantaged through ownership of aggregators by CBA, NAB and Macquarie.

Yet, Westpac and ANZ (which did not own aggregators at the time ASIC's data was compiled) maintained their share in the mortgage market, suggesting that ownership alone does not offer a market advantage, as much as incumbency and other pre-existing advantages (chapters 3 and 5). Overall, Westpac and ANZ ranked among the top four lenders by the number of loans generated through aggregators.[66]

More generally, lenders that did not have an ownership stake in an aggregator did not seem to be actively denied access to consumers where major banks owned aggregators. For example, the proportion of loans attributed to two small banks in particular through the NAB's FAST aggregator increased between 2012 and 2015. The proportion of these banks' loans also grew via those aggregators not owned by the major banks, in fact at a slower rate.[67] The counterfactual — what growth in broker channel share for these two banks might

[65] A white label loan is a 'home-branded' loan, most frequently underwritten by the major banks.

[66] Based on lenders' self-reporting of loans made through specific aggregators. Specific data by lender cannot be disclosed. Productivity Commission analysis of ASIC unpublished data (ASIC 2017x).

[67] Based on lenders' self-reporting of loans made through specific aggregators. Specific data by lender cannot be disclosed. Productivity Commission analysis of ASIC unpublished data (ASIC 2017x).

have been possible had FAST had different ownership — is not known. Thus we are wary of drawing simple conclusions.

However, there is no discernibly significant difference in the interest rates that CBA, NAB and Macquarie charged in 2015 between the aggregators they own and do not own, as well as direct channels (figure 9.5, panels A to C). Where CBA, NAB and Macquarie may have exerted some power via the aggregators they own, we may have expected to see differences in the distribution of interest rates provided by those aggregators in which the lenders have an ownership stake, versus independent aggregators and direct channels. Apart from more loans offered at slightly higher interest rates by CBA, NAB and Macquarie's aggregators, the overall differences are not large.

Even so, there is evidence that the broker channel has reduced in competitive effectiveness in recent years, coinciding with integration. Of the loans generated by non-major lenders, around 65% were generated via brokers (by count or by value) in 2015 (ASIC data). Despite relying more on the broker networks and seeing their share of all loans written through the broker network rise over time, smaller banks' and non-banks' overall influence on competition in the home loan market share has remained limited (chapter 3).

Market power of aggregators?

There is little doubt that banks other than the big four are highly dependent on aggregators and the broker channel generally (chapter 11). This dependency could potentially translate to market power for large aggregators.

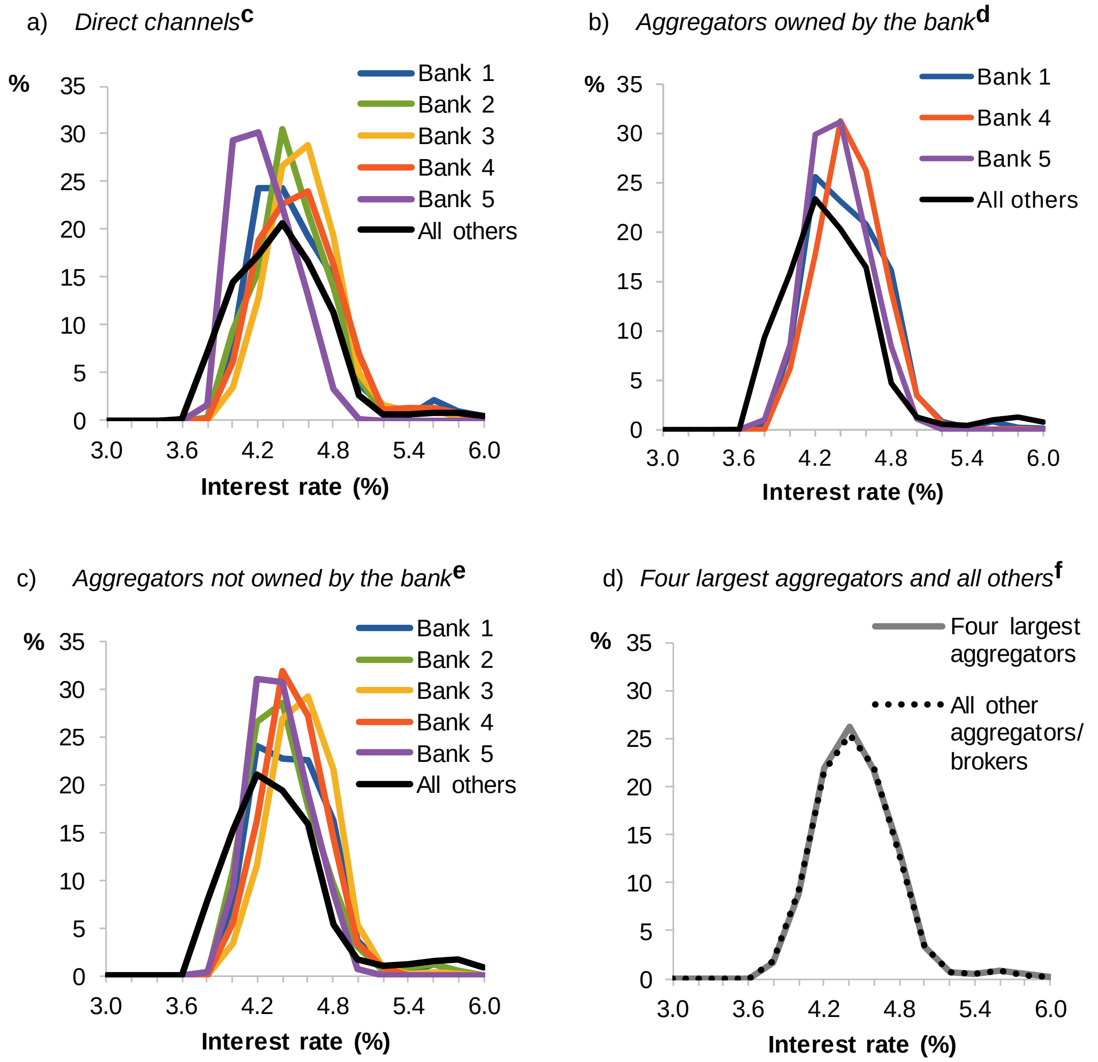
The aggregator level of the residential mortgage supply chain is highly concentrated, albeit less than the bank channel — the top 4 aggregators (Australian Finance Group Limited, BLSSA Pty Ltd, AHL Investments Pty Ltd and Connective Credit Services Pty Ltd) accounted for 57% of the loans generated in 2015 by count (compared with the major banks' 77% share of the broker market).[68]

Even though the aggregator level of the supply chain is highly concentrated, the spread of interest rates on the largest 4 aggregators is very similar to that of all other aggregators (figure 9.5, panel D). The rate spreads on aggregators are also similar to the spreads on loans the major banks have generated directly and via the aggregators they own (figure 9.5, panels A to C). But more significantly, the major banks' rates are consistently clustered at slightly higher levels (closer to 5%) than just the aggregators (closer to 4%).

68 Based on lenders' self-reporting of loans made through specific aggregators. Productivity Commission analysis of ASIC unpublished data (ASIC 2017x).

Figure 9.5 **Rate distributions of home loan channels[a,b]**

2015



[a] x axis is interest rate charged in groupings of 20 basis points (for example, all loans with an interest rate from 3.0 to 3.2 make up the first data point). y axis is % of total loans made by the specific bank via that channel charged within the corresponding interest rate grouping. [b] Based on lenders' self-reporting of loans made through specific aggregators. CBA includes Bankwest and Westpac includes St George. [c] Loans made directly by the bank, such as through branches. [d] Loans made through the specific bank's own aggregators. CBA-owned aggregators include AHL Investments Pty Ltd, Mortgage Choice Limited, National Mortgage Brokers Pty Ltd and Finconnect (Australia) Pty Ltd. NAB-owned aggregators include BLSSA Pty Ltd, Finance & Systems Technology Pty Ltd, Pennley Pty Ltd and Professional Lenders Association Network of Australia Pty Ltd. Macquarie-owned aggregators include Australian Finance Group Limited, Yellow Brick Road Finance Pty Ltd, Connective Credit Services Pty Ltd and Vow Financial Pty Ltd. The 'all others' category excludes Banks 1 to 5 as in panels A and C and only includes loans generated via all other lenders through the aggregators of Banks 1, 4 and 5. [e] Includes aggregators that are not owned by the specific bank. [f] The four largest aggregators include Australian Finance Group Limited, BLSSA Pty Ltd, AHL Investments Pty Ltd and Connective Credit Services Pty Ltd. All other aggregators/brokers includes brokers that are not affiliated with any aggregator.

Source: Productivity Commission analysis based on ASIC unpublished data on lenders' self-reporting of loans made through specific aggregators (ASIC 2017x).

This could suggest aggregators are better at getting discounts or that the profile of the loans is different via aggregators. But analysis of the data in chapter 11 does not show this to be the case. So, the slightly higher prices the major banks charge may just highlight their ability to exert pricing power outside of the vertically integrated supply chain and leverage consumer stickiness. For example, two of the major banks price at the higher end of the scale more often than via the broker channel (appendix C).[69]

In sum, while there are too many variables to be conclusive, the negative *price* impact on consumers that some may assume of vertical integration is not evident. As we show elsewhere in this report, the problem in the aggregator model is the potential for remuneration and employment conflicts of interest to get in the way of meeting a customer's best interest. This is particularly the case when there are ownership ties between lending product, distributor, and originator (chapter 11).

These conflicts do not disappear if there is forced structural separation, however. As we discuss in sections 9.3 and 9.4, structural separation is unlikely to benefit customers and is not a solution to the conflicted incentives facing brokers.

Vertical integration remains evident in asset management and financial advice

Competition concerns with the ownership of investment platforms has been raised in the past (ACCC 2010). But it is unclear that these concerns will remain relevant given the increasing ease with which new technologies are entering the market as alternatives to traditional platforms. And a relatively modest share of assets under management are invested through platforms, suggesting the scale of any problem would not be large.

Historically, the Australian platform market has been considered difficult to enter because of the hold that major banks have had. But this may be changing — incumbents no longer have the same exclusive claim to economies of scale in wealth management as the costs of technology fall.

Industry observers have characterised supply chains in Australian banks' wealth management businesses as being considerably behind other industries (Stevens 2015). The retail investment platforms based within the major banks continue to rely on complex webs of legacy technology, stifling their ability to adapt to improving technology and consumer expectations. Integration in the form of acquiring investment platforms that use technology to compete has been one strategy that the major institutions have employed to keep abreast of technological changes in product offerings. But this has also meant bolt-on technologies have left platforms struggling overall.

This has presented an opportunity for disruption in wealth management supply chains by those who incorporate more sophisticated analytics and personalisation in providing wealth

69 Specific data by lender cannot be disclosed. Productivity Commission analysis of ASIC unpublished data (ASIC 2017x).

management options and financial advice. Technology-backed solutions provide the scope to offer new and more flexible investment options and 'zero marginal cost' product offerings. And relatively cheap cloud-based hardware solutions have enabled new investment intermediaries to emerge.

While specialist or independent platform providers (as new entrants) have a relatively small market share, they appear to attract a sizeable proportion of annual net asset inflows across the industry. For example, in global markets, fintech start-ups such as Robinhood are challenging the status quo by offering free solutions to their equity trading customers. The independent platform market (such as NetWealth in Australia) has gained prominence after offering better technological solutions and attracting advisers that are choosing to work independent of bank networks. In the Australian retail banking sector, ING Direct's entrance into the Australian market had a similar structural impact on the savings market with its low-cost online offerings.

Foreign fund managers and specialised fund managers also have a significant presence to bring competitive pressure to bear on the Australian platform and broader wealth management market, with the likes of Vanguard and BlackRock competing for assets under management (table 9.1).

Ownership structures of platforms may also not always be transparent and well understood by consumers, nor are fee and pricing structures. As with the mortgage market, white labelling constitutes a feature of the platforms and broader wealth management market — giving the consumer an illusion of choice. However, as discussed below, these issues with transparency can arise regardless of vertical integration.

The majority of financial advisory firms are small, with about 78% of advice licensees operating a firm with less than 10 financial advisers, about 90% with less than 50 advisers, and 95% with less than 100 financial advisers (ASIC 2017f). The average number of financial advisers operating under an AFS licence is 34 individuals.

Vertically integrated firms may be able to apply scale to absorb higher regulatory costs to meet increasing regulatory obligations, such as those introduced under the Future of Financial Advice (FoFA) reforms. But vertical integration also appears to have created a competitive advantage for the largest financial service licensee groups in promoting in-house products over competitors' offerings.

Here, enforcing the conduct standards required in the financial advice market is pivotal to competition and ensuring the client's best interest are met.

Market pressures influence the decision to integrate and separate

Major banks have partially reversed the integration trend recently. There has been a shift to divest some of their business arms, such as wealth management and reduce their exposure to underwriting life insurance risk (although they remain distributors of life insurance products). For example:

- ANZ sold its wealth management business in 2017, including its life insurance, superannuation, financial advice and investment arms (but will remain a distributor).
- ANZ sold its life insurance division, OnePath, in 2017, which held 8% of the life insurance market (based on net policy revenue in the 12 months to December 2016).
- Westpac sold part of its share in BT Investment Management Limited to reduce its ownership in 2015, but has retained its remaining wealth management functions.
- NAB sold its 80% stake in MLC Life Insurance to Nippon Life in 2016 and in May 2018, and announced its intention to sell its stake in the remainder of MLC.
- Macquarie Life was closed and its risk business was sold to Zurich (with the remainder of Macquarie Life's business and funds transferred to Macquarie Group) in 2016.
- The Commonwealth Bank sold 100% of its life insurance businesses in Australia and New Zealand in 2017. The sale agreement included a 20-year partnership with AIA Group to provide life insurance products to its customers.
- In June 2018, the Commonwealth Bank announced it will spin off its wealth management and mortage broking operations, and consider selling its insurance business (CBA 2018a).

Divestment for commercial reasons

Divestment across the industry has been undertaken largely for commercial reasons (Golat 2016; Moody's 2017). The retreat from wealth management reflects a return by banks to the most profitable and efficient businesses where they dominate the market: retail and commercial banking.

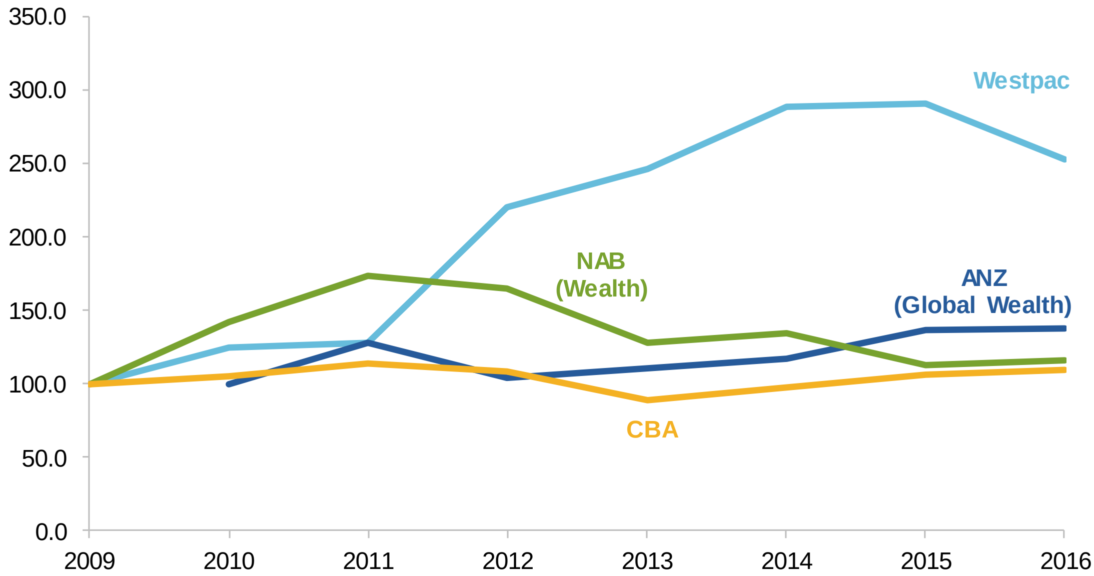
Overall, three of the four major banks' wealth management performance had been relatively weak and sluggish in the lead-up to key divestments, especially when compared to the specialised fund managers (figures 9.6 and 9.7).

Revenue from asset management has grown more slowly than revenue from other activities since 2007, noting that Westpac has remained competitive (figure 9.6). Margins have been narrowed and subject to downward pressure by competition from other funds and investment options, and (as noted above) from new and specialist platforms that disrupt traditional supply chains and are capturing market share. For example, specialist platform NetWealth, floated in late 2017, is reported to have taken 18% of net flows (of assets under administration) in the previous financial year despite only holding close to 2% of total assets under administration in the market (Netwealth 2018).[70]

[70] 'Assets under management' (AUM) represent the market value of assets for which the chosen representative acts as an appointed manager — that is, makes investment decisions. AUM are actively managed by

Figure 9.6 **Major banks' wealth management revenue**[a]

Indexed revenue



[a] Asset management or wealth management business divisions. Unadjusted for integration, such as mergers and acquisitions of other banks or businesses, alliances and divestments. These include Westpac's partial sale its shareholding in BT's asset management business (BT Investment Management) from 59% to 31% in 2015, NAB's acquisitions of Aviva Australia and JBWere in 2009 and 2016 respectively, and sale of 80% its life insurance business in 2016, Commonwealth Bank's sale of its St Andrew's insurance business in 2010 and acquisition of Count Financial (financial advisory firm) in 2011, and ANZ's acquisition of 51% shareholding in the ANZ-ING wealth management and life insurance joint ventures in 2010.

Source: ANZ (2017c), CBA (2017a), NAB (2017a), Westpac (2017)

There also appears to be significant variation in efficiency among the major banks in providing wealth management services. This is shown in their asset turnover ratio (figure 9.8).[71]

Compliance with regulatory requirements, including in particular dealing with the outcomes of past non-compliance, has also imposed costs on banks' asset management activities, affecting returns.[72] While these programs come at a cost to the banks, the need for them

investment managers (including fund managers and portfolio managers). 'Assets under administration' is the market value of assets for which a financial entity provides administrative services (such as those provided by platforms).

71 The 'asset turnover ratio' (measured by revenue, or income, as a proportion of AUM) indicates how efficient the banks are in using their assets to generate revenue from their wealth management activities. The higher the ratio, the better the performance.

72 For example, there have been large scale programs implemented by the banks in consultation with ASIC (such as CBA's Open Advice Review Program and the Financial Advice Customer Response Initiative of National Australia Bank) to identify, review and remediate customers who may have received non-compliant advice (ASIC 2017d, 2017k)

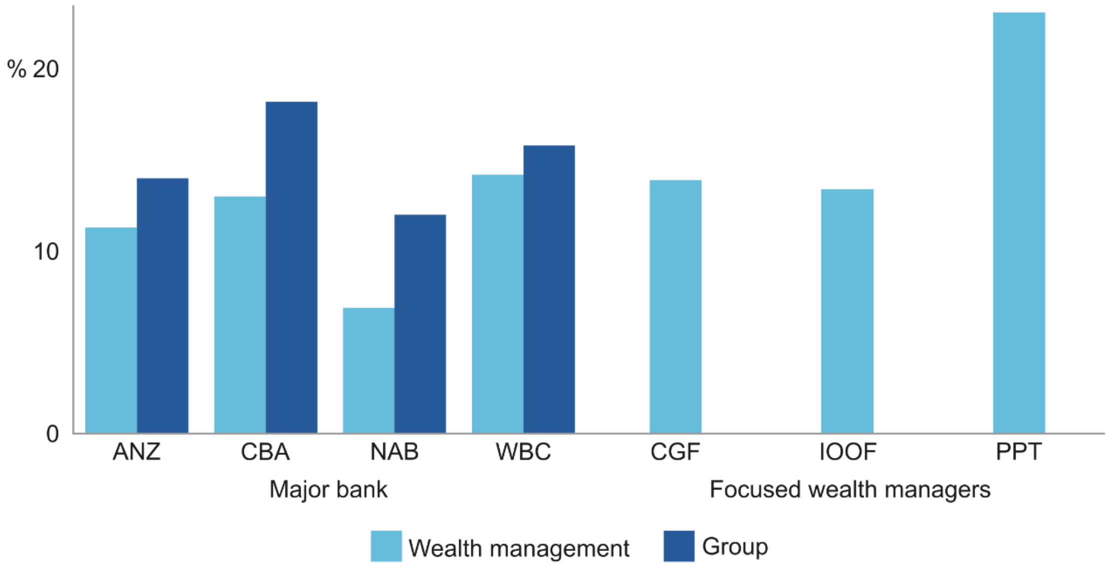
reflects an accrual of past practices where pursuit of commissions, fees and profits were put above a proper consideration of customers' needs.

The confluence of these factors may have resulted in lower returns on equity (ROE) from the major banks' wealth management operations than from their more traditional banking activities, while still in excess of the banks' estimated cost of capital (figure 9.7). Data received from some ADIs indicate that the ROE for wealth management was around 10-11% at June 2017, down from around 17% in 2010 (unpublished ADI data).

FINDING 9.1 COMPETITION ISSUES NOT CLEARLY CAUSED BY INTEGRATION

The Productivity Commission has not found any competition issues in either mortgage or wealth management markets that are clearly associated with integration. Where poor consumer outcomes arise in these markets, these outcomes may be compounded at times by integration, but are more likely associated with poor transparency and adverse remuneration incentives that arise even absent integration.

Figure 9.7 **Major banks' and funds managers' return on equity[a,b,c]**
2014-15

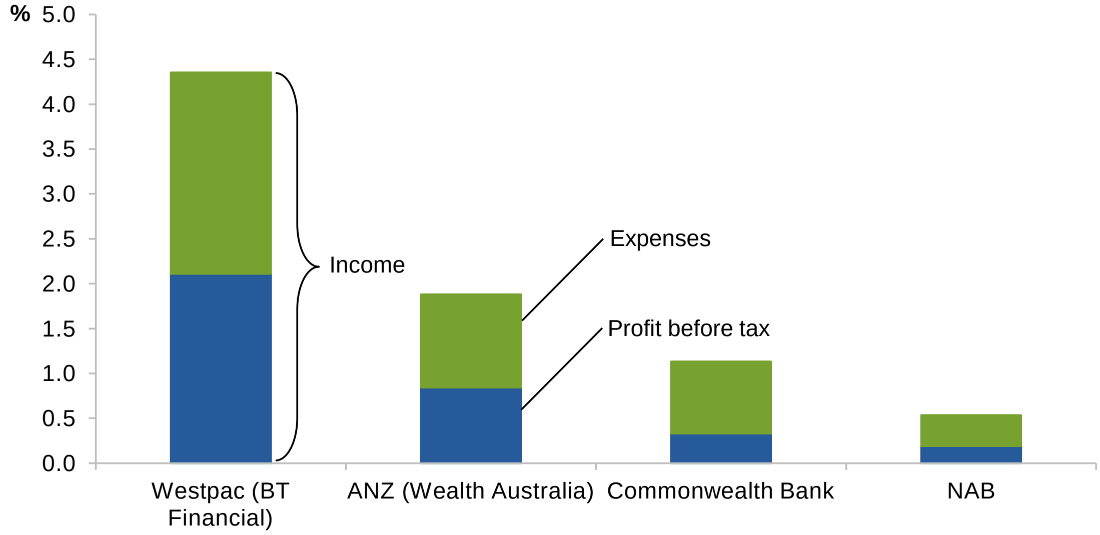


[a] Cash return on equity (ROE). [b] Focused wealth managers include Challenger (CGF), IOOF and Perpetual (PPT). [c] For the major banks, 'group' ROE presents the ROE for the relevant banking group as a whole as a point of comparison.

Source: Golat (2016)

Figure 9.8 **Major banks' asset turnover ratio for their wealth management operations[a,b,c]**

2016-17



[a] The 'asset turnover ratio' (measured by revenue, or income, as a proportion of AUM) indicates how efficient the banks are in using their assets to generate revenue from their wealth management activities. The higher the ratio, the better the performance. [b] Commonwealth Bank revenue and expense data excludes fund management activities of CommInsure. For Westpac, only data from BT Financial (the insurance and wealth management arm of Westpac) is included. BT Financial accounts for 71% of Westpac's AUM as at 30 September 2017. For ANZ, only data from Wealth Australia (the insurance and wealth management arm of ANZ) is included. Wealth Australia accounts for 63% of ANZ's AUM as at 30 September 2017. For NAB, operating income and expense data are attributable to the 'Wealth' side of its Consumer Banking and Wealth Division, as reported in its 2017 Annual Report. Wealth provides 'investment, superannuation and insurance solutions to help our customers build their wealth and secure their financial future' (NAB 2017). [c] Unadjusted for integration, such as mergers and acquisitions of other banks or businesses, alliances and divestments since the publication of 2017 annual reports. These include the Initial Public Offering for Colonial First State Global Asset Management in 2018 (Commonwealth), the 2018 sale of a 37.5% stake in BoComm Insurance to Mitsui Sumitomo Insurance Japan (Commonwealth), the 2017 sale of Hastings Funds Management (Westpac), the 2018 sale of OnePath Life (ANZ).

Source: ANZ (2017c), CBA (2017a), NAB (2017a), Westpac (2017)

9.3 Is there a case for forced structural separation?

Integration is a routine market behaviour. But in the financial system, it is sometimes viewed as being associated with poor consumer outcomes.

As discussed above, although we do not award the industry a clean bill of health, the Commission has been *unable to find a significant competition problem that is clearly associated with integration*. Forced separation would be a radical move for Australia.

Nonetheless, we recognise that concerns with integration exist. In this section we consider whether forced structural separation would be a suitable remedy to integration-based competition concerns *on the assumption that these concerns are legitimate*.

Forced separation on its own would do little to improve competition or consumer outcomes

The use of forced structural separation of integrated businesses to solve competition concerns is not common.[73] Forced divestiture can be a condition of a merger approval, but even so it has not been used commonly.[74]

Forced structural separation is rare because it risks creating unsustainable market structures and is likely to lessen, rather than increase, competition. Disentangling a business and dividing it into viable stand-alone entities through regulatory intervention is difficult. Inevitably the separation requires the cooperation of company insiders as otherwise the business being restructured has a strong incentive to make sure that separation does not result in profit-reducing competition. Dividing intangibles, such as IT systems, records and intellectual property can be difficult and risks leaving at least one of the separated entities unviable. Accordingly, structural separation to address competition concerns has been referred to as 'unscrambling an egg'.

Disintegration also risks leading to gaming, with the possible result of weak and unviable spin offs while the parent institutions maintain a hold of the most significant assets. Such strategic behaviour is difficult, if not impossible, for a regulator to prevent.

Even if structural separation created viable entities, competition is unlikely between former colleagues as alternatives to integration are utilised. For example, structural separation may be used to prevent a broker favouring the products of its owner. But these incentives can be recreated by contracts or exclusive arrangements between a lender and the new management. Even with structural separation, the incentive for a broker to act in favour of a lender during the clawback period or at times when the trail payments are significant, would still remain. In other words, structural separation is unlikely to address concerns about transparency or incentives without procedures and processes that apply to all companies, whether integrated or not.

We discuss these types of solutions at section 9.4 and chapters 10 and 11. Of course, if these solutions are in place, then they should address any issues that forced structural separation

73 The most famous international example of structural separation is the forced breakup of the vertically integrated telephone company, AT&T, in the US, in the early 1980s. The separation was driven by AT&T restricting access by a new entrant, MCI, to the integrated telephone network (OECD 2016c)

74 Merging entities have provided structural undertakings for specific divestments under Section 87B of the *Competition and Consumer Act 2010* (Cth) once so far in 2018, once in 2017, twice in 2016 and twice in 2015 (ACCC 2017g). The ACCC cannot compel parties to divest in the context of informal mergers. Merging parties can offer undertakings that the ACCC can choose to accept in order to quell competition concerns arising from the proposed merger.

is meant to address. Forced structural separation also would not solve underlying issues of market power, such as that relating to the major banks. As previous chapters have shown, this market power arises through size, networks, too-big-to-fail perceptions from ratings agencies and a powerful emphasis by regulators on keeping banks unquestionably strong. These will all survive forced divestment.

In wealth management and insurance, banks can sometimes preserve exclusive access to separated businesses by contract, as much as by ownership (such as in the 'bancassurance' model). Prices may change if new product manufacturers emerge, but it is not evident how separated platforms would do much to induce new products into the market.

In mortgages, aggregators would still need to have most, if not all, major banks on their platforms. Rather than direct influence through ownership, the majors would continue to influence separated aggregators through their bargaining power. This would benefit neither smaller lenders nor consumers.

Even where integration in the past has increased market concentration, undertaking forced structural separation now may dilute, and protect incumbent aggregators from, competitive forces or stifle innovation. Separating conglomerates or horizontally integrated entities may create incentives against investing and expanding markets in the future. Innovation, as we see with fintechs, is driven more by the prospect of being bought out by a large bank than it is to remain separate (chapter 4).

Integration is not the bane of systemic stability

Considering the full implications of market structure is important to an inquiry looking into competition.

We note that structural separation of banks has been considered overseas in order to reduce systemic risk. Since the GFC, United States' and European policymakers in particular have debated whether retail banks should be allowed into other more speculative financial markets at all (box 9.3). This reflects the experience of the GFC in these jurisdictions.

However, even in overseas jurisdictions that have been debating regulations to limit banks' activities, it appears that poor regulatory and prudential oversight played a larger role in the GFC than the breadth of any bank's activities. Historically, the same holds true in Australia. For example, the collapse of HIH Insurance — considered Australia's largest corporate collapse — was not due to an integrated business model but rather resulted from the under-pricing of risk, insufficient capital to cover future liabilities and criminal conduct, including fraud (Damiani, Bourne and Foo 2015). Stopping integration does not necessarily reduce risk-taking, as long as broader policy settings persist in giving rise to moral hazard or unfettered market power (King 2013; Murray et al. 2014a; Wallach 2012).

In the Australian context, there is evidence that the diversification that comes with integration has made institutions more resilient to negative shocks (Hsieh, Chen and

Yang 2013). Patterns of income growth for the major banks suggest there has been some diversification benefit, and their resilience could have been increased by the lower leverage associated with ownership of wealth management activities (Golat 2016).

Box 9.3 Does stopping integration reduce risk-taking? The experience from overseas

In the United States, there have been calls for a return to the post-Depression era 'Glass-Steagall Act' days, during which time retail banks, investment banks and insurance companies were prohibited from entering one another's business. These provisions of the Glass-Steagall Act were repealed in 1999. Referred to as 'Glass-Steagall lite', under the 'Volcker Rule' passed as part of the post-GFC Dodd-Frank legislation in 2010, retail banks can no longer use retail bank funds to make speculative investments to increase their profits. Currently on the cusp of further debate and potential reversal in Congress, the Volcker Rule disallows short-term proprietary trading of securities, derivatives and commodity futures and options (investment banking activities) to ensure banks do not take on more risk.

Similarly, the largest UK banks must separate core retail banking from investment banking from 1 January 2019 (known as ring-fencing). Ring-fencing was the central recommendation of the Independent Commission on Banking in 2011 (the Vickers Report). It is intended to simplify banking groups and make banking failures easier to manage by removing the need for a government bail-out where ring-fenced functions fail (Vickers 2010).

Despite these policies, the jury is still out as to whether such rules provide sufficient guarantees against, or address the cause of, risky behaviour.

Commenting on what caused the GFC, Stiglitz (2009) observed, 'there was a demand for the kind of high returns that could be obtained only through high leverage and big risk-taking,' and recommended reversing conglomerate integration.

But others, like former United States Treasury Secretary Tim Geithner, have said the focus on integration since Glass-Steagall's repeal is misguided (Geithner 2009). They argue factors more important in causing the GFC were: bad mortgage underwriting, poor work by the ratings agencies and an overheated securitisation market. Given these factors, these observers argue that the crisis would have occurred regardless of the size of the big banks. In fact, some of the firms that fared the worst in the United States at the time of the GFC, such as Bear Stearns, AIG, Lehman Brothers and Washington Mutual, were not part of large bank holding companies (Desai 2011).

Early research on the effects of the Volcker Rule found evidence that banks' overall risk levels did not decline (Keppo and Korte 2016). This was most likely due to less hedging of the bank holding companies' banking business, and an increase in trading book risks that was cancelled out by banks' trading books shrinking relative to total assets. The researchers stated that 'if the reduction of banks' overall risk was an essential target of the Volcker Rule, our findings suggest that the rule has so far not been effective', finding that the banks that were the focus of the rule increased risk-taking in other areas (Keppo and Korte 2016).

Capital and liquidity requirements that target the banks' activities, rather than structural regulations, are considered to be a relatively more direct way of managing prudential risk —

by getting firms that engage in risky activity to bear the costs rather than banning firms from integrating (Armour et al. 2016; RBA 2014b).

The already strong prudential settings applied to Australia's banks and insurers, together with vigilant regulators, suggest that divestment is unnecessary from that perspective, too.

FINDING 9.2 FORCED SEPARATION IS NOT A PANACEA

Forced structural separation is not likely to prove an effective regulatory response to competition concerns in the financial system, specifically not in either home loan or wealth management markets.

Strengthening existing regulatory structures

The Commission's analysis of integration has exposed some data weaknesses relating to the outcomes of mergers and acquisitions in the financial system.

The competitive implications of proposed mergers are considered by Australia's competition regulator, the ACCC. Under section 50 of the *Competition and Consumer Act 2010* (Cth), the ACCC may gain an injunction preventing a merger if it can show that a proposed acquisition will, or is likely to, substantially lessen competition in the future (post acquisition).

The ACCC has approached merger analysis on a case-by-case basis, and consequently, 'in the absence of any recent significant merger reviews having been conducted by the ACCC in the banking sector, the ACCC has limited information on which to provide an overall view on the impact of integration in the banking sector. This will change with the ongoing work of the [financial services unit]' (ACCC, sub. DR129, p. 13). The ACCC nevertheless believes market power has become increasingly concentrated in the financial sector as a result of conglomerate integration that has enabled brands to proliferate (ACCC, sub. 17).

Building a strong evidence base is the first critical step to be effective in promoting competition in the financial system and understanding the structural factors driving market dynamics. This is consistent with the Murray FSI findings, which concluded that 'the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and *should be proactively monitored over time*' (Murray et al. 2014a, p. xvi, emphasis added).

Scope for ACCC to analyse integration on a regular basis

As the ACCC has advised, its newly formed financial services unit's (FSU) is well placed to consider the longer term impacts of vertical and horizontal integration as well as bundling in the financial services sector on an ongoing basis (sub DR129). These studies would necessitate developing a robust evidence base of integration activity in the financial system, extending the ACCC beyond their role of assessing incremental mergers and acquisitions, and allowing a proactive position on the merits of integration.

We consider that investigating the impacts of integration on the financial system and understanding the longer term market implications are key roles in promoting competition in the financial system. Ongoing market studies on a 5-yearly basis would enable such investigation. The market studies may also include *ex post* reviews of past merger decisions, but at a minimum will necessitate broader data collection to determine likely situations where mergers and acquisitions could be driven by anti-competitive objectives rather than efficiency benefits.

Creeping acquisitions — where a business slowly increases its market share by a series of small mergers, none of which individually has a significant effect on competition but which in aggregate substantially lessen competition — may be an issue in financial services.

The recommended market study of the impacts of integration should include an analysis of creeping acquisitions. While creeping acquisitions may have been demonstrated as not having substantially lessened competition in other sectors of the Australian economy (such as supermarkets), there is scope to investigate the impacts they have had on the financial system over time — for example, in broking. The Harper Review did not recommend any explicit legislative changes that would allow the ACCC to act on creeping acquisitions. However, this does not preclude an analysis of their impact on competition in the financial system in order to balance the inevitable regulatory incrementalism of the mergers provisions under the *Competition and Consumer Act 2010* (Cth) (Harper et al. 2015).

The data to evaluate the overall impact of creeping acquisitions, however, does not exist. In part, this is because businesses in Australia do not have to inform the ACCC of relevant asset purchases — including acquisition of rivals or new licenses. Notification of a merger is voluntary in Australia. This is sensible in many parts of the economy. Many acquisitions are small and have little, if any, competition effect. Requiring notification, while common overseas, would create reporting costs that have little benefit.

However, if the ACCC is to analyse the outcomes of integration activity in the financial system and be well placed to consider future integration in the financial system, we expect that this would necessarily include information about a broader range of acquisitions, not just those that raise competition concerns.

The ACCC should seek to co-operate with ASIC in collecting the relevant information. ASIC currently collects data on an ad-hoc basis on instances of horizontal and vertical integration. As the regulator of financial service licences, its databases could also provide some visibility on which financial institutions have acquired additional licences over time.

RECOMMENDATION 9.1 UNDERSTANDING THE EFFECTS OF INTEGRATION

The ACCC should undertake 5-yearly market studies on the effect of vertical and horizontal integration on competition in the financial system. The first of these studies should commence in 2019 and include establishing a robust evidence base of integration activity in the financial system.

9.4 A Principal Integrity Officer for all ADIs

Why someone needs to report on conflicted remuneration

If forced separation will not deal with the direct causes of poor market outcomes that are evident in integrated industries, what would?

Addressing the risks that arise from conflicted remuneration structures requires full-scale cultural change and participation across the financial system. Directly addressing poor behaviour will also need to extend beyond a best interests obligation (as recommended in chapter 11) applied to a broker, wealth manager or an aggregator.

Changes must be *locked in to those who pay* — the banks — as well as those who receive payments (that latter are covered in chapter 11). Banks' market power extends to altering payment arrangements to benefit themselves, although evidence suggests that fear of being the first mover has limited them to date (chapter 11). But once reform of remuneration begins, as it must if consumers' best interests are to be protected, the effects of market power may become more obvious.

It will not suffice to put in place standards that collectively reflect the rules of good practice, if they are out-of-step with where the entities' leadership and management (namely, their boards and senior executives) consider their interests lay in day-to-day operations. Regulatory standards are necessary but not sufficient.

To this end, the entities best placed to directly manage these risks — senior management and boards of directors — need to be obliged to ensure that transparency around commissions' impact on incentives is not an afterthought.

Regulation should impose on all ADIs — as a condition of their banking licence — the appointment of a Principal Integrity Officer (PIO) to act as the source of internal (and, if necessary, external) accountability for payments that could compromise consumer best interests.

Payments related to finding or placing mortgage products are our principal focus. However, responsible entities might consider the PIO's wider use across potentially conflicted payments in other aspects of the financial system such as in those areas of insurance and financial advice (where such payments remain: for example, grandfathered tail commissions). Here, conflict is defined as that which may adversely affect, or be seen to affect, the delivery of a service in the customer's best interest.

The Principal Integrity Officer Role, as we envision, would: (i) minimise risks of negative consumer outcomes from remuneration structures, including conflict with the requirement to act in the consumer's best interest; and (ii) constantly re-evaluate the impact of integrated supply chains on fulfilling consumer best interests.

In our model, boards would receive regular reports from the PIO, without alteration or scrutiny by management. Investments in internal systems — what seems to be a standard justification for lack of awareness of current failures in meeting regulatory obligations — to support the PIO would be essential. The reporting line established would be a direct one, in effect to the Chair.

Many banks claim to put the customer first. A formal, accountable reporting line to the board with both a requirement and the authority to go the regulator if necessary, would put substance to this marketing.

The PIO's dual responsibilities — to the regulator, as well as the board, much as the Chief Pilot has in an airline — is essential if this is not to be another wasted add-on to the regulatory structure. This model is meant to come with such serious implications if red flags are ignored that no ADI would fail to respond to the PIO's advice.

In creating this dual line of responsibility, we have drawn on other regulatory models that seek to prevent day-to-day commercial pressures from causing companies to lose sight of crucial responsibilities. The priority that is given to airline safety — which extends *beyond an airline's commercial interests* to its passengers' safety — is being replicated here because the commitment by an ADI to act in the customers' best interests is meant to be central to trust in the banking system (Australian Government 2014).

Our recommendation is also consistent with the findings and recommendations of the recently concluded Prudential Inquiry into the Commonwealth Bank of Australia (the Laker Inquiry) (APRA 2018o).

The Laker Inquiry has recommended more rigorous board and executive committee governance of non-financial risks as well as substantially upgrading the authority and capability of the operational risk management and compliance functions within CBA.

We are of the view that, when it comes to customer best interests, across the industry clarity of accountability is highly desirable. The PIO role, as the Commission envisions, would aim to ensure that reward structures do not conflict with customer interests on an on-going basis. It would act, in the first instance, to ensure a board is well-informed on the subject, but (as a fail-safe device) have an obligation to report to the regulator where its advice is ignored.

The fail-safe obligation is vital. It is clear from successive recent reviews, that even where risk and audit processes of a bank may have reported a heightened risk of failure to comply with regulation, inaction can persist. Altering the mind-set that says this is acceptable when it comes to customers will be an important way to revive consumer confidence in banks, as well as ensure a regulator may have a window of the subject that they clearly lack today.

Further design details of this notable addition to accountability among ADIs should be determined through a consultation process.

Which entities need a Principal Integrity Officer?

We envisage, as above, that all ADIs would need to appoint such an Officer.

The appointment of the PIO would be articulated as a statutory condition of obtaining an ADI licence (or, if extended to other financial entities, credit or financial service licence).

In the current Banking Executive Accountability and Related Measures Bill (the BEAR legislation), there is a concept of an 'accountable person', defined as a senior executive who holds specific responsibilities within an ADI (Commonwealth Parliament 2018).[75] Legislatively, there is scope to replicate this concept within the *Banking Act 1959* (Cth) (which covers all ADIs), the *National Consumer Credit Protection Act 2009* (Cth) (which covers all lenders and other credit licensees) and/or the *Corporations Act 2001* (Cth) (which covers all financial service licensees).

However, the PIO's role would be more narrowly defined and not tied to the ADI's prudential standing.

And unlike the BEAR legislation, ASIC would be the regulator responsible for administering and enforcing the Principal Integrity Officer role across the full breadth of financial institutions.

To manage regulatory costs, we consider it is critical that the PIO role be focused on those institutions that impose the greatest risk with respect to potential and actual conflicted remuneration. We have designed this proposal around ADIs because non-bank lenders comprise only around 4% of the residential mortgage market. The regulator may choose to suspend this licence condition of requiring a PIO, if an ADI can demonstrate that it is not offering any product where potentially conflicted remuneration is paid .

The PIO role could easily be extended beyond ADIs if this were deemed necessary. It may be worth considering the wider application of the PIO concept — for example, to non-ADI financial entities that persist in paying commissions.

We also note that banks outside the major banks (including Macquarie Bank) may require more investments in internal systems, which they would be less able to undertake quickly. However, ADIs could appoint a PIO early to begin work on developing an organisational culture, with supporting systems to follow.

75 There is a wide range of responsibilities nominated in the Bill, applying all board members and executives in nine different business areas, from compliance to human services.

In order to keep close involvement with current and future commission structures applied by their institution, the PIO role would need to be located at the source of commissions within an incorporated ADI company that has an appointed Board of Directors.

The PIO is aimed at targeting the source of the payments, as the simplest way of keeping close control of their use in an integrity sense. Thus aggregators need not appoint such an officer. Commissions paid to aggregators, brokers, or referring agents (such as real estate agents, community organisation representatives and others who provide referrals but do not complete applications) should all be reported upon.

Failure to appoint an officer to the role on an ongoing basis should carry a substantial penalty, for example daily fines payable by the entity. The company's board would be obliged under the specified licence condition to ensure the PIO is appointed, has their independence protected, is sufficiently resourced and that their reporting is carried out.

What would the Principal Integrity Officer do?

Each entity would need to appoint a PIO, charging them with monitoring and reporting on all commissions paid for wealth and credit products within the entity against industry standards, as defined by the regulators.

The PIO would have a duty of reporting on the commission structures applied by their institution, including to contracted third parties.

To this end, the appointee would report directly and independently to the board. The position would carry the obligation to advise an entity's board of a potential breach of commission standards on an ongoing basis, as well as an obligation to inform the regulator if they consider the standards are not being observed. Similarly, the PIO should report to the regulator annually on its entity's performance against industry benchmarks in order for the regulator to also collect information on commissions paid on an ongoing basis.

Where the entity is in breach of commission standards and regulations, the entity would be subject to penalties and its board would be held liable. Penalties may be monetary, or include invoking ASIC's product intervention powers that are currently under development. A range of penalties have already been defined as part of ASIC's licensing frameworks, and include recently strengthened civil and criminal penalties for corporate and financial misconduct.[76]

76 Powers for ASIC to invoke strengthened civil and criminal penalties for corporate and financial misconduct comprised part of the Government's response to the 2016 ASIC Enforcement Review (Treasury 2017).

RECOMMENDATION 9.2 A PRINCIPAL INTEGRITY OFFICER

The Australian Government should mandate the appointment of a Principal Integrity Officer (PIO) in parent financial entities — authorised deposit-taking institutions in the first instance, but with potential extension to other Australian Credit Licensees and Australian Financial Service Licensees. The PIO should have independent status within the entity and would have a direct reporting line to its board.

Once created, the position must not be vacant for more than a minimal period defined in legislation.

The PIO should have a statutory duty to advise the entity's board on performance related to remuneration and practices that may be inconsistent with serving a customer's best interests, including breaches of commission or other remuneration benchmarks and regulations. The PIO should also review internal business practices as they develop over time that may be inconsistent with the entity's obligation to act in the customer's best interests.

The PIO would be required to report independently to ASIC on unsatisfactory responses to its reports, including persistent failure of its board to observe standards supporting consumer best interest obligations. The PIO should be protected from adverse action by statute where they do so report.

Details of the PIO, related legislative changes and penalties, should be determined through a consultation process starting by end-2018.

10 Financial advice

Key points

- Allowing financial advisers to compete with mortgage brokers in offering personal advice on home loans would expand the sources of competition in home loan distribution as well as provide more holistic personal financial advice services to consumers. But more work is required before this could become a reality.
  - In principle, financial advisers should be well-equipped to offer advice on credit products as they are already subject to a range of best interest obligations and have training requirements in responsibilities to clients and financial market behaviour.
  - But the evidence suggests that this duty is still a work in progress. Compliance with professional standards will need attention if competition is to be enhanced and consumers are to receive quality financial advice that encompasses credit products.
  - The different remuneration arrangements of mortgage brokers and financial advisers would be a barrier to the effectiveness of any new licence that is aimed at innovation and competition. Restricting new licensees to payment by a customer of a fee for service (to ensure consistency with Future of Financial Advice reforms) is likely to make financial advisers uncompetitive with brokers. Therefore, the question of conflicted remuneration needs to be dealt with, if this new licence is to be attractive (to the industry) and effective (for competition purposes).
  - The Commission recommends ASIC assess the feasibility of financial advisers providing advice on home loans and other credit products, examining the costs and benefits of a new licence and various remuneration models.
- General advice is an example of where we need better disclosure of the nature of advice given. General advice — while not tailored to a consumer's circumstance — can help inform and educate a large number of consumers on financial issues in an efficient way. But some consumers unduly rely on general advice, and in particular, sales and marketing material.
  - The Commission recommends the 'general advice' label be changed. The new label needs to convey the absence of suitability to individual personal circumstances and disclose any conflict of interest the provider may have. So even when faced with information that is framed by providers to appear tailored, consumers will be better informed about the nature of the material provided. Consumer testing of alternative terminology must be undertaken.
  - The term 'advice' should only be used in association with 'personal advice' that takes into consideration personal circumstances.
- Better information is needed on how financial advisers make product recommendations through the use of approved product lists. Australian Financial Service Licensees should disclose a range of data indicators to assist ASIC enforce the standard of conduct required of financial advisers. The Commission recommends annual public reporting of this information.

A key recommendation in our analysis of competition in the home loan market is that mortgage brokers be obliged to act in the best interest of consumers. That is, the information and advice given to consumers by mortgage brokers should help them make informed decisions and not be influenced by the commercial incentives facing the brokers (chapter 11).

In the Draft Report, we noted that, potentially, financial advisers could compete with mortgage brokers in providing credit advice on home loans (and other credit products) and, consequently offer more holistic personal financial advice services to consumers. This is a pro-competitive option that would extend competition in the home loan distribution channel.

In principle, financial advisers should be well-equipped to advise on mortgage products as they are already subject to a range of best interest obligations, and have training requirements in their responsibilities to customers and financial market behaviour. But more work is required, before our proposal could become a reality. Compliance with the current standards and obligations required of financial advisers and improvements in the professionalism of the industry will need attention if competition is to be enhanced and consumers not placed at risk.

The different remuneration arrangements for financial advisers and mortgage brokers would also need to be addressed for the competition effects of this proposal to be realised. In chapter 11, we chose to retain the mortgage broker remuneration model that is based on an upfront commission paid by lenders, for practical competition reasons. But we recognise also that as long as the commission is paid by lenders, it has the potential to create conflicts. Such payments are not allowed for financial advisers who depend on direct payments by consumers. These differences in remuneration may limit the ability of financial advisers to compete with brokers.

While more work needs to be undertaken, we consider our proposal to expand the remit of financial advisers has the capacity to help foster innovation and competition. We acknowledge that this proposal is forward looking, as it is important not to assume the status quo will always be.

This chapter starts with an introduction to the financial advice sector, including existing licensing arrangements and best interest obligations to clients. It then outlines our proposal to increase competition in the home loan and credit advice market. Following this, the chapter examines approaches that would further support improved outcomes for consumers from financial advice.

10.1 The financial advice sector — a brief introduction

Financial advice is a recommendation or a statement of opinion that is intended to influence a person in making a decision in relation to a particular financial product or type of products. It is regulated by the *Corporations Act 2001* (Cth) (Corporations Act), which defines two broad types of financial advice:

- personal advice: where the provider of the advice has considered the consumer's objectives, financial situation and needs
- general advice: where the provider of advice has not considered a consumer's personal circumstances.

In 2016, around 2.6 million Australians sought financial advice (Investment Trends 2017). Most clients sought financial advice relating to superannuation (including self-managed super funds) and loan and investment advice (IBISWorld 2018).

Who can provide financial advice?

Financial advisers are required to hold an Australian Financial Service (AFS) licence or become an authorised representative of a licensee, unless an exemption applies (ASIC 2014a).

At 4 June 2018, there were almost 6200 AFS licensees who offered financial advice services. Most licensees (over 70%) are authorised to provide personal advice, while the remainder are authorised to provide general advice.[77] The vast majority of financial advisers work as authorised representatives of a licensee. There are over 25 000 financial advisers registered with the Australian Securities and Investments Commission (ASIC) — more than four times the total number of financial advice licensees (ASIC, pers. comm., 7 June 2018).

Financial advisers are remunerated for their advice through:

- *upfront fees*: for preparing a statement of advice and implementing financial advice (including for consumers who want to change their financial plan after a review)
- *ongoing fees*: for regular reviews with a financial adviser, regular reports on a client's investment portfolio and investment management fees
- *commissions and volume-based payments*: these forms of remuneration are banned on new investments and superannuation products from 1 July 2013, but still exist for investment products purchased prior to this date (ASIC 2016d, 2017p).

The direct cost of advice can range from \$200 to \$700 for simple advice, and between \$2000 and \$4000 for more comprehensive advice — depending on factors such as scope of advice and the client's circumstances (ASIC 2017p).

---

[77] As at 1 March 2018.

What advice can a financial adviser give?

Financial advisers are licensed to provide 'financial product' advice on a wide range of products (as defined in the Corporations Act). The Corporations Act also defines a range of 'specific things' that are expressly excluded from the definition of financial products under this law, including credit products.

While financial advisers cannot advise consumers on specific credit products, they are permitted and encouraged to provide general credit advice (ASIC, sub. DR123). In some cases, for example, for advisers to comply with the best interest duty when providing personal financial advice, they may need to give the client advice on debt management, in order to meet the client's financial objectives and goals (see below). The Financial Services Council (FSC) acknowledges the importance of broad credit advice to financial goals (sub. DR108).

Where financial advisers do provide specific product advice on credit products, they must be licensed as an adviser (under the Corporations Act) as well as hold an Australian credit licence (ACL) (under the *National Consumer Credit Protection Act 2009* (Cth)) or be authorised representatives under both regimes. As at 31 January 2018, only 4% of AFS licensees also held a credit licence, and around 10% of representatives were authorised to provide both financial advice and credit assistance (ASIC, sub. DR123).

What obligations do financial advisers have to their clients?

Generally, financial advisers fall into two categories, those that are:

- affiliated with a financial institution (often referred to as aligned advisers)
- non-institutional operators (known as independent or non-aligned financial advisers).

A common means of alignment in the financial advice sector is through vertical integration of business activities. A vertically integrated financial advice business occurs where a wealth management entity engages in both the delivery of personal financial advice services as well as manufacturing the financial investment products. For example, the four major banks, AMP and IOOF (who manufacture their own financial investment products as well as provide advice) account for around 35% of the financial advice market, as measured by the number of advisers operating under a licence they control (ASIC 2018c).

A vertically integrated business model creates an inherent conflict of interest. The conflict arises as there are potentially competing priorities between the financial advisers providing advice that is in the best interest of the client while at the same time selling products that the aligned financial institution has manufactured. The Corporations Act does not prevent this conflict but requires financial advisers to manage it through a range of obligations (including a best interest duty to prioritise the interest of the client over those of the advisers or other related parties) (ASIC, sub. 40; box 10.1).

These requirements were introduced as part of the Australian Government's Future of Financial Advice (FoFA) reforms, which were designed to lift the standard of financial advice provided to retail clients (box 10.1).[78] But recent disclosures to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission) indicate that the best interest duty for financial advisers is still a work in progress.

In addition to these FoFA reforms, the Australian Government has recently announced design and distribution obligations to apply to issuers or distributors of financial products (Australian Government 2017a). Under the proposed changes, issuers and distributors would be obliged to consider the type of consumer whose financial needs would be addressed by buying the product in question, and the channel best suited to distributing the product. As a complement to these obligations, the Government has also consulted on enabling ASIC to intervene where a product is identified as creating significant consumer risk (Kell 2017a).

Box 10.1 **Key elements of Future of Financial Advice reforms**

The Future of Financial Advice (FoFA) reforms aim to increase the quality of personal financial advice, the transparency of fees, and to improve trust and confidence of retail investors in the financial advice sector. The main changes introduced were:

- *best interest obligations*: providers of financial advice have a duty to act in the best interests of the client in relation to the advice, and take reasonable steps to do so. If the provider knows or reasonably ought to know that there is a conflict of interest, the provider must give priority to the client's interests when giving advice.
- *ban on conflicted remuneration and other remuneration:* that is, remuneration that could be reasonably expected to influence advice to retail clients.
- *charging ongoing fees to clients* — financial advisers must renew their client's agreement to the ongoing fee arrangement every two years, and give clients a renewal notice and fee disclosure in relation to the arrangement ('opt-in requirement'). In addition, financial advisers must provide fee disclosure statements every year.

Best interest obligations

The best interest obligations apply to all providers of financial advice, including licensees, and cannot be contracted out. These obligations include the duty to:

- act in the best interests of the client
- give resulting advice that is appropriate to the client
- warn clients of advice that is based on incomplete or inaccurate information
- give priority to the client's interests when there is a conflict of interest.

Source: ASIC sub. 40; ASIC (2014c); *Corporations Act 2001* (Cth)

[78] A person is presumed to be a retail client where the value of the financial product to which the advice relates is less than $500 000 (Corporations Act).

10.2 Seeking a new source of competition in home loan distribution channels

Currently, home loans are largely distributed by lenders through their own branches and mortgage brokers. But as outlined in chapter 11, the high degree of vertical integration between lenders, aggregators and mortgage brokers reduces competitive pressures and can mean that the interests of brokers are not necessarily aligned with those of their clients. The Commission has made recommendations to introduce a legally-backed best interest obligation for all providers in the home loan market (chapter 11) and to develop an online calculator for greater home loan price transparency (chapter 12).

To further support competition and improved consumer outcomes in the financial system, it would be desirable to remove existing impediments in product distribution channels — in particular, the dividing line between what a financial adviser can offer to a customer compared with what a credit adviser can offer.

In the Draft Report, we sought feedback on whether financial advisers should be allowed to compete with mortgage brokers in providing credit advice on home loans (and other credit products). This is a pro-competitive option that would extend competition in the home loan distribution channel.

While the Commission received some support from participants, our proposal was high level and consequently many participants sought clarification regarding how an integrated advice service would be regulated (for example, CBA, sub. DR79; FPA, sub. DR81; AFA, sub. DR83; NAB, sub. DR94; FINSIA, sub. DR96; CHOICE, sub. DR97; FSC, sub. DR108). These submissions raised issues relating to the duties required to the client, the source of remuneration for advisers, and training and qualifications necessary to provide home loan and other credit advice.

While ASIC would outline how such a licence would be implemented, we envisage that any new licence would *ideally* require the licensee and authorised representatives to:

- apply the current best interest duties to advice on home loans and other credit products (as outlined in the Corporations Act)
- demonstrate relevant education and training in the specific credit product area in line with any ASIC requirements
- charge a fee for the provision of credit advice (rather than commission).

Greater choice, time saving and more holistic advice for consumers

Consumers stand to benefit from increased contestability in the provision of home loan and credit advice.

Ultimately, consumers will have greater choice in where they seek advice on credit products, in particular home loans. They would no longer be restricted to seeking advice from lenders (either at a branch or website) or through mortgage brokers.

Consumers would also benefit from receiving more holistic advice in one professional relationship. Integrated advice reduces the possibility of inconsistent financial and credit advice being provided to the consumer. The Association of Financial Advisers (AFA) noted that consumers would benefit from more comprehensive advice:

> From our perspective this is largely a reform to enable financial advisers to give a more comprehensive service to their clients, but in a way where there is only upside for consumers. In many cases, rather than getting this advice from another source, consumers are going without this advice. (sub. DR83, p. 3)

Furthermore, consumers are also increasingly time poor. An integrated financial and credit advice service would reduce time spent meeting with and consulting with different professionals.

A source for innovation in the financial advice market

Removing the regulatory barriers of separate licensing and conduct regimes could provide a motivation for some advisers to diversify their financial advice business. The financial costs of holding two licenses are not insignificant (table 10.1).

Removing the regulatory barriers also allows for service innovation. Customers may prefer a single adviser despite historic differences between credit and financial services. In general, we consider that it is better for consumers themselves to determine the service mix that best suits their needs, not regulatory distinctions.

A recommendation to allow financial advisers to advise on home loan and credit products should, therefore, be seen as forward looking. And we envisage that the role of financial advisers in the credit space would most likely be focused on providing holistic advice to customers, rather than the often administrative services, such as completing the loan application process, currently associated with mortgage brokers.

Table 10.1 **Financial costs of applying for and maintaining two licences add up**

	AFS	*ACL*
	$	$
Upfront and ongoing costs regulatory costs		
Application fees	1 643	1 160
Annual financial statement and auditor's report lodgement fee	608	—
Annual compliance certificate lodgement fee for credit licensees		1 160 – 24 384
Industry funding for the regulator		
ASIC industry funding (2017-18)	1 500[a]	1 000[b]

[a] Australian Financial Service (AFS) licensees that provide personal advice to retail clients on more complex products will pay a minimum levy of $1500, and an additional graduated component based on each licensee's share of the total number of advisers registered on the financial advisers register. [b]Each credit licensee will pay a minimum levy of $1000 and a graduated levy based on the number of credit representatives the entity has as a proportion of the total number of credit representatives in the subsector.

Source: ASIC, sub. DR123

But barriers exist to more competition in the credit advice distribution channels

While our proposal is a pro-competitive option in that it would extend competition in the home loan distribution channel, there are impediments that are likely to limit the effectiveness of this proposal in the immediate future. These impediments include: the current conduct standards in the financial advice sector; the different means that financial advisers and mortgage brokers are remunerated; and the level and nature of training and experience necessary to advise on both credit and investment products.

These areas will need further consideration and investigation before a new licence can be implemented and provide an additional source of competition in the credit advice distribution channels. Fundamental to this additional analysis is ensuring the potential benefits are not outweighed by the cost of designing and implementing a new licence.

Current standards of conduct need lifting

Some participants viewed the change as a natural extension of the current advice given, and one that the financial planning industry could easily perform given the regulatory standards required in the industry (CBA, sub. DR79; FPA, sub. DR81; AFA, sub. DR83; NAB, sub. DR94; FINSIA, sub. DR96; CHOICE, sub. DR97; FSC, sub. DR108). The Financial Planning Association (FPA) submitted that the current 'professional and regulatory standards financial planners must adhere to would enable financial planners to appropriately assist clients with their credit needs' (sub. DR81, p. 7). FSC viewed the proposed changes as a 'sensible streamlining of licensing arrangements' that will 'improve outcomes for consumers' (sub. DR108, p. 6). Both the CBA and NAB supported the proposal:

> CommBank supports the inclusion of credit as an option for licensed advisers as it can help facilitate clients and their advisers engaging in conversations on a broader range of financial needs, and on topics which naturally complement each other (for example debt management and savings). (sub. DR79, p. 67)
>
> NAB believes that simplifying the ability of customers to receive holistic financial advice is positive. (sub. DR94, p. 27)

While financial advisers, in principle, have the desirable regulatory obligations to clients and should be well-placed to provide this advice, there is considerable evidence that standards are not comprehensively effective. ASIC stated:

> While some advisers operate as professionals (that is, ethically and in the public interest), large sectors of the financial advice industry still employ a sales-driven model, in which financial advisers primarily operate as distributors of financial products, rather than trusted professional advisers.
>
> ASIC surveillances over time have also found that many financial advisers are not adequately trained or competent to provide appropriate financial advice to clients and that this often leads to poor advice outcomes for their clients. (Kell 2018a, p. 16)

In discussing this proposal at our public hearings, CHOICE noted that educational standards of financial advisers are very much in a transition process and will take some time to be lifted to the required level:

> … if one of the assumptions is that it's safe to move to that system because much higher standards apply to financial advisers, and that's only partially true at the moment because of the nature of the transition period of a number of the changes around financial advisers.
>
> … But some of the new requirements around education and qualifications are being phased in very, very slowly so in the financial advice industry there are a number of people who would have levels of qualification that are very similar to some of the lowest level of qualification of mortgage brokers, so at least for the next sort of five or so years. But there's not necessarily a significant gap in the level of qualifications between brokers and advisers so that's just something to be mindful of in the transition period if this needs to be measured. (PC transcript, 2018, p. 12)

Compliance with the best interest duty is an area where more attention is required to ensure competition related reforms deliver the full intended benefits. To this end, there are some current initiatives in train, including the introduction of several measures to lift education standards and professionalism of advisers (ASIC 2018l). But, as noted by CHOICE, these will take time. Other possible options to lift the standards of the sector more generally are outlined in sections 10.3 and 10.4.

Differing remuneration sources

A principal problem of any new licence would be the inconsistency that would arise for a financial adviser over remuneration.

As outlined above, one of the objectives of the FoFA reforms was to remove conflicted remuneration and move to a fee for service model — in order to lift the standard and quality of financial advice delivered to consumers (box 10.1).

Brokers would remain in receipt of large upfront payments, which consumers would consider are not a cost to them (chapter 11); but a financial adviser could not, if this new licence was to be consistent with FoFA. Instead, the financial adviser would be required to charge a fee, a visible cost to the home loan-seeker.

Requiring advisers to charge a fee for service for credit products is likely to make them broadly uncompetitive with other providers, such as mortgage brokers and bank employees, who can offer a free service and receive commission from the lender. Financial advisers may be competitive in situations where the advice on credit products is part of a broader financial advice package. In this sense they are only likely to appeal to a (possibly small) set of existing customers of mortgage brokers. However, the depth of demand for holistic advice — and customers' willingness to pay for it — is best tested by the market, not regulatory exclusion.

While broader than the licencing regulatory remit of financial advisers, the current practice of payment for referral is another likely constraint on financial advisers moving into the advice market on credit products. Providers (such as financial advisers, real estate agents, accountants and solicitors) that refer clients to a particular lender receive a payment for doing so. The amount received by the referrer is only slightly below the amount received by a mortgage broker for providing credit assistance, but for little effort (ASIC 2017x).

For financial advisers currently in receipt of this source of income (with limited effort), shifting to a licence that allows them to provide the credit advice but have to charge a fee to a customer is unlikely to prove attractive. The Royal Commission has raised issues regarding the value of referral payments more broadly and their removal might shift the incentives back towards making a new licence an option for some financial advisers.

Are there different skill sets for financial and credit advice?

Support for the Commission's proposal was not universal, with much of the concern stemming from the perception that the two industries are fundamentally different (box 10.2). The regulator submitted:

> Credit and financial services may be viewed as distinct offerings by industry. For example, large banks that are dual licensees may have a separate 'wealth advisory' division, in which qualified financial advisers refer clients to a more general banking area if they are seeking advice in relation to credit (and vice versa). This distinction could result from historical practice, the different skills required, regulatory requirements and systems used for different advisory services. Credit may have prudential considerations and requirements that must be taken into account by industry that may contribute to it being seen as a separate product offering or service. (ASIC, sub. DR123, p. 24)

Box 10.2 Industry views on why financial advice and credit assistance are different

Insurance Council of Australia:

> There is currently nothing to prevent a financial adviser from obtaining a mortgage broking qualification and acting as an authorised representative of both an Australian Financial Services Licensee and an Australian Credit Licensee. However, this does not typically occur because of the level of complexity inherent in each of these activities. Lender policies and procedures vary greatly and change regularly, and it is extremely difficult to maintain sufficient knowledge and understanding of a wide range of products and to meet lender continuing accreditation requirements as a minor sideline to another professional occupation (such as providing personal financial advice to retail investors). (sub. DR71, p. 7)

Canstar:

> The credit skill-set is distinct and it is reasonable that the distinction continues to be respected.
>
> - Current licensing requirements recognise the differing skills and demands required for credit.
> - In addition to suitability for purpose, affordability becomes a consideration in respect of credit contracts.
> - Credit is the area of finance that causes the greatest level of consumer financial stress. A relaxation of skill and experience requirements could only exacerbate the potential for financial stress. (sub. DR73, p. 3)

Finance Brokers Association of Australia (FBAA):

> … If a financial adviser wishes to advise on credit products now, they must obtain an Australian Credit Licence or be appointed as a representative of an ACL holder. If they want to give credit assistance in relation to third-party home loans then they must hold the relevant qualification and undertake 20 hours relevant CPD each year.
>
> We see no reason why there is a need to grant any dispensation to anyone from complying with these obligations and there is no reason to attempt to duplicate these obligations in the Corporations Act. While there are many similarities and some overlap, there are significant differences between the credit legislation and financial services legislation and anyone wishing to practice in both fields must be cognizant of both. (sub. DR85, p. 8)

Mortgage and Finance Association of Australia (MFAA):

> … we note the significant difference between these disciplines. Under the current arrangement, a business providing financial and credit services must hold both a licence/authorisation under the Australian Financial Service Licence (AFSL) regime and the Australian Credit Licence (ACL) regime. (sub. DR86, pp. 14–15)

Westpac:

> … financial advisers provide advice that is conceptually distinct from credit assistance under the Australian credit licence (ACL) regime. In particular, financial advisers consider risk of loss of an investor's capital, while credit assistance involves facilitating the distribution of credit products to customers that are affordable and meet their requirements and objectives. (sub. DR125, p. 28)

On face value, we do not see a fundamental difference in the skills set required (which is different to the regulatory requirements). Furthermore, with scope for online tools that guide and facilitate timely updates in product features and comparisons, any differences are seen to be increasingly manageable. Nevertheless, ASIC should undertake further consultation with industry to determine the merits of these claims.

An interim step to more competition but closely supervised

Ideally, we would like to recommend a new licence that allows financial advisers to provide financial product advice as well as credit advice that is consistent with FoFA principles (as outlined above). Such a proposal is aimed at allowing innovation in service delivery and expanding competition.

But the question of conflicted remuneration needs to be dealt with, if this new licence is to be effective (for competition purposes) and attractive (to the industry).

In chapter 9, we recommend a new line of constant scrutiny — the Principal Integrity Officer (PIO) — for bank-sourced remuneration payments that might result in a conflict with a consumer's best interest. This position recognises the practical reality that shifting to a customer paid fee for service in mortgage broking is unlikely to be attractive to consumers, but equally preserves a form of conflicted remuneration. To deal with this, instead of directly regulating broker behaviour (a challenging task given the thousands of parties to be placed under scrutiny), the PIO structure places the burden on each bank as the party paying the commissions to satisfy itself (and report to its board; or ASIC, in certain circumstances) that conflicts are consistently being managed over the long term.

Appointing a PIO in each ADI will help align the remuneration standards for financial advisers and mortgage brokers, lowering barriers to financial advisers being able to effectively compete through a new, broader financial service licence.

RECOMMENDATION 10.1 ASIC TO ASSESS A NEW LICENCE TO ALLOW FINANCIAL ADVISERS TO ADVISE ON HOME LOANS

ASIC should assess the feasibility of financial advisers providing advice on home loans and other credit products, via a new Australian Financial Services Licence that would not require a separate Australian Credit Licence to be obtained.

This assessment should examine the costs and benefits of a new licence, the consequences of various remuneration models and the applicability of a Principal Integrity Officer.

10.3 General advice — a case for reform

General advice is financial advice that does not take into account a consumer's personal circumstances, as noted above. It covers a wide range of activities (figure 10.1).

Broad guidance (so-called general advice) can help inform and educate consumers, in an efficient way (AIST, sub. DR78). Newsletters, media articles, blogs, seminars and online calculators for example, can provide practical financial investment or debt reduction strategies, outline the merits and flaws of particular financial products, or explain ways to reduced insurance premiums while acknowledging future risks or higher charges. There is a legal requirement that when providing general advice, it is given with a disclaimer stating that it is not tailored to an individual's circumstance.

Figure 10.1 **General advice comes in a variety of formats**

Source: ASIC, sub. DR123

There is widespread acknowledgment that consumers do not fully understand the nature of the advice provided in general advice, when seeking guidance on investment, superannuation, insurance and taxation, among other matters.

First, the label of 'advice' is an important consideration for consumers when making an assessment of the nature of the material received. CHOICE noted at the Commission's public hearings that:

> We have been long concerned about the term general advice because in reality no advice as a normal person would understand is provided in those situations. (PC transcript, 2018, p. 22)

Similarly FINSIA noted:

> With regards to the general advice, FINSIA concurs with draft recommendation 12.1 that the term "general advice" defined in the Corporations Act has the potential to mislead consumers. (PC transcript, 2018 p. 87)

Consumer research indicates terminology affects consumer understanding and perceptions (for example, ASIC 2013d, 2014e). This opens up the possibility that consumers will unduly rely on general advice — guidance that has not taken into account their personal circumstances (Murray et al. 2014b).

Second, the way general advice is framed by providers can also cause confusion about the true nature of the 'advice'. The framing of general advice in certain ways can exploit the behavioural aspects of financial decision-making (appendix D) by giving the consumer the impression that the advice is suitable for them. The FPA, for example, noted this problem:

> Anecdotal evidence shows that it is common for individuals to interpret general advice or product information as personal advice because it is relevant to their circumstances at the time they receive the information. Framing 'general advice' as advice gives the impression to consumers that the information they are receiving is based on that person's personal circumstances and that the product is appropriate for them. (sub. 26, p. 6)

ASIC research highlights that sales and marketing material, which would fall under the category of general advice, can play an influential role in consumers' decision making process:

> Our research has indicated that marketing information plays a particularly strong role in product distribution and may influence investors' decision making more than other product disclosure. In particular, when investors approach product issuers or other intermediaries responsible for selling products directly, rather than going through advisers, the information contained or implied in product issuers' marketing information is often the first, and may be the only, information that investors use to decide whether or not to invest in that product. (ASIC 2014e, p. 32)

AIST submitted that *conflicted* general advice was problematic as, in such cases, the person providing the 'advice' is not working for or required to place the consumer's interest ahead of their own. AIST advocated that consumers have the right to high quality unconflicted advice and in renaming general advice it recommended to:

> - Tighten the definition of general advice to exclude advertising and sales activities.
> - Tighten the definition of general advice to exclude all activities that generate commissions as a result of grandfathering or exemptions from the ban on conflicted remuneration under FoFA (eg. insurance and life insurance). (sub. DR78, p. 6)

Barring the use of the term 'general advice'

The Commission recommends renaming 'general advice' to reduce consumer misinterpretation and excessive reliance on this type of information.

The aim is to improve consumer understanding of the nature of the information and guidance being provided through a more informative description. In particular, this label would ideally emphasise that the information or other material is not tailored to a consumer's circumstances nor is there any obligation to consider the consumer's best interest. (Indeed, in some cases, the interest of the provider to sell financial products will be the highest priority.) The new label needs to convey the absence of suitability to individual personal circumstances and disclose any conflict of interest the provider may have. Any new label should be consumer-tested prior to its introduction.

An essential part of any reform is to limit the use of the term 'advice' only to circumstances where it is demonstrably 'personal advice' — that is, assistance that takes into consideration personal circumstances and where, for retail clients, a best interest duty is triggered.

This approach is consistent with the recommendations in the Murray Financial Services Inquiry (Murray et al. 2014a).

Support for label change and consumer testing

Following the Draft Report, Inquiry participants were largely supportive of the recommendation to change the label of general advice, following consumer testing of the alternative (for example, ANZ, sub. DR74, CBA, sub. DR79, NAB, sub. DR94, Westpac, sub. DR125, ASIC, sub. DR123, AFA, sub. DR83).

Consistent with this, ASIC are currently investigating whether:

- consumers understand the difference between general and personal advice
- the current terms are enabling consumers to choose the right type of advice
- consumers who receive general advice are relying on it without adequate consideration of how it applies to their own personal circumstances (ASIC, sub. DR123).

This research will provide greater understanding of how consumers interpret existing advice terms, greater clarity of the nature of the problem and the effective regulatory response (ASIC, sub. DR123).

Transitional timeframe to minimise costs

We sought advice in the Draft Report on a suitable timeframe and other ways to minimise transitional costs of such a reform. While participants' views varied on how costly it would be to change the name of general advice, most considered regulatory costs could be minimised with at least a 12-month transition (box 10.3).

Some stakeholders noted that costs could be further minimised if they are combined with other regulatory changes or incorporated as part of planned updates to customer material (FPA, sub. DR81; CBA, sub. DR79). One participant also noted that it is easier to make document changes when they are provided to customers electronically rather than hard copy (AFA, sub. DR83).

Box 10.3 Inquiry participants’ views on timeframes for changing the general advice label

National Insurance Brokers Association of Australia:

> We would expect a minimum of at **least 2 years** would be needed as a transition period in order to facilitate such changes and to allow for existing processes and documentation to be amended accordingly. (sub. DR56, p. 9)

Association of Financial Advisers Limited:

> From a financial advice perspective, this change would not have a significant impact upon costs. Financial advisers do have some documents that might refer to general advice, however these are already changed on a regular basis and could be updated relatively easily if there was a transition period of **12 months**. They are also increasingly provided to customers in an electronic format rather than in hard copy. (sub. DR83, pp. 3–4)

P&N Bank:

> P&N Bank believe that the benefits of removing the misleading term General “Advice” outweighs the inconvenience of transitioning advertising, promotional and training materials albeit we strongly recommend that to minimise the costs involved in transition, that a reasonable time frame be assigned to this process to prevent wholesale scrappage and impost on resources. We consider a **6-12 month** time frame would be optimal to transition. (sub. DR88, p. 9)

National Australia Bank:

> As well, consideration must be given to the timing of such change, given the significant number of document and system changes required, as well as training. (sub. DR94, p. 26)

Financial Services Council:

> Costs associated with renaming General Advice could be minimised by ensuring sufficient transition timeframes. The FSC suggests a **minimum of 18 months** to align with regular updates to disclosure documents such as Product Disclosure Documents and Financial Services Guides. This timeframe would also allow Licensees to train their financial advisers on the changes. (sub. DR108, p. 8)

Australian Financial Markets Association:

> The costs of implementing draft recommendation 12.1 for participants in the financial services industry would be significant. For example Australian Financial Services Licence holders would be required to provide extensive training to all client facing employees, update client documentation, their websites and the systems they use to document Statements of Advice and Records of Advice. As an indicative guide to the time costs of the proposed change **a minimum 24 month** transition period would likely be required if the proposal were to proceed. (sub. DR117, p. 13)

Westpac:

> While we are supportive of recommendations to improve customer understanding, we note that industry consultation and consumer testing will be needed around the appropriate labelling and scope of a new “general advice” category, supported by a carefully considered transition regime **(greater than 12 months)** given the implications of such a change. In particular, it will be important to consider the appropriateness of the current laws in light of rapidly evolving technology to ensure that any reforms are technology neutral and therefore suitable in an increasingly digital world. (sub. DR125, p. 30)

RECOMMENDATION 10.2 RENAME GENERAL ADVICE TO IMPROVE CONSUMER UNDERSTANDING

General advice, as defined in the *Corporations Act 2001* (Cth), is a misleading term and should be renamed. Any replacement must ensure that the term 'advice' can only be used in association with 'personal advice' — that is, advice that takes into consideration personal circumstances.

Consumer testing of alternative terminology is required to ensure that misinterpretation and excessive reliance on this type of information is minimised. Including time for consumer testing and a transition period to enable industry training and adjustment, a new term should be in effect by mid-2020.

10.4 More information about APLs to enforce the current best interest duty

An approved product list (APL) sets out the financial products, such as investment, superannuation and life insurance products, the licensee considers are suitable for their authorised representatives or employees to recommend to clients (ASIC 2018k).

APLs are pivotal in the provision of financial advice, influencing the number of options and quality of advice that is provided to the client.[79] APLs are not required by the Corporations Act but are used by the sector as they have potential benefits for a client and licensee, in terms of efficiency of research, the quality of advice given and the ability to fulfil regulatory obligations (box 10.4).

Ideally, a well-constructed APL should represent a manageable list of high performing financial products with research backing the inclusion of each product. Even in such a case, there is an expectation from the regulator, ASIC, that financial advisers will make inquiries and undertake research on the products that they give advice on (ASIC 2017s).

But APLs can also intensify conflicts of interest that are present in vertically integrated financial advice businesses, increasing the risk that a client's best interest duties will not be fulfilled (section 10.1).[80] For example, APLs can provide a means for the parent financial institution to restrict choice of products, potentially towards in-house products. Furthermore, the parent financial institution could also make it difficult for advisers to consider products

[79] A financial adviser's legal obligations, including an obligation to put the client's interest first, should also influence the number of options and quality of information and advice that is provided to the client. The extent that this occurs is discussed below.

[80] Operating with a well-constructed APL is also important for the quality of advice for non-vertically integrated financial advisers, including ensuring that a client's best interest duties have been met. But this largely rests on the capabilities of the business to develop the APL and the capabilities of the advisers. Non-vertically integrated businesses do not have the same conflicts as vertically integrated models or face the potential that APLs can be used to put the parent product manufacturer interests ahead of a client's.

that are not on the APL (known as off-APL products) that may be in the best interest of the client. (ASIC 2018k).

Box 10.4 **Potential benefits of approved product lists**

There are a multitude of financial products on the market with varying product features and performance outcomes. A well-constructed APL reduces the range of products that a financial adviser needs to consider while maintaining a sufficient range of products so the licensee can meet most clients' needs. Therefore, the development of an APL can be an efficient way of sorting through the large number of products down to a manageable list. The Financial Planning Association of Australia noted that:

> Given the plethora of financial products available and the lack of transparency about purported performance objectives and comparable product information, financial planners commonly rely on the licensee's Approved Product List (APL) to compare products … (sub. 26, p. 19)

The construction of an APL is also a vetting process by the licensee, eliminating poor quality or low performing products. Operating as a risk management tool, this process safeguards that only products that have been assessed as suitable can be recommended by an adviser. ANZ outlined:

> The central purpose of the APL for the Wealth Entities is to support financial advisers to meet their regulatory obligations and in particular their best interest duty and related obligations. This is achieved, for example, by providing financial advisers with research on, and assessment of, the Products. (Sillar 2018, p. 5)

Under this scenario, each client does not need to bear the research costs of an adviser starting from 'scratch' when determining financial product advice. The Financial Services Council submitted:

> APLs offer cost savings for Licensees and efficiencies to advisers, providing them with comfort that the products on the APL have been reviewed and approved by the Licensee's own internal governance. (sub. DR108, p. 4)

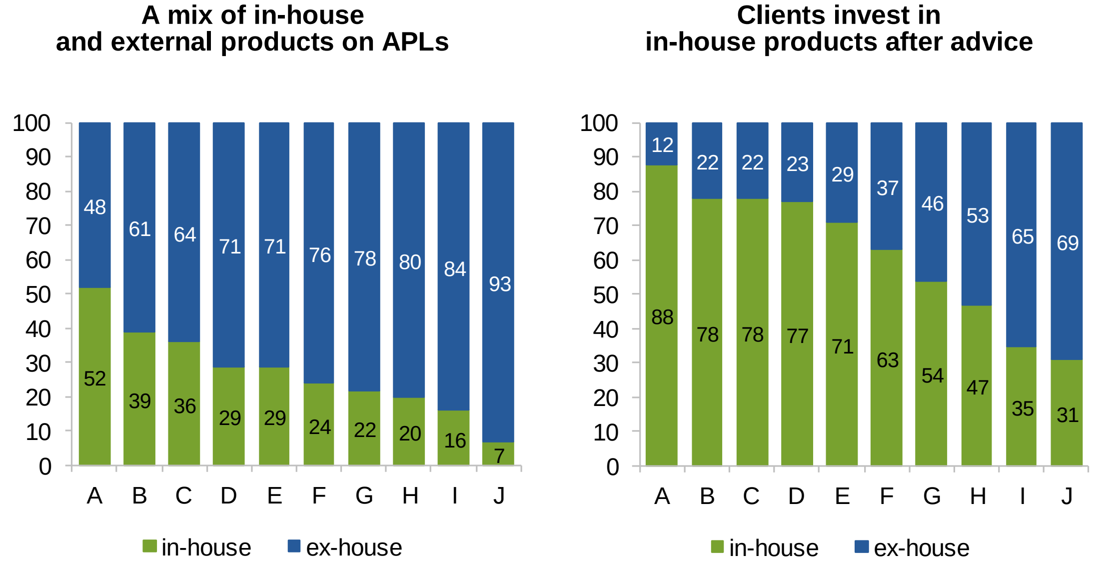
It is an empirical issue as to whether the use of APLs reduces a client's access to products and whether best interest obligations to a client have been fulfilled. ASIC highlighted the interaction between the construction of the APL and the decisions by the financial adviser:

> So there is also an issue about how products get on to the APL, and whether there is a consistent process applying both to products related to the firm and external products.
>
> Having said that, and this is why the second part of that formulation is important, you can have a broad-based approved product list, but if the adviser is still, through various ways, ending up recommending a very narrow set of products, and only in-house products to the individual customer, then that itself may not be appropriate either. So it's the interaction between the two [that] may result in conflicts not being managed appropriately. (Royal Commission transcript, 2018, pp. 1043–1044)

Evidence on the use of APLs for clients' benefit is sketchy

Recent ASIC research indicates that APLs generally have a mix of in-house and external products, but the majority of customer funds are invested in in-house products (ASIC 2018k) (figure 10.2). The recommendation of an in-house product is not necessarily a problem. The issue is whether the adviser is providing quality advice: have the client's interest and goals been considered, and has the adviser considered a sufficient number of products, including the clients existing products (where applicable), to ensure that the client's best interest are being served?

Figure 10.2 **APLs, investments: in-house and external products**[a,b]



a ASIC examined 10 APLs. These were drawn from the two largest advice licensees that were controlled or owned by the five largest banking and financial services institutions (AMP, ANZ, CBA, NAB and Westpac). b The providers listed as A to J are not the same providers in each chart.

Source: ASIC (2018k)

But research findings on the quality of advice are not encouraging. In 75% of the customer files reviewed by ASIC, the adviser had not demonstrated compliance with the best interest duty in the Corporations Act.[81] Around 10% of the cases examined potentially had significant implications for the client's financial situation. ASIC concluded that, in the cases examined, licensees 'may not be appropriately managing the conflict of interest associated with a vertically integrated business model' (ASIC 2018k, p. 36).

In addition, the same research has found that the five major advice licensees had a process by which an adviser could seek approval for off-APL products, the process was 'quite involved' and may also require the advisers to personally research and monitor the product (ASIC 2018k, p. 34). The additional research may be a disincentive for advisers recommending off-APL products, including recommending clients retain their existing products (notwithstanding their regulatory obligations to do so).

81 This research examined the quality of advice given to new customers that were recommended to invest in an in-house superannuation platform from 1 January 2017 to 31 March 2017. A total of 200 files were reviewed.

One possible reason for these outcomes is inadequate monitoring and supervision practices by licensees, which is symptomatic of a generally poor compliance culture. ASIC submitted to the Royal Commission that while internal controls of licensees to monitor and supervise advisers have improved, many remain deficient (Kell 2018a).

Improving APL transparency

Information about the products on an APL can highlight whether advisers are able to provide advice on a 'reasonable' range of in-house and external products in specific product categories. Information about the proportion of funds invested by clients in in-house products, compared to external products, may indicate whether or not there is a bias towards in house products (ASIC 2018k). But currently information on APLs and investment decisions are not publicly available.

Greater information transparency can provide 'sunlight' to the practices of licensees and advisers in relation to how APLs are constructed, their composition, as well as data on the proportion of in-house products recommended. ASIC have indicated in their research that they will consult with the industry on a proposal to introduce public reporting on APLs and where clients funds are invested for a vertically integrated institution (ASIC 2018k).

The Commission supports the introduction of public reporting by industry but would extend this requirement to mandatory reporting to ASIC by mid-2020. This additional information will enhance ASICs ability to enforce existing regulatory obligations.

RECOMMENDATION 10.3 GREATER TRANSPARENCY OF PRODUCTS ON THE APPROVED PRODUCT LIST

Australian Financial Service Licensees should disclose to ASIC (for each broad class of financial product):

- the number of products on their approved product list (APL)
- the proportion of in-house products on their APL
- the proportion of products recommended that are in-house
- the proportion of products recommended that are off-APL

ASIC should publish this information annually.

ASIC should also conduct selected audits of the information received to facilitate assessment of the effectiveness of advisers in meeting clients' best interests.

10.5 Scope for digital advice to increase consumer access to financial advice

For consumers and investors to engage effectively with the financial system and have their financial needs met, they need access to affordable and high quality financial advice to make informed decisions (ASIC, sub. 40, att. 1). However, the existence of unmet demand for financial advice presents a fundamental problem for the effectiveness of that decision making process, particularly given growing household wealth and the high level of complexity of some financial products.

A difference between what consumers are willing to pay and the actual cost of supplying financial advice is, in part, driving this unmet demand. For example, Investment Trends estimated that about half of the Australian population (48%) had unmet advice needs with consumers only willing to pay $750 on average for advice but the estimated average cost of financial advice around $2500 (Investment Trends 2016, 2017).

The emergence of credible digital advice may help fill unmet demand

Digital advice (box 10.5) holds promise as a relatively low-cost solution that could be delivered by new entrants or existing providers.

Box 10.5 What is digital financial advice?

Digital advice (also known as robo or automated advice) is financial advice delivered by a computer. It uses algorithms and technology instead of the direct involvement of a human financial adviser. Customer personal details (such as age, gender, income, expenses, assets, financial goals and risk tolerance) are entered into a computer program, which then generates financial advice based on these details and financial market information. Examples of computer-generated advice include advice on superannuation, investment and self-managed super funds.

Providers of digital advice (such as start-up businesses, banks and superannuation funds) are subject to the same regulatory requirements as human financial advisers. For example, to carry on the business of providing digital advice, the person or entity must hold an AFS licence or be an authorised representative of an AFS licensee, unless an exemption applies. Digital advisers are subject to the best interest obligations like other advisers.

Source: ASIC (sub. 40, att. 1).

ASIC highlighted in their submission that digital advice has the potential to increase competition through new entrants that have a lower cost base due to the need for fewer staff and a smaller physical office (sub. 40). In turn, such an increase in competition could deliver savings to consumers in the form of lower fees. This may place competitive pressure on incumbents to offer their own digital advice service and/or improve their own traditional services. In their research, Lochner, Duenser and Reeson (2017) note that marginal costs of delivering digital services is considerably lower than face-to-face models.

Industry providers are showing interest in entering the digital advice market. Although still in the early stages of development, a few asset managers have begun to recognise the benefits of digital advice, partnering with digital advice providers to rollout the service to clients (Chong 2018). Other providers are looking to develop digital advice products that target specific demographics, such as millennial savers or self-directed retiree investors (Kendell 2017).

The provision of digital advice has grown rapidly in Australia since 2014 (ASIC sub. 40, att. 1). More broadly, consumers are aware of digital advice and willing to consider using such services. In 2016, 27% of the Australian online investor population had heard of digital advice and 12% of the Australian adult population were open to using automated investment services (in line with the UK, France and Germany) (Investment Trends 2016; ASIC sub. 40, att. 1).

Despite this, some consumers do appear reticent in using digital advice, potentially representing a barrier to making financial advice more accessible. Lochner, Duenser and Reeson (2017) found that 74% of survey respondents preferred to receive financial advice regarding superannuation from a person, noting that:

> While technology can easily handle the maths, many people may also need the human touch, for example with emotional support and motivation, to get them to confidently engage with these difficult and important decisions. (p. 3)

ASIC submitted that while digital advice had the potential to increase competition and lower prices for consumers in the financial advice market there were also risks. The complexity of financial products and the large volume of products mean that the task of writing algorithms to accurately portray the full offerings will be considerable. Moreover, to provide good quality automated advice, some key information on people's individual and household financial circumstances and their risk profile will need to be accurately acquired (sub. 40).

While the provision of digital advice is also subject to the Australian Financial System licencing regime, there is a question as to whether digital advice might benefit from an additional accreditation process in order to enhance its credibility and trustworthiness from a consumer's perspective. A possible accreditation process would check the programming of digital advice to ensure that:

- key information is sought on a client's circumstances
- it has adequate coverage of the available product offerings
- it is accurately scripted.

To facilitate knowledge of a client's financial circumstances, digital advice should be enabled to have ready access to a person's electronic financial records (for example, under the new Open Banking arrangements).

The Commission is supportive of further research and consultation with stakeholders into methods of increasing the uptake of digital advice.

11 Are mortgage brokers a force for competition?

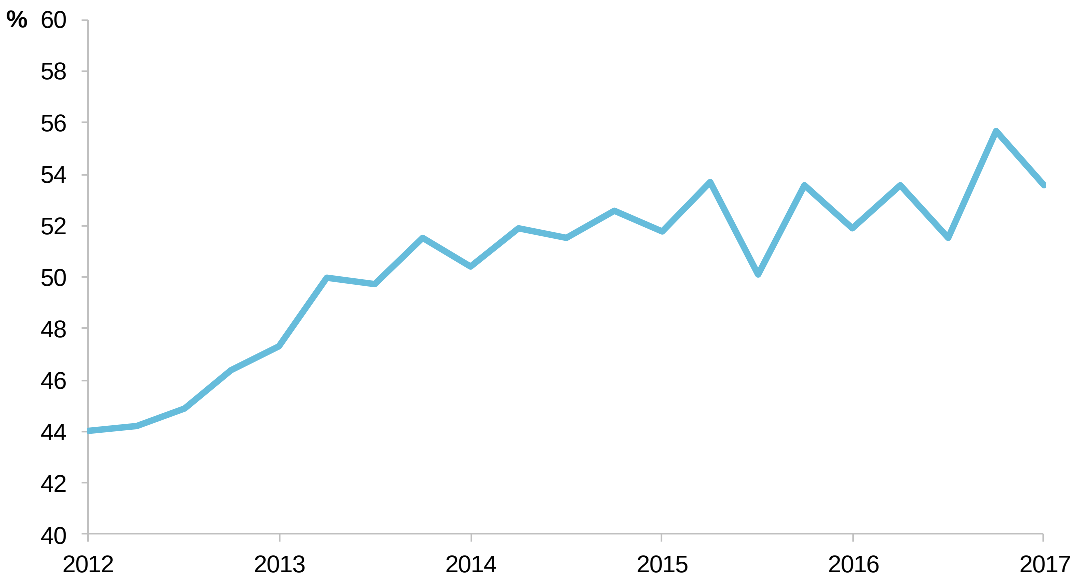
Key points

- Mortgage brokers are now the source of a majority of home loans. As at December 2017, brokers originated approximately 54% of all new home loans. Brokers can make the home loan market more competitive by increasing consumers' knowledge of loan products and exerting competitive pressure on lenders on behalf of consumers.
- The pro-competitive effects of brokers in the market were large and obvious in the 1990s, but have since declined. Many mortgage aggregators are now owned by lenders — the revolution has become part of the establishment.
  - Aggregator ownership creates a conflict of interest as lenders have natural incentives to favour their own products. Lenders that own aggregators have gained a disproportionately large share of loans through their white-label products.
  - Conflicts of interest can also exist for independent aggregators, where the increasing use of white-label products can create an in-house preference.
- Consumers may believe that brokers can get them a better interest rate, but the interest rates on loans obtained through brokers are most often similar to those obtained through proprietary channels. And although consumers say they value the services brokers provide, this does not appear to extend to *paying* for them.
- Brokers enable smaller lenders to diversify and compete with lenders that have branch networks. On average, we estimate each smaller lender would need to open 118 new branches to generate the equivalent market share achieved through use of brokers.
- Larger lenders do not generally consider brokers to be more cost effective than branches. However, the major banks appear on the vast majority of aggregator panels because many consumers prefer to obtain loans through brokers. This is due to the intimidatingly complex and confusing nature of the product, as well as the absence of a direct cost to use a broker.
- Trail commissions and commission clawbacks create a range of incentives for brokers, some of which are clearly inconsistent with acting in a customer's best interest. Brokers' reliance on ongoing client relationships may create a counterweight, but remuneration arrangements can still result in poor consumer outcomes.
- Trail commissions should be abolished, commission clawbacks should not be allowed beyond 2 years and passing clawbacks on to the borrower should be banned.
- The Australian Government should impose a best interest obligation on credit licensees that provide credit or credit services (both individuals and corporate entities) in relation to home loans. This should be implemented through the existing credit licensing legislation.

From a relatively small industry in the 1990s, mortgage brokers have grown to become a significant channel through which home loans are distributed (figure 11.1). As at December 2017, brokers originated approximately 54% of home loans, compared to only about a quarter in 2003 (MFAA 2017a; RBA 2004).

Figure 11.1 **Home loans are increasingly being written through brokers**

Proportion of new residential home lending originated through brokers



Source: MFAA (2017a, pers. comm., 16 May 2018, 2017b)

Mortgage brokers were a significant disruptor when they first entered the home loan market. As Morgan Stanley said:

> Brokers were able to offer lower interest rates, address customer perceptions that the major banks did not provide choice, and access alternative sources of funding to grow their business. They entered the market in 1996 and have ~47% share of in-force loans today. The impact on home loans was significant and immediate, with margins falling ~200bp within two years. (2015, p. 60)

Since that time, however, the size, nature and structure of the mortgage broking industry has changed. As noted above, brokers are now the source of the majority of home loans. The contractual and regulatory obligations of brokers have also evolved, and many lenders are now owners or significant shareholders of mortgage aggregators (the institutions that submit loans to lenders on behalf of individual brokers).

In light of these developments, this chapter assesses the extent to which brokers continue to be a force for competition in the home loan market. In particular, it examines:

- how brokers and aggregators, as they currently operate, benefit consumers and lenders
- how lender ownership of aggregators affects competitive dynamics

- how commissions (and the way these are paid) can influence broker behaviour and consumer outcomes
- what might reduce the inconsistency between a broker being paid by a lender, but (in future) having to act in a customer's best interest.

In conducting this competition Inquiry, we have assessed the extent to which the mortgage broking market resembles one that is strongly competitive, as it was in the 1990s.

We have not investigated specific instances where poor behaviour by brokers has led to adverse outcomes for consumers, but have noted the efforts of other inquiries.

Australians have an outstanding track record of repaying their home loans, and as such the consequences of poor advice on mortgages are most likely never going to be fully visible, unlike in the wealth management sector. This naturally results in fewer complaints. Claims that there are no problems in mortgage broking because of the low number of complaints ignore this fact.

And home loans are sold to a wider cross-section of the community compared to wealth products, which creates an arguably greater need for clear obligations in favour of the consumer. Our recommendations aim to ensure that poor practices evident in other financial products do not adversely affect home loan borrowers, which is preferable to waiting until the system is self-evidently broken.

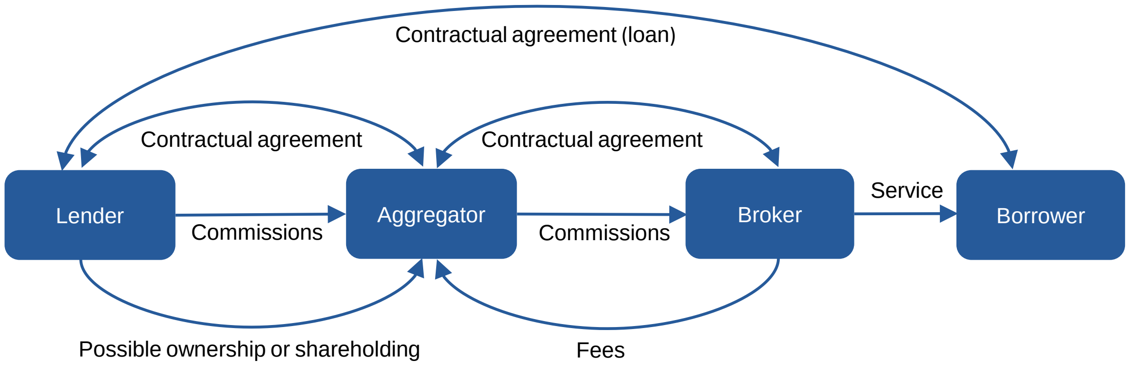
11.1 Overview of the mortgage broking market

Mortgage brokers are intermediaries that recommend home loans to prospective borrowers and submit loan applications to lenders on borrowers' behalf. Lenders assess, approve and ultimately fund home loans. They usually employ business development managers to liaise with brokers regarding potential borrowers. Some lenders impose minimum volume thresholds on broker-generated loans, which are dollar-value thresholds stipulating the minimum volume of loans the lender is willing to accept from any one broker. This is so that the lender avoids the need to engage with many hundreds or thousands of small broker businesses generating low volumes of loans.

As a result, most mortgage brokers do not interact directly with lenders, but instead operate through mortgage aggregators, which gather loan applications from many individual brokers to meet lenders' thresholds. Aggregators enter into contractual relationships with multiple lenders (which form the aggregator's 'panel'), and with brokers that submit loan applications to the lenders on their aggregator's panel.

Figure 11.2 provides an overview of the parties within the mortgage broking industry.

Figure 11.2 **The mortgage broking industry — a stylised model**[a]



[a] This model outlines only business and contractual arrangements, and does not include the licensing regime outlined in the *National Consumer Credit Protection Act 2009* (Cth)

There are a lot of mortgage brokers, but exactly how many is unknown

Mortgage brokers are regulated under the *National Consumer Credit Protection Act 2009* (Cth) (the Credit Act). Under that Act, brokers can either hold their own Australian Credit Licence or act as an authorised credit representative of another licensee, such as an aggregator, a broker business, or a lender. The Australian Securities and Investments Commission (ASIC) found that, as at January 2015, approximately 61% of mortgage broker businesses (including both individual brokers and businesses with two or more brokers) operating under the 13 aggregators who provided data were credit representatives of their aggregator, while the remainder held their own licence or acted as a credit representative of another licensee (ASIC, pers. comm., 1 June 2018).

Because of the scope for a broker to be a credit representative rather than a direct licensee, the precise number of mortgage brokers in Australia is unknown (including by ASIC).

- The Mortgage & Finance Association of Australia (MFAA) (2017b) reported that there were approximately 16 000 brokers as at March 2017. This was based on data provided by 13 aggregators representing the majority of the market.
- The Finance Brokers Association of Australia (FBAA) claimed that there were approximately 22 000 brokers in Australia, based on the number of credit representatives on ASIC's credit representative register identifying as 'finance and mortgage brokers' (PC transcript, 2018, p. 231). However, this register provides an inaccurate estimate of the number of mortgage brokers because:
  - not all finance brokers provide credit assistance on home loans
  - some double counting may occur where both an individual broker and the corporation within which they operate are authorised as credit representatives

– brokers who hold their own licence or are direct employees of a broker business holding a credit licence may be excluded.

The exact number of aggregators is also not known because, although credit licence applicants are asked to select their intended business activities from a list as part of the application process, it appears that many do not do this correctly. In addition, some applicants may not conduct their nominated activities once they have received a licence (this does not affect the way in which the regulator administers the licence). As at May 2018, the MFAA website listed 50 aggregator members (MFAA 2018).

We consider that the effectiveness of reforms to mortgage broking, as outlined in this chapter, would be enhanced by the ability of the regulator to readily identify aggregators, broker businesses and individual brokers operating in the market.

RECOMMENDATION 11.1 BROKER REPORTING THAT ACCORDS WITH IT BEING THE DOMINANT HOME LOAN DISTRIBUTION CHANNEL

As part of the process of issuing credit licences, ASIC should provide clear definitions for, and collect information from licensees about, whether they operate as mortgage aggregators, mortgage broker businesses or individual mortgage brokers. This information should be collected in a way that can be reliably used for analyses of the mortgage broking industry.

Aggregators should be required to report to ASIC annually on the number of individual brokers operating under them, whether as credit representatives of the aggregator, credit representatives of another credit licensee, credit licence holders or direct employees of a broker business.

Interaction of brokers, aggregators and lenders

As noted above, aggregators have contractual relationships with multiple lenders, and these lenders form its lender panel. Out of 23 aggregators examined by the Commission (which included large and medium-sized aggregators that represent the majority of the market),[82] the median number of lenders on a panel was 28. The minimum was 9 (Citiwide) and the maximum was 56 (Outsource).

In many cases, brokers can only recommend lenders from their aggregator's panel, which restricts the range of loans available to their clients. ASIC (2017x) found that approximately 60% of aggregators did not permit brokers who are their credit representatives to recommend

82 The 23 aggregators included by the Commission were: AAA Mortgage Solutions, Aussie Home Loans, Australian Finance Group Limited, Ballast Finance Pty. Ltd., Bernie Lewis Home Loans Pty. Ltd., Centrepoint Alliance, Choice Aggregation Services, Citiwide, Connective, Custom Equity Group, eChoice, Finance & Systems Technology, Finconnect, Finsure, Loan Market, Mortgage Choice, My Local Broker, National Mortgage Brokers, Outsource, PLAN, Smartline, Vow Financial and Yellow Brick Road.

loans that were 'off-panel'. Even if brokers were permitted to make off-panel recommendations, their ability to do so would be limited by the relatively common minimum volume thresholds set by lenders.

Further, a broker may be required to be accredited with a lender before being permitted to recommend that lender's loans. ASIC (2017x) found that only about 20% of aggregators required brokers operating under them to be accredited by all lenders on their panel.

Together, these limitations mean that:

- a consumer may be unaware that the broker they engage is limited to offer only the products on the aggregator's panel
- a consumer, observing the brands that an aggregator may list in its promotional material, may be unaware that *their* broker may not be able to access all the promoted products.

Lenders generally do not have direct contractual relationships with brokers. Rather, their relationships with brokers are established indirectly through their relationships with aggregators, who in turn have relationships with brokers. Under the agreements between aggregators and brokers, aggregators provide brokers with aggregation services, IT infrastructure and support, marketing and professional development training, in return for a fee. An aggregator may also provide the credit licence under which a broker operates. Brokers usually only operate under one aggregator at a time, unlike aggregators who have contracts with multiple lenders.

Lenders usually pay a commission to aggregators when a loan is successful, and a portion of this is passed onto brokers. ASIC found that, in 2015:

- The average rate of upfront and trail commissions paid by lenders to aggregators was 0.62% and 0.18% per year respectively. On an average new home loan of approximately $369 000, this amounts to an upfront commission of $2 289 and a trail commission of $665 per year.[83]
- The average rate of upfront and trail commissions paid by aggregators to brokers was 0.54% and 0.14% per year respectively. On an average new home loan of approximately $369 000, this amounts to an upfront commission of $1 992 and a trail commission of $516 per year.

In recent years, some aggregators have become wholly or partly owned by lenders. For example:

- The Commonwealth Bank of Australia (CBA) acquired a 33% stake in Aussie Home Loans in 2008, increasing its share to 80% in 2012, and then to 100% in 2017 (Aussie

83 Based on unpublished data obtained from APRA by the Commission, the average (mean) size of a new home loan in the year to 30 June 2017 was $369 195. Trail commissions usually decrease over time, since they are calculated on the value of the loan outstanding rather than the initial loan value. That said, some lenders increase the rate of trail commission the longer a loan is active (ASIC 2017x).

Home Loans 2017). CBA also has a 20% share in Mortgage Choice (Roddan 2016), and Finconnect is a wholly-owned subsidiary of the bank (Finconnect 2018).

- The National Australia Bank (NAB) has full ownership of three aggregators — Choice, FAST and PLAN.
- Westpac owns approximately 80% of online mortgage broker Uno (Eyers 2018c).
- Macquarie has minority stakes in Connective and Lendi (ASIC 2017x; Thompson, Macdonald and Moullaki 2018). Until mid-2018, it also had a minority stake in Yellow Brick Road (Macquarie Bank, pers. comm., 25 June 2018).
- Non-bank lender Liberty Financial purchased National Mortgage Brokers (previously owned by Aussie Home Loans) in August 2017.

While vertical integration is only relevant to a minority of the *number* of aggregators, these aggregators account for a majority of the loans originated through the broker channel. Using data obtained from ASIC, we estimated that, as at December 2015, aggregators owned by lenders originated approximately 70% of broker-originated loans, and 36% of all loans (since broker-originated loans made up approximately 52% of all loans at that time — figure 11.1). NAB (sub. 31, p. 14) submitted that the aggregators it owns collectively represent about 30% of mortgage brokers in Australia.

11.2 Why do consumers use brokers?

Consumers say that they use brokers for a range of reasons, including to:

- gain access to a wider range of loans
- get a better interest rate
- get help regarding the process of obtaining a home loan
- increase their chances of getting an application approved (ASIC 2017x; EY 2015; Genworth Financial 2009; MPA 2017; RFI 2009).

These functions can be grouped into two broad categories: educative and transactional. Under their educative functions, brokers provide consumers with information about the home loan market and the process for obtaining a home loan, among other things. By performing these functions, brokers can, in theory, increase consumers' knowledge and enable them to more effectively exert competitive pressure on lenders, which can result in lower prices and products that better suit their preferences.

Brokers carry out their transactional functions through services such as obtaining pre-approval, submitting loan applications, enabling access to particular lenders and negotiating with lenders on the consumer's behalf. These save consumers time and allow the application process to be completed more efficiently.

Different types of consumers place higher value on different aspects of brokers' services. A survey by Mortgage Professional Australia (2017) found that first home buyers placed the most value on help with the loan application, while investors and those switching properties placed higher value on access to specialist lenders.

Consumers want to use brokers, but will not always pay for them

Faced with the decision to obtain a loan directly from a lender or through a mortgage broker, an increasing proportion of consumers have chosen the latter. Mortgage brokers provide consumers with reassurance in an increasingly complex market.

> The reason I use mortgage broker is they provide a fantastic service for people like me who wouldn't have a clue how to navigate the financial banking system. (Joseph Ripolles, sub. DR69, p. 1)

The MFAA also said that:

> [the growth in the broking industry] is accredited to an increase in more complex scenarios and products in the property investment market … requiring greater credit advice to meet consumer needs. Consumers have increasingly sought a financial professional to assist with the more detailed application processes … (sub. 48, p. 2)

Most consumers are satisfied with the services they received from brokers, based on surveys conducted on behalf of the broking industry.

- Mortgage Professional Australia (pers. comm., 15 September 2017) found that 82% of consumers surveyed (out of a sample of 541) would use a broker again to obtain a home loan.
- A survey conduct by EY (2015) on behalf of the MFAA showed that 92% of respondents were either 'very satisfied' or 'fairly satisfied' with their broker. The same survey found that consumers who obtained their home loan through a broker are more likely to recommend their approach than those who obtained a loan directly from a lender.
- A survey by Deloitte (2016a), also on behalf of the MFAA, found that consumers who had obtained their loan through brokers were marginally more likely to say that they were completely satisfied with their experience of seeking a mortgage, compared to direct-to-lender customers.

But it is not at all surprising that consumers would consider they are getting good value from what appears to them to be a totally free service, in an environment where the purchase being facilitated is considered a milestone and the nature of the process can appear intimidatingly complex.

Consumers — again unsurprisingly — are also not attracted to paying for a service that they currently receive for 'free'.

- Deloitte (2016a) found that 37% of surveyed broker customers were not willing to pay mortgage brokers a fee. Of the 63% that were, 22% were only willing to pay up to $500, and a further 18% were only willing to pay up to $1000. Focus groups revealed that most consumers would not pay, and would instead approach lenders directly.

- Mortgage Professional Australia (2017) found that having to pay to use a broker would make 14% of consumers consider going directly to a branch.
- Habitat Finance, a broker business, also said that:

> We know if our business model moves to a fee for service model, the average consumer will not be willing to pay a fee. (sub. DR95, p. 1)

Of course, consumers ultimately do pay for brokers (in whole or in part), whether through direct charges or higher interest rates. The evidence for the alternative — that shareholders pay this cost through lower returns — is unconvincing.

The way in which consumers pay for brokers has implications for their use of brokers — an apparent free service encourages consumers to use brokers, while an explicit charge would deter them from doing so (or, at the very least, require them to evaluate the benefits of a broker and weigh this against the cost). This in turn affects the extent to which the competitive benefits that brokers bring can be realised. Section 11.4 discusses the efficacy and scope for a consumer-pays model for mortgage broker remuneration.

Do brokers achieve lower interest rates for their customers?

An important reason why consumers chose to use brokers (though by no means the only one) is that they believe a broker would be able to get them a better interest rate (ASIC 2017x; EY 2015; Genworth Financial 2009; RFI 2009). This is an unsurprising perception, given that many consumers feel they are unable to navigate the plethora of home loan options on their own.

However, one would not necessarily expect interest rates on home loans obtained through the broker channel to be lower than those obtained through direct channels.

- Those who approach lenders directly tend to be more experienced and confident (Deloitte 2016a), and may therefore be equally as effective at applying competitive pressure on lenders as brokers.
- If brokers were more effective at negotiating interest rates than those who obtained loans through direct channels, lenders would likely decrease interest rates on loans offered through direct channels so that their proprietary channels were not disadvantaged.

As ANZ said:

> … we would suggest that a competitive market would deliver convergence of the rates. If one channel delivered better rates through better negotiating power or market insight, it would be reasonable to expect the other channel to drop its rates in response. (sub. DR74, p. 21)

This is especially true if lenders preferred to distribute loans through their proprietary channels, rather than through brokers, since lower interest rates on loans through direct channels would be necessary to encourage consumers to use those channels. As discussed in section 11.3, some lenders with extensive branch networks *do* prefer originating loans through their proprietary networks.

Some lenders also said that they employed pricing parity policies to ensure that interest rates across both channels were similar.

> At Westpac, on a like for like basis, there is no differentiation in pricing based on channel. Headline pricing and discretionary discounts available to customers are set at the same level regardless of the channel the customer is originated through. (Westpac, sub. DR125, p. 13)

> Generally, the price of NAB's products is determined by the brand, as well as product, customer and loan characteristics rather than the channel through which the product is originated. (NAB, sub. DR94, p. 23)

We verified ASIC's findings that, in 2012 and 2015, interest rates on home loans obtained through brokers were similar to those obtained through direct channels (ASIC 2017x). While median interest rates on home loans obtained through brokers were generally lower for different categories of loan amount, loan-to-value ratio (LVR) and borrower age, statistical analysis showed that these differences were very small, and in some cases were not statistically significant.

FINDING 11.1 BROKERS ARE NOT CONSISTENTLY FINDING LOWER INTEREST RATES FOR CONSUMERS

While many consumers believe that mortgage brokers can secure them a lower interest rate, interest rates on home loans obtained through brokers are not significantly different to those obtained directly from lenders.

11.3 Why do lenders use brokers?

In distributing home loans, lenders choose whether to engage in various distribution channels, including branches, brokers, telephone sales, proprietary websites and third-party comparison websites. Some lenders choose to make their products available through multiple channels, while others focus more narrowly on particular channels.

Lenders undoubtedly consider the costs of different distribution channels when choosing which ones to pursue. The Commission sought data from authorised deposit-taking institutions (ADIs) on their costs of distributing home loans through different channels, but some ADIs were unable to provide such information and others claimed not to collect it. We view this as more to do with commercial sensitivities than bad business practice.

AFG said that:

> … the inability of lenders to provide the Commission with data about the cost of originating loans through branch networks versus the cost of broker originations should be considered to

be disingenuous. It is difficult to accept that entities that are sophisticated enough to develop and manage banking products and meet complex legal and regulatory obligations do not have information about product costs that would be needed to price those products. (sub. DR71, pp. 2–3)

The Commission agrees that it is highly unlikely that lenders would not undertake analysis to assess the cost of the broking channel relative to other channels, especially considering that many lenders have chosen to *own* aggregation businesses.

Nevertheless, we have been able to draw some conclusions about the relative costs of the broker channel compared to branches for different types of lenders using information submitted to us and available in the public domain.

Brokers are a cost-effective distribution channel for smaller lenders

Many smaller lenders considered brokers to be a cost-effective way of distributing home loans. The Reserve Bank of Australia said that:

> Smaller lenders have made greater use of [the broker] distribution channel than the major banks because it is lower cost than a branch network. (sub. 29, p. 23)

ING also said that it:

> … leverages a network of independent mortgage brokers … since [it] judge[s] this to be a more cost effective way to access the market. (sub. 20, p. 5)

Many smaller lenders do not have extensive branch networks, in contrast to the major banks that, in many cases, have branch networks that pre-date the 1980s bank deregulation. In some cases, smaller lenders may not have branches at all. Therefore, a strategic decision to distribute through branches would require these lenders to invest significant resources in setting up branch infrastructure.

The costs of setting up a branch can be large. In 2011, the average start-up capital and costs for a Bendigo Community Bank were reported to be close to $1 million (Ferguson and Epstein 2011). In the case of Bendigo Community Banks, these costs are funded by the community. However, they would otherwise be borne by lenders. One major bank also said to us that it considered the average cost of setting up a branch to be approximately $1 million.

By contrast, distributing through the broker channel requires fewer upfront investments on the part of lenders. A lender may need to establish systems to communicate with brokers, which may include employing business development managers or making adjustments to IT systems. Once these systems have been established, lenders would only incur additional costs when a broker successfully places a loan and a commission payment is due.

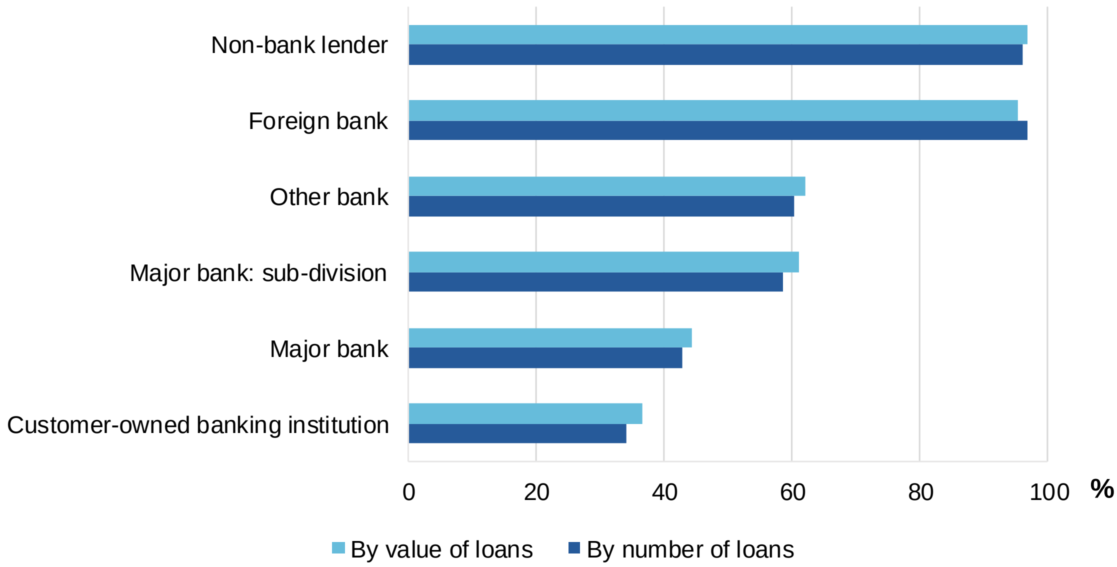
These dynamics lead many smaller lenders to be more reliant on brokers. As the Regional Banks (AMP, Bendigo Bank, BOQ, ME, Suncorp) said:

> … smaller banks are typically dependent on unbiased distribution networks to overcome the disadvantage of smaller physical branch networks and marketing budgets. (sub. 37, p. 63)

In recent years, non-bank lenders, foreign banks and non-major banks have originated a larger proportion of loans through brokers compared to the major banks (figure 11.3). Customer-owned banking institutions relied on brokers the least, despite most of these being small institutions. This may be due to these institutions' focus on providing more personal service to their customers, and as a result, building local branches to service particular regional communities. Other data from selected ADIs also showed that smaller lenders and foreign banks tended to originate a higher proportion of loans through the broker channel.

Figure 11.3 **Most smaller lenders are more reliant on mortgage brokers**

Proportion of loans originated through brokers in 2015, by type of lender[a,b]



[a] Non-bank lenders comprise Liberty Financial and Pepper Group. Foreign banks comprise ING Bank and Citigroup. Other banks comprise Bank of Queensland, Macquarie Bank, Members Equity Bank and Suncorp-Metway. Major bank subdivisions comprise Bankwest, Advantedge Financial Services and St George. Major banks comprise ANZ, CBA, NAB and Westpac. Customer-owned banking institutions comprise Credit Union Australia and Police & Nurses Limited. Where an institution type is represented by a small number of lenders, the aggregate proportion of loans originated through brokers may not be representative of the individual institutions. [b] Based on lenders' self-reporting of loans.

Source: Productivity Commission analysis based on ASIC unpublished data on lenders' self-reporting of loans (ASIC 2017x).

Based on analysis of ASIC data, we estimate that, by distributing loans through brokers, smaller lenders have on average increased their market shares by 1.55 percentage points. If mortgage brokers were not available, these lenders would need to have an additional 118 branches each on average in order to maintain their current shares in the home loan market. Mortgage brokers are thus integral to smaller lenders' ability to compete.

Brokers are not necessarily more cost-effective for larger lenders

Some larger lenders said that it is more cost-effective for them to distribute loans through proprietary channels rather than brokers. For example, Westpac said that:

> Our preference would be to write through our branch network, home finance managers. … Because of the cost. (PC transcript, 2018, p. 45)

Similarly, in giving evidence to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, CBA said that:

> … [loans that come through the proprietary channel] are more profitable, yes, but it is less the margin and more the other costs which are associated with that. There aren't the same commission costs associated with – with a proprietary loan versus a third party loan. (Royal Commission transcript, 2018, p. 234)

Whereas smaller lenders face material costs to set up branches, larger lenders often already have branch networks. Thus, they do not seem to consider these costs when assessing the costs of distributing loans through branches. As Westpac explained, the relevant consideration is the marginal cost of hiring an additional staff member to originate home loans.

> … in the case of proprietary flow of mortgages, or coming directly into Westpac, the decision you have there is how many home finance managers do you have. So do you employ a new person or not. So I wouldn't frame it around do you open a branch. Often we've got a branch there. … I think I would reframe it to say well, … how would you compare hiring a home finance manager versus using an external broker … (PC transcript, 2018, p. 44)

CBA also said that it assessed the costs of branch distribution based on marginal cost.

> … we've got a – you know, approximately 1000 branches and we don't take all of those costs and load them into the cost of the home loan, we sort of consider, "Well, those are fixed costs which exist there" and in that case we are able to utilise that network for our lenders. … when I think about the loans, I'm more thinking about it on a marginal cost basis, rather than a fully loaded cost basis. It is how I tend to run the business. (Royal Commission transcript, 2018, p. 234)

When comparing the marginal cost of employing a home finance manager compared to paying broker commissions, it is clear that home finance managers are more cost-effective for those lenders writing a large number of loans. Home finance managers represent a (largely) fixed cost, whereas brokers are paid for each loan successfully settled (a variable cost). Our analysis shows that — assuming the all-up cost of employing a home finance manager within a branch was $150 000 per year (based on advice from banks) — an employee would only need to originate approximately 27 average-sized loans each year to be more cost-effective than the broker channel (box 11.1). This is approximately one loan every two weeks. Data from the major banks suggested that they currently write much higher volumes than this.

Box 11.1 **How many loans would a home finance manager need to write to be more cost effective than the broker channel?**

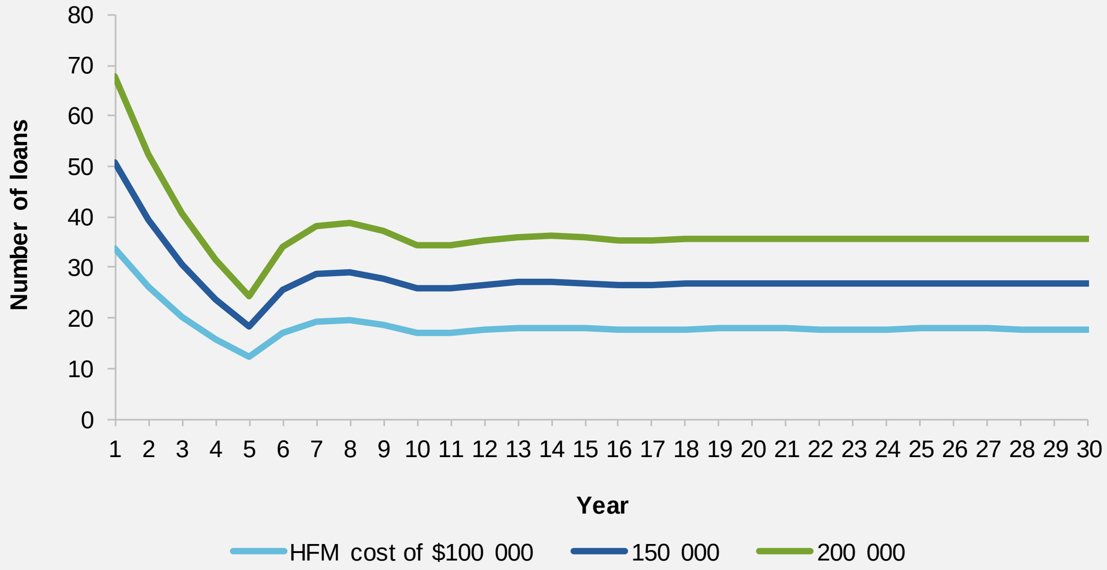
The Commission conducted analysis to determine the how many loans a home finance manager (HFM) within a larger lender would need to originate in order to be more cost effective than the broker channel. Broker commissions are paid on each successful loan, whereas employing a HFM is largely a fixed cost. A break-even point can therefore be determined at which HFMs would be more cost-effective than brokers.

The analysis made the following assumptions.

- The cost of employing a HFM is fixed at $150 000 per year. This cost includes the total salary package, training, insurance, taxes and other costs associated with employing a staff member, and is based on advice received from a selection of banks.
- Lenders pay upfront commissions of $2 289 and trail commissions of $665 per year for loans originated through brokers. These figures are based on ASIC's findings of average commission rates paid by lenders to aggregators, and the average size of a new home loan being approximately $369 000. (For simplicity, we have assumed that trail commission is paid on the initial loan amount rather than the outstanding amount. This assumption has only a marginal effect on the breakeven number of loans and does not affect the conclusion of the analysis)
- Home loans are refinanced with a different lender every 5 years.
- The cost of employing a HFM is equivalent to the amount that would otherwise be paid to the broker channel in *each* year of the analysis.

Based on these assumptions, over the long term a HFM would need to originate 27 average-sized home loans per year (approximately one every two weeks) before they would be considered more cost effective than the broker channel (figure below). If, instead, the cost of employing a HFM was only $100 000, the HFM would only need to originate 18 loans each year. A cost of $200 000 would require the HFM to write 36 loans a year, which is still significantly less than the number of loans that HFMs are currently writing.

Number of loans required to break even with the broker channel over time



Source: Productivity Commission estimates

That said, large lenders are likely to have a weaker preference to retain branches (and may even prefer to use brokers) for home loans in some regional areas. This is because regional areas tend to have lower population densities, which would likely translate into fewer loans across which to spread the fixed costs of a branch.

FINDING 11.2 BROKERS ARE A COST-EFFECTIVE WAY TO DISTRIBUTE HOME LOANS FOR LENDERS WITHOUT WIDESPREAD BRANCH NETWORKS

For smaller lenders without national branch networks, brokers tend to be a more cost-effective distribution channel than branches, since branches involve a significant investment. Competition is thus assisted by the presence of brokers.

Larger lenders with established branch networks generally find brokers less cost-effective than existing branches.

Consumer preferences compel larger lenders to engage with brokers

Despite the stated preferences of some larger lenders to distribute loans through their proprietary channels, an examination of aggregators' panels showed that these lenders have nevertheless engaged heavily with the broker channel. Of the 23 aggregator panels that we examined, the vast majority included the major banks and a number of their subsidiaries (figure 11.4).

Lenders explained this apparent paradox by pointing to their inability to direct potential borrowers towards their preferred channel.

> … the concept that you can choose to direct the flow I don't think works because it's a customer choice about where they go. (Westpac, PC transcript, 2018, p. 44)

This inability has meant that, in light of consumers increasingly approaching brokers to obtain home loans, lenders have chosen to make their loans available through the broker channel as a matter of commercial necessity, rather than as an active strategic decision.

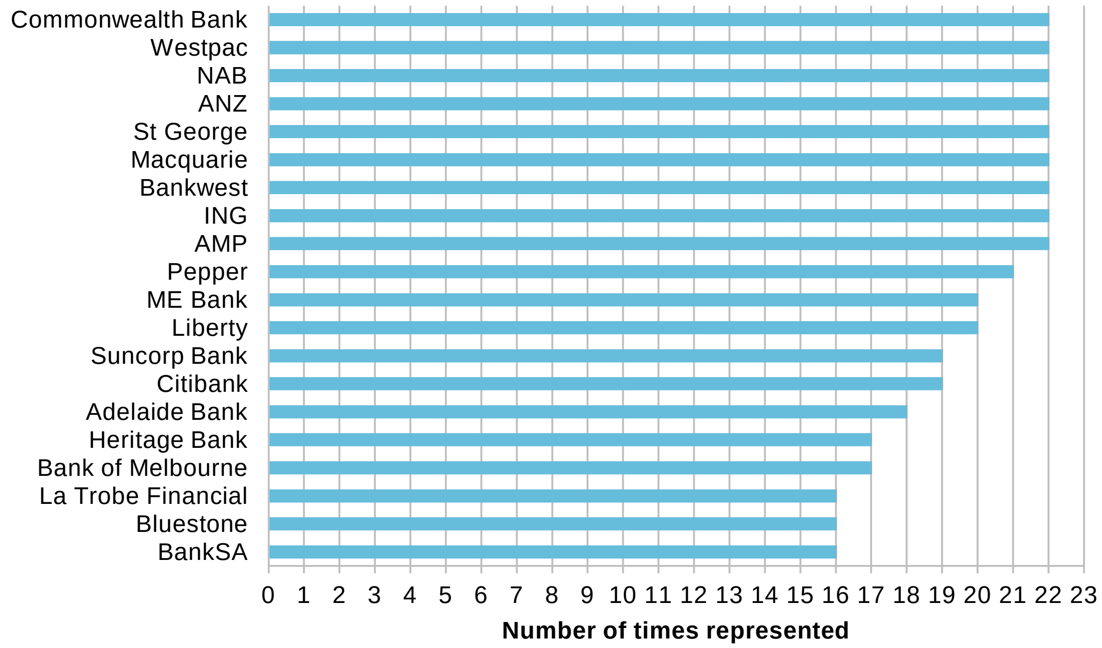
> Regardless of the economics of each channel, consumers are choosing in increasing numbers to use mortgage brokers and for lenders to be competitive they will choose to distribute loans through mortgage brokers. (CIF, sub. DR106, p. 6)

The decisions of larger lenders to engage with the brokers channel are therefore likely to have been made somewhat reluctantly. As CHOICE noted:

> … our sense is that the banks have a love/hate relationship with brokers. Because on the one hand … they resent the high commissions that they have to pay to get mortgages that are originated by brokers. On the other hand it's a very effective channel, and we know from the ASIC data that it also tends to bring in higher value loans. (PC transcript, 2018, p. 10)

Figure 11.4 **Which lenders appear most frequently on aggregators' panels?**

Number of times each lender appears within the 23 panels examined[a,b]



[a] The Commission examined the panels of 23 aggregators, which represented large and medium aggregators and a selection of smaller aggregators (listed below in the sources to this chart). As noted in section 11.1, the total number of aggregators in the market is unknown, but publicly available information suggests there are approximately 50. [b] Centrepoint Alliance's panel did not include ANZ or Westpac, and Citiwide's panel did not include the Commonwealth Bank or NAB.

Source: AAA Mortgage Solutions (2018), Aussie Home Loans (2018), Australian Finance Group (2018), Ballast (2018), Bernie Lewis Home Loans (2018), Centrepoint Alliance (2018), Choice Aggregation Services (2018), Citiwide (2018), Connective (2018), Custom Equity Group (2018), eChoice Pty. Ltd. (2018), Finance & Systems Technology Pty. Ltd. (2018), Finconnect (2018), Finsure (2018), Loan Market (2018), Mortgage Choice (2018), My Local Broker (2018), National Mortgage Brokers (2018), Outsource (2018), PLAN Australia (2018), Smartline (2018), Vow Financial Pty. Ltd. (2018) and Yellow Brick Road (2018)

Over time, aggregators have also begun to offer white-label loans, which are offered under the aggregator's brand but funded by another financial institution (box 11.2). Some consumers have a preference for white-label loans, due to their reputation as 'no frills' loans or trust in the aggregator's brand.

White-label loans make up an increasing share of loans written through brokers (Bendel 2017), with the result that lender-branded loans are losing out. Individual lenders therefore have an incentive to fund white-label loans in order to maintain market shares, despite this supporting yet another addition to the panoply of brands. In many cases, the opportunity to fund an aggregator's white-label loan arises through ownership of the aggregator, although arrangements to fund white-label loans also exist independently of ownership.

Box 11.2 **White-label loans**

White-label loans are loans that carry an aggregator's brand, but are funded by another (generally mainstream) financial institution. White-label loans add to the welter of brands and alter competitive dynamics in the home loan market. Aggregators become de-facto manufacturers of products as well as distributors, which can make those loans more profitable for the aggregator.

This can change aggregators' focus from simply distributing other lenders' loans (with objectively indifferent views on the 'best' product) to selling their own white-label loan, creating a conflict of interest for aggregators and brokers (CBA, sub. DR79). As Maria Rigoni, a broker, explained:

> The original concept of aggregation was for one business to gather many competing small enterprises results to obtain a better outcome for all the businesses involved. "Broker Groups" are designed to create a distribution channel of the aggregators own brands of loans to be positioned as priority products over other channels. The mortgage broker proposition is being changed from that of a mortgage broker service to a broker group Whitelabel sales force. (sub. 46, p. 3)

White-label loans may also provide an incentive for the aggregator not to include on their panel other products that would compete the white-label loan or reduce its attractiveness. One mortgage manager said that they faced increasing difficulties in gaining access to aggregator panels, and that lenders were increasingly precluding brokers from recommending loans off-panel. (Mortgage managers access lines of credit from funders, and issue loans under their own brand. In this way, mortgage managers perform similar roles to aggregators issuing white-label loans. However, mortgage managers generally take a more active role in the application process and subsequent management of the loan. The precise responsibilities of the mortgage manager dependent on the arrangements it has with lenders, and the distinction between loans issued under a mortgage manager arrangement and white-label arrangement is not always clear (ASIC 2017x).

These circumstances lay the groundwork for lenders' decisions to *own* aggregators.

Some lenders, observing the development of the market towards the use of brokers and away from their proprietary channels, have considered it worthwhile to own aggregators, since this allows them to share in aggregator's profits and reduce the net costs of the broker commissions. Where that lender funds the aggregator's white label loans, they also earn a profit from those loans. Moreover, by owning an aggregator, a lender gains the *opportunity* to influence the products recommended to consumers by brokers working under that aggregator, which can enhance its competitive position. As noted below, lenders said that they did not take advantage of this opportunity.

Do lenders use ownership to their competitive advantage?

The ownership of an aggregator creates the potential for lenders to exercise influence over loan flows. This could be done in several ways.

- Lenders that own aggregators could influence the aggregators' panel, as well as the extent to which brokers operating under them can recommend loans 'off-panel'. Exercising such influence would limit the competition that the lender faces on the aggregator's panel.

- An integral part of the aggregator business model is the use of (often proprietary) software to summarise a large number of loan options to select one that meets a customer's requirements. It is plausible that such software, when faced with two largely equivalent loan products (from the consumer's perspective), might be programmed to recommend the product offered by the aggregator's owner over the product offered by another lender.
- Owning an aggregator gives lenders access to data on the volume of loans settled with each of their competitors, the associated loan pricing and features, the commissions paid to brokers, and the profiles of borrowers selecting different types of loans. Lenders could conceivably use this data to offer products, prices or commissions that increased their market share. In some cases, such as where consumers are offered a lower price, this could be beneficial for competition in the market. However, if this data were used to offer higher commission rates, brokers and lenders would benefit at the expense of consumers.

Industry participants asserted that lenders did not take advantage of these opportunities. For example, brokers testified that the ownership of aggregators had no bearing on the loans they recommended to consumers.

> … I can assure the Commission that these independently owned mortgage brokers that just so happened to be sitting within aggregation businesses owned by banks, they are not swayed, influenced at all, by the lenders that just so happen to own their aggregation businesses. (Money Quest, PC transcript, 2018, p. 277)

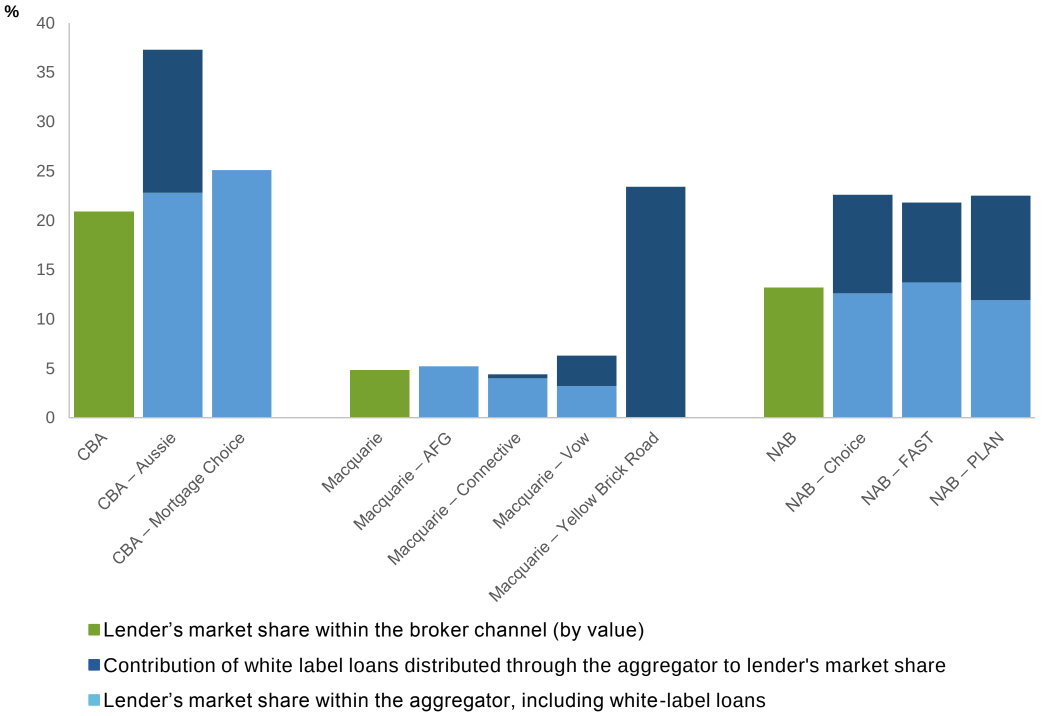
The FBAA (PC transcript, 2018, p. 242) also said that it was unaware of any situations where lenders applied pressure on aggregators they owned to select certain lenders over others, and they perceived it was highly unlikely that this would be occurring.

One major bank advised us that it applied strict ethical boundaries to ensure that the aggregators it owned did not favour the bank's loans over its competitors', and that, as a result, it did not receive a disproportionate share of its own-branded loans from these aggregators compared to its overall market share.

Yet the data shows that while ownership of an aggregator does not necessarily allow a lender to gain a disproportionate share of the aggregator's business through its *own-branded loans*, it does enable the lender to capture a greater share through *white-label loans* (figure 11.5). ASIC (2017x) found that when including white-label loans, the share of an aggregator's business that a lender was able to capture was substantially larger if the lender had an ownership interest in the aggregator.

Lenders therefore appear to benefit from aggregator ownership by: gaining a greater share of aggregators' business (largely through white label loans); potentially greater control of the home loan distribution channel and competitors' use of it; and the scope to recoup a portion of commissions paid. This cannot happen without other lenders getting a disproportionately lower access to consumers through those aggregators owned by lenders.

Figure 11.5 **White label loans allow lenders to substantially increase their share of business from owned aggregators[a,b]**



[a] CBA did not fund any white-label loans for Mortgage Choice. For Macquarie – AFG and Macquarie – Connective, the volume of white-label loans was minimal as Macquarie only began issuing white-label loans for these aggregators in late 2015. Macquarie sold its interest in AFG in September 2016. [b] Based on aggregators' self-reporting of loans made by specific lenders.

Source: ASIC review of mortgage broker remuneration (ASIC 2017x)

In terms of loan interest rates, there is no significant difference in the rates the major banks have charged between the aggregators they own and do not own, and for loans via direct channels.

Lenders were not forthcoming when we asked them to explain the benefits of aggregator ownership. But regardless of whether their ownership allows them to exercise influence over the aggregator, the potential for them to do so and the adverse ramifications for market structure and outcomes should not be underestimated.

In this vein, the best interest obligation proposed in section 11.5 is intended to address in part the potential for conflicts of interest, to ensure that consumers continue to benefit from having brokers in the home loan market.

11.4 Mortgage broker commissions

The main way in which brokers are remunerated is through commissions, which are paid by lenders (ASIC 2017x). Typically, commissions include:

- upfront commissions, paid as a lump sum at the time the loan is originated and calculated as a percentage of the loan value

- trail commissions, paid over the life of the loan, where each instalment is calculated as a percentage of the outstanding loan value — in some cases, the percentage increases over time.

Industry participants have committed to removing bonus commissions (paid when certain criteria are met, such as the total value of loans written or the rate of applications converted into settlements) as part of recent industry-led reforms (box 11.3). But the evidence of actual implementation of these commitments is thin on the ground. Nevertheless, the Commission supports some of the proposed measures and recommends that these be implemented as part of an enforceable Code created and imposed by ASIC (recommendation 11.2).

The Commission sought data from ADIs regarding schedules of commissions paid to brokers over time, but very few ADIs provided this information. Other data obtained by the Commission showed that broker commission rates increased in the period from 2002 to 2007, decreased between 2007 and 2012, and have since increased slightly (figure 11.6).

What is the purpose of commissions?

A number of participants contended that commissions are intended to reflect the work that brokers perform as part of originating a home loan (CBA, sub. DR79; NAB, sub. DR94).

> Mortgage broker remuneration – both upfront and trail is structured to remunerate brokers for the work they perform. Brokers undertake much of the work on behalf of the lender which would normally be done by branch staff and or head-offices. In many cases lenders require brokers to undertake additional work to help the lender discharge their legal obligations. (FBAA, sub. DR85, p. 9)

However, several participants attested that the effort or cost involved in originating a home loan does not primarily depend on the size of the loan (FINSIA, PC transcript, 2018, p. 92; Money Quest Australia, PC transcript, 2018, p. 274). Thus, the payment of a commission for a loan is more properly characterised as a reflection of the value that the loan represents to the lender, rather than a reflection of the effort involved.

Commission-based remuneration has implications for the incentives that brokers face. Most obviously, 'upfront and trailing commissions incentivise sales' (Sedgwick 2017, p. 33). How commissions are calculated can also affect broker behaviour. ASIC (2017x) identified two ways in which commissions can create conflicts of interest.

- Lender choice conflict — whereby the broker has an incentive to favour lenders that pay higher commissions, even if that loan is not the best loan for the consumer.
- Product strategy conflict — whereby the broker has an incentive to favour borrowers taking out higher loans, and could involve recommending a particular product or strategy to maximise the amount that the consumer borrows.

Box 11.3 A start to industry-led reforms in mortgage broking?

In May 2017, representatives from the mortgage broking industry — including the Australian Bankers' Association, the Customer-Owned Banking Association, aggregator groups and broker businesses — formed the Combined Industry Forum (CIF) to respond to the proposals from ASIC's 2017 Mortgage Broker Remuneration Review and the recommendations from the 2017 Sedgwick Review. In December 2017, the CIF set out a package of reforms. This included a commitment to achieve 'good customer outcomes', defined as a borrower having obtained a loan that:

- is appropriate in terms of size and structure
- meets the customer's stated requirements and objectives
- is affordable for the customer
- is applied for in a compliant manner, meeting all responsible lending requirements.

Other measures include:

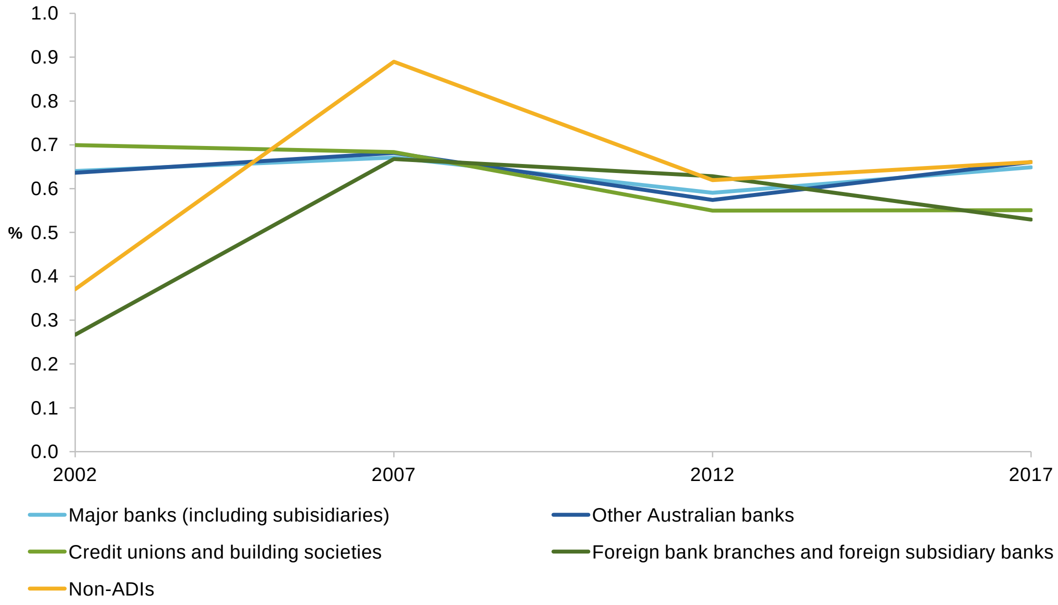
- upfront and trail commissions to be paid on the funds limit drawn down by customers net offset account balances, instead of the limit of the loan facility
- the industry to cease the practice of offering volume-based commissions (commissions that increase if an aggregator writes a certain amount of business), volume-based payments (payments other than commissions conditional on a certain volume of loans being written), and campaign-based commissions (where higher commissions are offered for a short period of time)
- access to exclusive benefits (such as priority service and hospitality events) to be determined using a balanced scorecard with a maximum 30% volume component
- conferences and professional development events to include a minimum of 80% educational content and be held at business-appropriate locations
- the provision of entertainment and hospitality to be capped at $350 per person per event, and lenders, brokers and aggregators to maintain a register for entertainment or hospitality valued at over $100 (given or received)
- ownership structures to be disclosed to consumers
- a public reporting regime to be implemented to provide ASIC and consumers with data on the number of lenders used by each aggregator, the proportion of business written by aggregators with each lender, and average commission rates paid by lenders
- an improved governance framework to be developed, incorporating key risk indicators that lenders must report to aggregators and unique identifiers for credit professionals.

Bonus commissions were planned to be removed by the end of 2017, but we have not received any evidence that this has occurred universally. Members of the CIF have also committed to implementing most of the remaining reforms by the end of 2018, and the improved governance framework is proposed to be implemented by the end of 2020.

Source: ABA et al. (2017); ASIC (2017x, sub. 40).

Figure 11.6 **Commission rates over time[a]**

Average upfront commission rates paid by lenders (% of loan value)



[a] Data are for the years 2002, 2007, 2012 and 2017 only. The lenders included within some categories changed over time, for example as some banks were acquired by major banks.

Source: Unpublished industry data

However, brokers and aggregators suggested that commissions are not the sole or primary driver of broker behaviour. In particular, some brokers attested that they were primarily motivated by the interests of their customers (Money Quest Australia, sub. DR57).

> [T]he main incentive which motivates brokers in their work is the incentive to achieve good outcomes for their customers. Brokers' incentives cannot be understood simply by adding up the dollars on either side of the ledger in any given transaction. (REA Group, sub. DR80, p. 13)

It was also submitted that the incentives created by commission payments were tempered by brokers' reliance on reputation and relationships with clients.

> Brokers already have a strong business incentive to act in the interests of customers, given that a broker's business is based on the relationship model and is contingent on customer referrals, established by a history of good customer outcomes. (MFAA, sub. DR86, p. 4)

Studies by Deloitte (2016a) and Retail Finance Intelligence (2009) provide some support for this claim. According to these studies, most people choose their broker either because of recommendations by family and friends or because they had previously sourced a home loan through them. In addition, once a customer had established a relationship with a broker, they were highly likely to return to them for future home loan needs and unlikely to turn to other brokers when refinancing.

We accept that many brokers are likely to be motivated by the welfare of their clients, whether due to their reliance on these relationships for future business or the intrinsic value they derive from providing a good service. However, we ultimately consider it implausible that the industry as a whole is unaffected by the substantial incentives created by commission-based remuneration. And, as discussed below, these incentives are overwhelmingly stacked in favour of the party paying for commissions — that is, the lender.

Commission clawbacks

Brokers are often required to pay back some or all of the upfront commissions they receive for a loan if it is paid off or refinanced within a certain time period, or the borrower defaults on the loan (a 'clawback') (ASIC 2017x). Typically, the clawback period runs for between 18 and 24 months after the loan is originated, with 100% of the upfront commissions being repayable if the loan is discharged within 12 months and 50% thereafter.

Clawbacks serve at least two purposes from a lender's perspective. First, clawbacks are a mechanism for lenders to recover the cost of originating a home loan (AFG, sub. DR71; NAB, sub. DR94; Connective, sub. DR104). In essence, this means that lenders are able to pass on to aggregators and brokers the risks associated with loans being discharged prematurely.

> And for me, the clawback is the transference of commercial risk from the lender to the broker; it's clear-cut. And because [brokers] have no negotiation right in any remuneration contract, we're left sitting there. (Maria Rigoni, PC transcript, 2018, p. 253)

Clawbacks also enable a lender to overcome the information asymmetries that arise because the broker interacts directly with the customer, while the lender the does not. This direct interaction allows brokers to glean additional information about a customer's likelihood of refinancing or defaulting the near future, which they might have an incentive to withhold from lenders in the absence of clawback.

Clawback can therefore align brokers' incentives with lenders' by ensuring that only creditworthy clients are offered loans, and that clients are not offered products that are clearly unsuitable for them (since they are likely to discover this shortly after being placed into the loan, and may then wish to refinance). These incentives benefit borrowers by ensuring they are not offered loans that differ wildly from their needs or ability to service a loan, which supports the provisions in the Credit Act that also safeguard against this.

However, clawbacks also provide a disincentive to refinance a loan (within the clawback period), regardless of whether the borrower would be better off doing so. In the first instance, clawback can deter a broker from recommending that a client switch to another lender, muting their ability to act as a conduit for demand-side pressure. We also received evidence that, in some cases, brokers were passing on the clawback to borrowers, which would directly discourage them to switch.

> On one occasion, our client was unsatisfied with the service provided by the broker and wanted to refinance the loan so as to no longer be associated with that broker. The broker later contacted the client advising that their commission had been clawed back by the lender and so the broker was in turn clawing it back from the customer. (Consumer Action Law Centre, PC transcript, 2018, p. 216)

Comments made during hearings drew parallels between clawbacks and early exit fees, which allowed lenders to recoup losses associated with a borrower exiting the loan early (Consumer Action Law Centre, PC transcript, 2018, p. 216; FBAA, PC transcript, 2018, p. 235). Early exit fees were banned in 2011 because they were considered one of the biggest roadblocks to refinancing.

The reforms that banned exit fees gave ASIC the power to enforce the ban and to ‘stop banks re-badging an unfair exit fee as another type of charge’ (Swan 2011). However, ASIC considered that its powers in relation to prohibiting early exit fees did not extend to clawbacks, since, unlike exit fees, the charge was not levied directly by the lender onto the borrower.

> The prohibition in reg 79A [of the National Consumer Credit Protection Regulations 2010 (Cth)] would not generally cover a fee related to clawback that is imposed by a broker (or an aggregator), as the fee would not be imposed under or provided for in the credit contract [between the lender and borrower]. (pers. comm., 8 June 2018)

We consider that, where the commission clawback is passed onto the customer, it creates the same disincentive to refinance as an early exit fee. To eliminate gaps in the law, the Commission recommends an express prohibition on commission clawback being passed on to borrowers.

In recognition of the positive short-term effects of clawbacks when levied on brokers, however, we have not recommended banning the practice of clawback altogether. Instead, clawbacks should be allowed only within the first 24 months of the loan being originated, since a consumer is less likely to benefit from refinancing within this period. Although clawbacks only tend to operate for up to 24 months currently, a legal restriction is worthwhile given that some of our other recommendations may create the incentive for lenders to extend the clawback period.

Trail commissions

In addition to upfront commissions, brokers usually receive trail commissions, which are paid on a regular basis throughout the life of the loan. The payment of trail commissions is tied to whether the customer remains in the loan — it ceases to be paid once the borrower ceases to make repayments on the loan, whether through discharge of the mortgage or default on loan repayments.

Inquiry participants put forward a range of (sometimes conflicting) views as to why trail commissions are paid and what their effect is on broker behaviour. Broadly speaking, the rationales put forward by participants can be characterised as:

- to influence the level of refinancing, including disincentivising ‘churn’
- to align the interests of the broker with those of the lender
- to remunerate brokers for providing ongoing services to their clients.

Effect on refinancing

A number of participants said that trail commissions are designed to influence broker behaviour in relation to helping borrowers switch and refinance. Notably, brokers and aggregators tended to describe trail commissions as discouraging ‘churn’ (FBAA, PC transcript, 2018, p. 233; MFAA, sub. DR86; REA Group, sub. DR80), with the implication that the type of refinancing that was being discouraged was motivated by brokers pursuing upfront commissions, and was not in the interest of the borrower.

The Combined Industry Forum (CIF) also observed that, for many consumers, refinancing is not the best option.

> If the loan is established in line with the customer’s requirements and objectives, there are very few reasons in the customers interests to switch the loan regularly and frequently. Regular and frequent switching increases administrative costs, which may be passed on to the consumer, without corresponding savings in fees or interest rates. It is also industry practice for a broker to negotiate a better deal with the client’s existing lender, rather than refinance or refinance with a new lender. (sub. DR106, p. 10)

Brokers may generally be presumed to be aware of prevailing market conditions, which may enable them to negotiate with a borrower’s existing lender relatively effectively, even if they did not first look elsewhere. However, approaching an existing lender should not presumed to be the best option, and any such presumption would raise the question of whose interests brokers are really acting in.

However, CHOICE argued that trail commissions can also discourage refinancing that *is* in the interest of the borrower.

> Trail commissions … simply encourage brokers to never approach a client again and encourage them to review their circumstances … we do want a situation where consumers are encouraged to review their circumstances from time to time and where it’s in their best interests to switch products or switch lenders. Trail commissions discourage that. (PC transcript, 2018, p. 6)

Some stakeholders argued that the payment of trail commissions has no bearing on refinancing decisions at all (AFG, sub. DR71; REA Group, sub. DR80).

> Trail does not restrict the movement to restructure or refinance a loan, should such need be the consideration for the best interests of the borrower. So if a trail stops with one lender, it then restarts with another. It is not the barrier for movement. (FBAA, PC transcript, 2018, p. 233)

However, if this is true, it also stands to reason that trail commissions create an incentive for brokers to prefer doing business with new clients, rather than help their existing clients refinance. This is because, for a new client, a broker would receive a new upfront commission payment and a new stream of trail commission payments, whereas helping an existing client refinance would yield a new upfront commission payment only.

Moreover, the argument that brokers are 'neutral' about refinancing is not persuasive in light of the prevalence of 'ramping' trail commissions — that is, where the rate at which trail commissions are paid increases over time. Under these arrangements, brokers face a disincentive to help their clients refinance with a new lender because they stand to lose the higher commission rate that has accrued over time. For this reason, some participants supported a ban on ramping trail commissions (for example, AFG, sub. DR71), although there have been no moves to put this into practice.

Alignment of interests

A related, but distinct, argument put forward by participants was that trail commissions are designed to align the interests of the broker with that of the lender in general (not just in relation to client retention). This is done by giving the brokers a stake in the maintenance of the loan, and hence a stake in the interests of the lender, through the mechanism of terminating trail commissions payments if loan repayments cease to be made.

According to REA Group, this gives brokers an incentive to put forward customers who have a lower probability of default, which is in the interest of lenders.

> (a) if the loan is successfully paid down to completion, the broker continues to receive trail;
>
> (b) if the loan falls into arrears, the broker loses their commission … (sub. DR80, p. 13)

Some participants also submitted that this incentive structure benefits borrowers; the incentive to minimise the risk of default in part requires an assessment of whether a loan is affordable for the borrower.

> Trail commissions ensure alignment of interests between a lender, aggregator, broker and customer over the life of a loan. For example, if a loan goes into arrears (60+ days); is refinanced for any reason (including if it becomes uncompetitive or inappropriate for the customer's needs); or if fraud is uncovered, the trail commission income flow will cease. (MFAA, sub. DR86, p. 16)

While it is true that borrowers benefit from being matched with affordable loans, this is a consequence of the lender's preference for customers who are less likely to default. In fact, the mechanism goes no further than incentivising brokers to match customers with loans that are affordable — beyond that, it does not create an incentive to recommend loans that are better or less costly for the borrower.

Remuneration for ongoing services

Many participants asserted that the purpose of trail commissions is to support brokers providing ongoing services to clients (box 11.4). This was said to include assisting clients in managing their home loan, as well as pursuing refinancing opportunities (at unspecified future dates).

Box 11.4 **Participant views on the purpose of trail commissions**

Money Quest Australia:

> Trail commissions are paid to mortgage brokers with an expectation from lenders that mortgage brokers manage their customers throughout the life of loan; lenders do not have this capacity and trail commission represents our remuneration for doing this work (sub. DR57, p. 4)

Home Loan Experts:

> The purpose of trail is to incentivise brokers to stay in contact with their customers and to service their needs for many years after the mortgage is set up … Mortgage brokers that do not remain in contact with their past customers are likely to lose those customers and, therefore, lose their trailing commission. (sub. DR70, pp. 1-2)

Mortgage & Finance Association of Australia:

> The current standard commission model includes upfront commission paid on settlement of the loan, in recognition of economic value created by the broker for the lender, and trail commission paid over the life of a loan, which supports the broker in providing ongoing service to their customer base over time … Importantly, trail defers payments of broker income to coincide with the provision of services over time. (sub. DR86, pp. 15-16)

John Evans:

> I am not a huge bank owned entity, if you force a removal of trail onto the industry, you will kill us. To expect me to maintain my level of service and continue to refinance loans that to go from trail, to no trail is too much to ask. Overseas environments that do not pay trail, pay a considerably higher upfront. (sub. DR55, p. 1)

Westpac:

> Payment of a trailing commission is intended to promote an ongoing relationship between the broker and the customer. (sub. DR125, p. 16)

Commonwealth Bank of Australia:

> As in other financial services products, a combination of upfront and trailing commissions has been used to balance the upfront and ongoing costs of establishing and maintaining a customer relationship … Trail commission payments are made to compensate brokers for the ongoing costs associated with servicing and maintaining home loans. (sub. DR79, p. 53)

But CHOICE pointed to the illogicality of lenders remunerating brokers for services provided to the borrower:

> … the trail commissions are not being paid by the client. The trail commissions are being paid by the lender. So I don't understand the argument that says that it encourages an ongoing relationship with the client. (PC transcript, 2018, p. 6)

The illogicality is especially acute when one acknowledges that those ongoing services could drive some borrowers to refinance with a different institution, potentially causing the lender to lose business.

During consultation, we sought evidence to substantiate the connection between trail commissions and the ongoing provision of services to clients — such as agreements, contractual terms or policy documents exhibiting an expectation or requirement that those services be performed. During hearings, participants said there was no formal documentation of those expectations or requirements (for example, Maria Rigoni, PC transcript, 2018, p. 253; Money Quest Australia, PC transcript, 2018, pp. 280-281). The Commission also requested information from ADIs about whether their agreements about commissions required brokers to provide ongoing services in order to receive trail commissions. Almost all respondents said that their agreements did not include such a requirement. Moreover, none of the respondents required brokers or aggregators to report on whether those services had, in fact, been provided.

If the genuine purpose of trail commissions were to support the provision of ongoing services, we would expect the conditions that govern their payment to be formulated differently.

- First, the quantum of commission paid would reflect the cost or value of providing ongoing services, rather than the value of the outstanding loan.
- Second, we would expect to see documentary evidence of a requirement that particular services be provided. For example, agreements between lenders and brokers could include an explicit statement of the services to be provided. Alternatively, these agreements could include a contractual stipulation that the payment of trail commission is conditional upon the performance of particular services. It could also be evidenced by a mechanism for monitoring or reporting whether services have been rendered.

Neither of these arrangements are prevalent in the industry today. The reality is that trail commission is and has been paid even when services are not provided. For example, commissions often continue to be paid on trail books that are sold to a different broker (CHOICE, PC transcript, 2018, p. 6) or after a broker has retired.

We do not doubt that many brokers do provide ongoing services to their clients (box 11.5). And perhaps many do so with the understanding that trail commission is intended to remunerate them for this work. Some participants also said that brokers would not be able to provide ongoing services to clients in the absence of trail commissions (John Evans, sub. DR55). However, given brokers' claim that their businesses depend on their relationships with clients (as discussed above), they would likely be willing to provide some of these services regardless of remuneration.

Box 11.5 Brokers provide ongoing services

Brokers provide a range of ongoing services to their clients. Money Quest Australia said that it undertook regular review of their clients' loans.

> The first review we undertake is around the five week mark, and we contact our clients, either over the phone or we ask them to come in, and that is very important because we make sure that they're direct debits and they're off-set accounts have been correctly linked … We then do the next review at 12 months. And at 12 months it's really just checking in, seeing how mortgage clients are coping with their loan repayments. (PC transcript, 2018, pp. 277-8)

Similarly, John Evans said:

> My son and I revisit our customers every 3 years, to review their loan and circumstances. The majority of the time we are able to find an improved loan and the customer walks away better off. (sub. DR55, p. 1)

Brokers are sometimes also the first port of call when borrowers experience problems with their loans. Maria Rigoni said:

> And I've had an instance twice over the last couple of days: one on Friday night and one yesterday actually, where clients have contacted me and said, "I've received this email from my bank Maria, I don't understand it. Can you explain what it's about?" … have no problem, that's part of my role because I introduced that client to [the loan]; they are unsure of what's going on, please ask me. (PC transcript, 2018, p. 253)

We consider that brokers are not (directly) remunerated for the provision of ongoing services, and that they fund these activities with earnings from other parts of their business (such as writing loans) as a matter of practice. This is supported by the fact that the scope of services that brokers are expected to provide has increased over time, with no commensurate increase in the value of trail commissions paid (Maria Rigoni, PC transcript, 2018, p. 258; Money Quest, PC transcript, 2018, p. 278).

This arrangement is advantageous for lenders because it allows them to provide less customer service directly, while asserting that they enable brokers to provide these services.

FINDING 11.3 TRAIL COMMISSIONS ARE NOT CONSISTENT WITH BORROWERS' INTERESTS

There is little if any evidence to substantiate the claim that trail commissions are a payment for the ongoing provision of services to borrowers.

In practice, trail commissions have the effect of aligning the broker's interests with those of the lender, rather than those of the borrower.

Current remuneration structures work against consumer interests

Ultimately, the Commission was not able to ascertain a credible rationale based on consumer interests for the structure of broker remuneration. Taken together, the conditions that govern whether and how much commission is paid has the effect of creating a range of different, and at times countervailing, incentives. This has made it easy to rationalise different aspects of remuneration arrangements in different ways. As the National Australia Bank said:

> If there was an upfront commission only then you may say … would there be an economic driver for a broker to put the customer into a new product to receive the new commission. If there was a trail only, you may say the broker would win the customer and then they'd just go and try and win another new customer to build their ongoing trail book. (PC transcript, 2018, p. 172)

What has resulted is a particular set of remuneration arrangements that have become entrenched in the mortgage broking industry as a matter of convention.

The entrenchment of these arrangements has likely been underscored by the fact that firms within the industry appear to be reluctant to unilaterally change their practices, due to first mover disadvantage. During hearings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, CBA said it would be reluctant to unilaterally change its remuneration arrangements for fear of losing business.

> Any changes will need to be made uniformly across the industry and across both proprietary and broker channels to eliminate bias and avoid significant market disruption … there is a first mover problem in that the person who moved first would likely — you know, lose a lot of volume. (Royal Commission transcript, 2018, p. 242)

Likewise, the Sedgwick Review into retail banking remuneration considered that a market-driven move to fee-based remuneration had effectively been precluded by first mover disadvantage.

> It is possible that an individual bank would be unwilling to move in this direction for fear of suffering a first mover disadvantage. This could arise, for example, if a fee based payment structure led to a lower payment for simple cases and a larger payment for complex ones, relative to current commissions. (Sedgwick 2017, p. 37)

Overall, the conditions in the mortgage broking market do not appear to favour reform driven by individual market participants. This has limited the extent to which the market has been able to incrementally change over time to respond to community expectations. And, on balance, current remuneration structures do not align the interests of mortgage brokers with those of their clients.

In line with the recommendations of the Murray Financial System Inquiry, reforms are currently underway to give ASIC a proactive intervention power for financial products where there is a risk of significant consumer detriment. The Australian Government is undertaking consultation on an exposure draft of the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (Cth). This new power would not enable interventions in relation remuneration arrangements generally, but there is an exception 'where the remuneration arrangement is contingent upon the achievement of objectives directly related to the financial product' (Australian Government 2017j, p. 41).

According to ASIC, this exception could empower it to intervene in the remuneration arrangements, to break a deadlocks that result from first mover disadvantage.

> ASIC considers that the intervention power is intended to, and in any case should, extend to allowing ASIC to make prohibitive orders in respect of the remuneration that is linked to a product. Given that significant consumer detriment in financial services is caused by the misaligned incentives constituted by remuneration structures, a product intervention power that can reach those structures would equip ASIC to help break first mover deadlocks that emerge in the future, by expression prohibiting remuneration structures that result in significant consumer detriment. (ASIC 2018n, p. 9)

However, the current proposed Bill would not allow ASIC to make intervention orders lasting more than 18 months. As such, there is limited scope for ASIC to use this power to effect reform and influence conduct over a longer time frame. In addition, the product intervention power could not be used in relation to some types of remuneration. For this reason, the Commission has made recommendations to directly reform mortgage broker remuneration, rather than rely on the product intervention power.

RECOMMENDATION 11.2 REFORMING MORTGAGE BROKER COMMISSION STRUCTURES

An enforceable Code applying to all mortgage lenders should be created and imposed by ASIC, to implement the following reforms to broker remuneration structures:

- ban the payment of trail commissions in mortgage broking for all loans originated after end-2018
- require upfront commissions to aggregators and brokers to be paid based on the funds limit drawn down by customers, net of offset, instead of the limit of the loan facility
- ban the payment of volume-based commissions, campaign-based commissions and volume-based payments
- limit to two years the period over which commissions can be clawed back from aggregators and brokers.

RECOMMENDATION 11.3 REFORMING COMMISSION CLAWBACK ARRANGEMENTS

The Australian Government should extend the ban on early exit fees to explicitly prohibit commission clawbacks being passed on to borrowers. ASIC's powers should be expanded to allow it to enforce the ban.

Could brokers be paid fees-for-service?

Under a fee-for-service model, brokers would be paid a fee for the services that they provide. These fees could be paid by lenders, consumers, or a combination of both. The Commission has not recommended the adoption of fee-for-service remuneration in mortgage broking, for reasons set out below.

Should lenders pay fees?

Under current remuneration structures, commission payments reflect the value of brokers as a source of additional business (section 11.3). Nothing prohibits a lender from paying brokers in fees, but this practice has not emerged in the industry.

A ban on commission-based payments in favour of fees would not eliminate the conflicts of interest that brokers face. While such a ban may address the product-strategy conflicts (that is, the incentive to prefer larger loans), it would not address lender-choice conflict (the incentive to prefer lenders that offer higher payments). This is because a lender could still offer higher fee-for-service payments than its competitors, in order to win referrals from brokers.

In fact, mandating remuneration via fees strengthens the incentive for *lenders* to prefer borrowers taking out larger loans. This is because, all else equal, the fee payment for a small loan is likely to be similar as for a larger loan (given that the effort required to originate a loan does not generally increase with loan size). However, the lender's profit is likely to be higher for larger loans.

Would consumers pay fees?

Lender-choice conflict could be reduced if fees-for-service were paid by consumers. However, Inquiry participants overwhelmingly rejected such a proposition (CIF, sub. DR106; Connective, sub. DR104; FBAA, sub. DR85; Maria Rigoni, sub. DR118; MFAA, sub. DR86; Mortgage Experts, sub. DR124; REA Group, sub. DR80).

In particular, participants argued that requiring consumers to pay for brokers would result in fewer consumers using brokers. This would then result in a less competitive home loan market.

> The introduction of a fee for service payable directly by the consumer would provide a clear disincentive for consumers to use brokers and would inevitably cause a major disruption in the finance industry. The four major banks would be the only beneficiaries of a change of this kind as they would gain an additional competitive advantage over competing lenders that do not have extensive direct distribution channels. (AFG, sub. DR71, p. 71)

> … it is our belief a fee for service model would actually benefit the big banks. As they would have the resources to effectively provide the "advice" free. Meaning consumers would almost always end up with a limited scope of information. With that information being directly supplied by the retailer. Whilst the broker model isn't perfect. It is most certainly better than a direct sales option whereby the banks are charged with educating their customers. (Habitat Finance, sub. DR95, pp. 1-2)

Evidence supports that proposition that many consumers would not pay to use a mortgage broker (section 11.2), despite the fact that brokers provide access to a wider range of loans and are arguably better able to recommend a better loan compared to a lender's employee.

The Commission agrees that fees-for-service paid by consumers are unlikely to be pro-competitive, because a lack of willingness to pay is likely to result in a smaller mortgage broking industry, and the greater damage would be to the lenders without branch networks. Given that many mid-size and smaller lenders rely on brokers to compete (section 11.3), competition in the home loan market would likely be weaker as a result.

11.5 A best interest obligation

The interests of providers who match borrowers to home loans are not always aligned with those of their clients. This chapter has identified two broad ways in which these service providers could be influenced to act in ways that are not in the best interests of their clients, namely:

- where influence is exerted through ownership (section 11.3)
- through remuneration arrangements (section 11.4).

In light of the conflicting incentives that service providers in the home loan market face, we are recommending the introduction of a comprehensive 'best interest obligation' (box 11.6). This new obligation would clearly articulate what duties lenders and brokers owe to their clients, and provide an overarching legal framework for resolving conflicts of interest.

A best interest obligation is not intended to reduce or replace any of the existing requirements upon providers; its introduction would represent a step up in terms of the obligations owed to borrowers, and fill a gap in the current regime by providing for a clear positive obligation owed to consumers. In practice, this would likely require multiple parties across the industry (including lenders, aggregators and brokers) to have systems in place to satisfy themselves that these new standards are being met. The obligation is not intended to represent a fundamental departure from the existing regulatory framework that governs the mortgage broking industry; rather, as discussed below, it is designed to build on existing laws.

Participant responses to this proposal in the Inquiry Draft Report were mixed but helpfully provided us with insight on which aspects of the obligation needed to be better defined (box 11.7).

Box 11.6 A summary of the best interest obligation

What is the best interest obligation?

The best interest obligation sets out a new standard for acceptable conduct on the part of financial service providers in the home loan market. This obligation is designed to build on the existing laws that apply in the home loan market, and represents a step up in terms of the duties that financial service providers owe to borrowers.

Who must meet the standards?

Anyone who directly interacts with and offers or recommends a home loan to a borrower will be held to the 'best interest' standard. This includes all mortgage brokers, as well as bank staff who sell or recommend home loans. The standard will cover both individuals and corporate entities.

When do these standards apply?

The best interest obligation applies whenever a financial service provider interacts directly with a consumer in preparing or making a recommendation about a home loan, or offering a home loan. This includes recommendations and offers relating to an initial loan, as well as when refinancing an existing loan.

What needs to be done to meet these standards?

To fulfil the best interest obligation, a financial service provider must:

- act in the best interests of the client
- not offer or recommend a home loan unless it is appropriate to the client, having regard to the duty to act in the best interests of the client
- prioritise the interests of the borrower
- meet certain disclosure requirements.

The exact steps that a provider will need to take to meet these requirements will vary across different providers.

Who is legally accountable?

In some cases, other parties that do not interact directly with consumers may also be responsible for ensuring that the best interest obligation is met. There are two ways in which this could happen:

- where that party's **representatives** interact directly with borrowers — for example, a lender is accountable in respect of the conduct of their bank staff
- where that party has an **ownership interest** in a financial service provider that is subject to the best interest obligation — for example, a lender who owns a brokerage firm is accountable in respect of the conduct of that firm.

Box 11.7 Mixed responses to a best interest obligation

Introduction of a best interest duty received support from many participants

The Commission received a range of responses to the proposition of a best interest duty. Unsurprisingly, consumer groups supported such a duty.

> We support Draft Recommendation 8.1 to impose a clear legal duty on mortgage aggregators to act in the consumer's best interests. (Consumer Action Law Centre, sub. DR130, p. 5)
>
> CHOICE welcomes Draft Recommendation 8.1 that a 'best interest' duty be imposed on mortgage aggregators owned by lenders. (CHOICE, sub. DR97, p. 97)

Some brokers also considered it appropriate that a best interest duty be applied to them (Mortgage Experts, sub. DR124). Habitat Finance said:

> We believe all financial service operators should act in the best interest of their clients. In fact, we've built our business around this model and gone from strength to strength by doing so. (sub. DR95, p. 2)

The FBAA (PC transcript, 2018, p. 241, 244) and Money Quest (PC transcript, 2018, p. 277) also supported a best interest duty, with the FBAA considering that such a duty would not materially impact how brokers operated in practice. And P&N Bank (sub. DR88, p. 6) considered that 'ASIC should also impose a clear legal duty on all mortgage aggregators and brokers to act in the consumer's best interests'.

Some participants said it would be unnecessary

However, other lenders and aggregators questioned the need for a best interest duty. Some contended that the provisions under the *National Consumer Credit Protection Act 2009* (Cth) were sufficient to protect consumers (ANZ, sub. DR74; REA Group, sub. DR80).

> AFG is of the view that the current obligations in the National Consumer Credit Protection Act 2009 (NCCP Act) provide appropriate consumer protections and that the proposed additional regulatory obligation is unlikely to provide any real consumer benefits. (AFG, sub. DR71, p. 3)

Some participants said that the CIF reforms made a best interest duty unnecessary (ABA, sub. DR119; Connective, sub. DR104; FBAA, sub. DR85).

Some questioned how it would work in practice

REA Group (sub. DR80, p. 7) was concerned that it would 'be overly onerous and impracticable to require brokers … to identify and recommend the loan in the "best" interest of any given customer'. Westpac considered that differences in financial advice and mortgage broking made it difficult to transfer a duty that applied to financial advisors onto mortgage brokers.

> For mortgage broking to be governed by the "best interest" test would be challenging, given mortgage broking is driven by factors different to financial advice, including the extent of product comparison and enquiry and the weighting given to price or rate. In addition, borrowing tends to be more heavily influenced by a customer's subjective priorities, shorter term behaviours and life events, whereas financial advice on insurance and investments tends to have a longer term focus. (sub. DR125, p. 15)

Why a best interest obligation for mortgage brokers?

A framework for resolving conflicting interests

The purpose of a best interest obligation is to safeguard against both *real* and *potential* conflicts of interest. Understood this way, there is a role for a best interest obligation, even if lenders do not currently attempt to influence broker behaviour through ownership or remuneration arrangements. The obligation is designed to deter lenders' attempts to do so in the future.

In the same vein, there is a role for a best interest obligation, even if brokers claim not to be swayed by certain incentives. The fact that these incentives exist, and that brokers may yield to them if they so choose, justifies the need for an obligation.

Because the best interest obligation is intended to safeguard against conflicts of interest broadly, the Commission considers that it should apply to all brokers (discussed further below).

Delivering on a promise

Currently, the mortgage broking industry trades on a belief that broking services are provided with the interests of the borrower at the forefront. As ANZ said:

> I imagine that a lot of people think that the broker does have a duty of care to them. I imagine that when mums and dads walk into a broker, they assume that that is the case. (PC transcript, 2018, p. 287)

Certainly, many brokers hold themselves out as acting in the best interest of their clients. As a result, many borrowers put their trust in brokers to do so, and make decisions about their home loan in reliance of the recommendation they have received from their broker. The introduction of a clear, positive obligation owed to the client would ensure that the legal obligations of brokers align with customer's beliefs.

> What's needed is a tangible, legal obligation to make brokers live up to the promises they make to their customers. (CHOICE, sub. DR97, p. 8)

Drawing clear lines of responsibility

The CIF has recently developed the concept of a 'good customer outcome' as a new industry standard to improve consumer outcomes in the mortgage broking industry (box 11.3). However, it is unclear how CIF's statement of aspirations will translate into practice; at present, the framework does not indicate how the stated outcomes are to be achieved or assign responsibility to any particular party for taking certain actions or achieving certain outcomes. In an industry where there are multiple parties with a stake in the final product (lenders, aggregators, brokers and borrowers), framing customer outcomes as an industry-wide responsibility diffuses that responsibility. A best interest obligation, by contrast, would impose specific duties on specific parties, creating accountability and increasing the likelihood that the desired outcomes will be achieved.

What a best interest obligation would mean in practice

The best interest obligation would comprise several distinct but complementary elements — which, in practice, are about:

- the process undertaken by the credit licensee prepare a recommendation for the client
- the outcomes delivered to the client
- priorities in the event of conflicts of interest
- disclosure requirements.

A duty about process: to act in the best interests of the client

A key part of the best interest obligation would be a requirement for mortgage brokers to act in the best interests of their client. This requirement would govern the *process* through which mortgage brokers prepare recommendations for their clients, which would enable them to demonstrate meeting this duty.

In particular, the best interest obligation would be framed to encourage mortgage brokers to take certain steps when preparing a recommendation for the client (including recommendations about refinancing), including identifying and considering:

- the client's needs and objectives — including the amount to be borrowed and the term of the loan sought
- the client's priorities and preferences over different products — including preferences relating to the price of the loan, the level of customer service offered by the lender and product features such as offset accounts or bundled products
- the client's personal circumstances and financial situation, to the extent that they could affect the suitability of different products
- whether the broker has the expertise or ability to make a recommendation that meets the client's needs, objectives, priorities and preferences
- whether the broker has access to mortgage products that meet the client's needs, objectives, priorities and preferences
- which of those mortgage products best meet the client's needs, objectives, priorities and preferences.[84]

As a matter of practice, acting in the best interests of the client would also entail certain disclosures being made. This would include disclosures about the role of mortgage brokers in matching borrowers with home loan providers, the types of products offered by different

84 These steps could be framed as a requirement or as a safe harbour defence. In the case of financial advisors, the Corporations Act s. 961B imposes a duty to act in the best interests of the client. Subsections 961B(2)-(3) outline certain steps which, if taken by the provider, may be relied upon as a 'safe harbour defence' to show that they have discharged that duty.

lenders (including white-label loans and which lender provides the funding for them), the features associated with different loans, and the types of products that will not be considered by the broker. (We also envisage that the best interest obligation would also require certain other disclosures to be made, which are discussed in more detail below.)

In the financial advice industry, one of the effects of a duty to act in the best interests of the client has been to compel financial advisors to consider products outside their approved products list. (An approved products list comprises financial products that a financial advisory firm has researched and given their advisers the authority to provide advice about — chapter 10). However, due to the way the mortgage broking industry operates, it is not feasible to compel mortgage brokers to make recommendations for products outside their panel of lenders. This is because a lender may refuse to deal with a particular broker — for example, where a broker does not meet the lender's minimum volume thresholds or does not have accreditation with the lender.

That said, this would not preclude mortgage brokers from looking beyond their panel when considering whether there exist other mortgage products that better meet their client's needs. In these instances, a broker would not be required to recommend a specific product outside their panel; instead, they should inform the client that they are unable to make a recommendation from the lenders on their panel.

A duty about outcomes: recommendations must be appropriate to the client

Currently, under the Credit Act, credit licensees are prohibited from entering into a credit contract, suggesting a credit contract or assisting a consumer to apply for a credit contract if the credit contract is 'unsuitable' for the consumer. The Act prescribes particular circumstances when a loan will be unsuitable for a particular consumer.

> The contract will be unsuitable for the consumer if … it is likely that:
>
> (a) the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship …
>
> (b) the contract will not meet the consumer's requirements or objectives …
>
> (c) if the regulations prescribe circumstances in which a credit contract is unsuitable--those circumstances will apply to the contract … (*National Consumer Credit Protection Act 2009* (Cth), ss. 118(2), 119(2), 131(2))

But, in light of the reliance that customers place on brokers, the Commission considers that mortgage brokers should be held to a higher standard. For this reason, the Commission recommends that the best interest obligation stipulate that the loan recommended by the credit licensee must be appropriate to the client, having regard to the duty to act in the best interests of the client. This would be comparable to the duty imposed on financial advisors in the Corporations Act s. 961G.

A conflict duty: to prioritise the client's interests

Mortgage brokers can exert great influence over the decisions that borrowers make. For many consumers, taking out a home loan is one of the biggest financial commitments that they will make and, as such, can have a significant impact on their financial wellbeing. Consumers who go to brokers are especially vulnerable — they tend to be younger and have lower incomes (ASIC 2017x).

As discussed above, brokers face a range of different incentives when conducting their business — and not all of these are aligned with the interests of their clients. The requirements outlined above will go some way to addressing this misalignment. But these requirements do not guarantee that all conflicts of interest will be resolved in favour of the client.

For this reason, the Commission recommends the best interest obligation require brokers to prioritise the interests of their client, in the event that their interests conflict. Accordingly, brokers will not be able to manage their conflicts by simply disclosing them, nor should they be able to contract out of this duty. This duty goes further than the existing requirements in the Credit Act s. 47(1)(b), which requires brokers to ensure that consumers are not disadvantaged by conflicts of interest. This requirement would be analogous to the duty imposed on financial advisors by the Corporations Act s. 961J. But, whereas conflicted remuneration has been banned in financial advice, this is not the case in mortgage broking. As a result, it is likely that actual conflicts between the interests of the client and the interest of the broker will arise more frequently. What this means in practice is that it may be necessary to have more rigorous mechanisms for documenting and monitoring compliance with this requirement.

A disclosure duty

Currently, credit licensees have various disclosure obligations under the Credit Act (box 11.8). However, the information provided does not necessarily facilitate consumer understanding or ensure that consumers can evaluate the services they receive from brokers or the quality of the loans recommended (appendix D).

The Commission recommends the best interest obligation include additional disclosure requirements. Broadly, there are two types of disclosures that should be made. First, there should be disclosure of any factors which bear on the ability of the broker to act in the best interest of the client or the recommendation that is made. This includes disclosure:

- where the broker has made a recommendation based on information about the client that could be inaccurate or incomplete
- about the range of products that the broker can and cannot access, including limitations as a result of lenders not being on an aggregator's panel or the broker not being accredited by a particular lender
- about why a particular loan was recommended, including the methodology used to identify that loan (such as computer software).

Second, there should be disclosures about any real or potential conflicts of interest, including remuneration arrangements and any ownership relationships between lenders and aggregators. This should also include a disclosure of the broker's obligation under the conflict duty — that is, that the broker is under a duty to prioritise the interests of the client, in the event that the interests of the client and the broker conflict.

Box 11.8 Mortgage brokers' disclosure obligations

Under the *National Consumer Credit Protection Act 2009* (Cth), credit licensees and their representatives are required to disclose certain information through specified documents.

Credit guides must be provided to consumers as soon as it is apparent that a licensee or its representative is likely to provide credit assistance to, or enter into a credit contract with, a consumer. Credit guides provide key information about credit licensees or their representatives, their obligations, and consumers' rights. Credit guides must usually also provide information about commissions that are likely to be paid or received, including arrangements for volume-based commissions and payments made to third parties (such as real estate agents) for referrals.

Credit proposal documents must be given at the same time as credit assistance is being provided to consumers. Credit proposal documents outline any costs to consumers of using the licensee's services, as well as more detailed information about commissions associated with the particular credit contract being proposed. Documents must contain a reasonable estimate of total commissions, as well as a description that breaks down the different types of commissions (for example, advertising subsidies or payments for attendance at events).

Pre-contractual statements are provided by credit providers (lenders) rather than credit assistance providers (brokers). Pre-contractual statements include details about the terms of the credit contract, and must also state the parties paying and receiving commissions and the relevant amount.

Source: ASIC (2017x).

Extending the obligation to lenders

In the Draft Report, we put forward the proposition of imposing a best interest obligation on aggregators owned by lenders only. In response, participants said that differential obligations for different types of brokers and aggregators would be inconsistent and cause confusion (box 11.9). Accordingly, participants generally agreed that any obligations should apply universally.

For similar reasons, the Commission also considers that there is merit in extending the obligation to apply to all providers in the home loans market that interact directly with consumers seeking a home loan product. This would include credit providers (that is, lenders) that have staff that sell or market home loans to potential borrowers. For borrowers, this could reduce confusion around whether the person they are speaking to about their home loan is under a best interest obligation or not.

Box 11.9 Widespread agreement that the obligation should apply to all brokers

P&N Bank:

> ASIC should also impose a clear legal duty on all mortgage aggregators and brokers to act in the consumer's best interests. (sub. DR88, p. 6)

Connective:

> From a practical perspective, introducing one standard for certain brokers (those who are connected with a lender-owned aggregators), and a different set for other brokers will lead to confusion and regulatory uncertainty. (sub. DR104, p. 4)

NAB:

> …to apply this standard to lender-owned aggregators only would create an uneven playing field. (sub. DR94, p. 25)

Consumer Action Law Centre:

> …we recommend that the best interests duty apply to all mortgage brokers, not just mortgage aggregators owned by lenders. There is no clear policy reason for the duty to only to apply to brokers owned by lenders. (sub. DR130, p. 5)

HSBC:

> We are supportive in principle but we believe that the duty of care obligation should extend to all mortgage aggregators rather than limited only to those which are lender owned. This will ensure that all mortgage aggregators operate on a consistent landscape and the outcome would be in the interest of consumers. (sub. DR102, p. 2)

AFG:

> AFG is also very concerned about a proposed test that would be applied to only one section of the industry as it is likely to result in market distortions and unintended consequences. For example, lender owned aggregators could suggest that consumers are at risk if they use a broker that is not subject to the same test and assert that the safest course for consumers is to only use brokers that are subject to the additional "best interests duty". (sub. DR71, p. 3)

CBA:

> … CommBank does not support a best interest duty, unless it is applied to all brokers at the same time to avoid confusion for consumers and maintain an even playing field for industry participants. … Different regimes for brokers based on ownership would cause significant and unnecessary confusion for consumers in selecting a broker and what they can expect from the service. (sub. DR79, pp. 53-54)

Like mortgage brokers, lenders can also face incentives to act against the interests of borrowers, or create incentives for their staff to do so. Extending the obligation to all providers in the home loans market would limit the extent to which lenders can act on or create these incentives, and would safeguard the interests of borrowers.

As a practical matter, we anticipate that, in many instances, the bar that lenders would need to meet in order to discharge their obligations would be lower. In part, this is because lenders and brokers play different roles in the mortgage market. For example, while mortgage brokers can recommend products from a range of different lenders, it would be infeasible to require lenders (and their staff) to provide information about or recommend the loans of their competitors. As a result, the laws that implement the best interest obligations may need to have provisions for lenders specifically. This approach is in line with the carve outs for employees and agents of ADIs in the financial advice industry (Corporations Act ss. 961B(2), 961J(2)).

In addition, the Commission considers that there is merit in extending responsibility to lenders that have ownership interests in firms that are subject to the best interest obligation. As such, both parties would each be liable for breaches of the obligations. This is designed to recognise ownership as a potential avenue through which brokers can be influenced to act against their client's interests, and align the interests of both parties with those of the borrower. In the case of the party holding the ownership interest, the penalties for breaches would need to take the form of fines, rather than licence suspension.

Implementation: through the National Consumer Credit Protection Act

The Commission recommends that the new best interest obligation be implemented through the National Consumer Credit Protection Act ('the Credit Act'). The Commission's proposed reforms are designed to fit within the existing regulatory framework, and this approach will allow those reforms to build on and recognise current regulatory arrangements. The Credit Act is a natural fit for the new best interest obligation because it governs the licensing and conduct regime that applies to providers in the credit market. And the key purpose of any licensing regime is to regulate behaviour through imposing conditions, requirements and obligations upon those who are licensed.

Indeed, the Credit Act already imposes a range of obligations and requirements upon all credit licensees (not just those in the mortgage broking market). Some of these bear similarities to the duties that the Commission is recommending, such as:

- responsible lending requirements, including the requirement that loans are not unsuitable (as discussed above) and certain disclosure obligations
- general conduct obligations, including a requirement to have in place adequate arrangements to ensure that consumers are not disadvantaged by conflicts of interest (NCCP Act, s. 47(1)(b)).

The Credit Act also has a ready-made framework for identifying parties in the mortgage broking industry, which can be leveraged to specify *who* the obligations will fall upon. Providers in the mortgage broking industry are commonly categorised as lenders, aggregators or brokers. However, these terms are not used in the Credit Act. Instead, the legislation identifies different parties in the mortgage broking market as credit providers, credit service providers and their representatives (table 11.1).

The statutory terms do not neatly translate to the commonly used categories; providers could fall within different (and at times multiple) statutory categories depending on the activities they undertake and their business model.

> [A] mortgage broker who suggests a particular home loan or assists the consumer in obtaining a home loan will be a credit assistance provider, a credit representative or a (mere) representative of a credit licensee (who has a licence authorising credit assistance) and supervised by that

licensee. Some mortgage brokers who are credit representatives are franchisees of a credit licensee and subject to a franchise agreement that requires them to comply with the policies of the franchisor. (Paterson and Howell 2018, pp. 26–27)

Table 11.1 **Different parties in mortgage broking**

Under the National Consumer Credit Protection Act

Type of credit licensee	*Definition*	*Who?*[a]
Credit provider	A person who provides credit	Lenders
Credit service provider	A person who acts as an intermediary or provides credit assistance to a consumer	Aggregators, brokers
intermediary	A person, who in the course of a business, acts as an intermediary between a credit provider and a consumer for the purposes of securing a provision of credit for the consumer under a credit contract with the credit provider	Aggregators
credit assistance provider	A person who deals directly with the consumer in the course of a business and who: • suggests that the consumer: apply for, increase the credit limit with or remain in a particular credit contract with a particular credit provider, or • assists the consumer to apply for or increase a credit limit in a particular credit contract with a particular credit	Aggregators, brokers
Representative	• An employee or director of a credit licensee or related body corporate • A credit representative of a credit licensee, or • Any other person acting on behalf of the licensee	Bank staff, brokers
credit representative	A person who is authorised by a credit licensee to engage in specified credit activities on behalf of the licensee	Brokers

[a] Whether a provider falls into a particular category may depend on their business model. A given provider may fall into multiple categories.

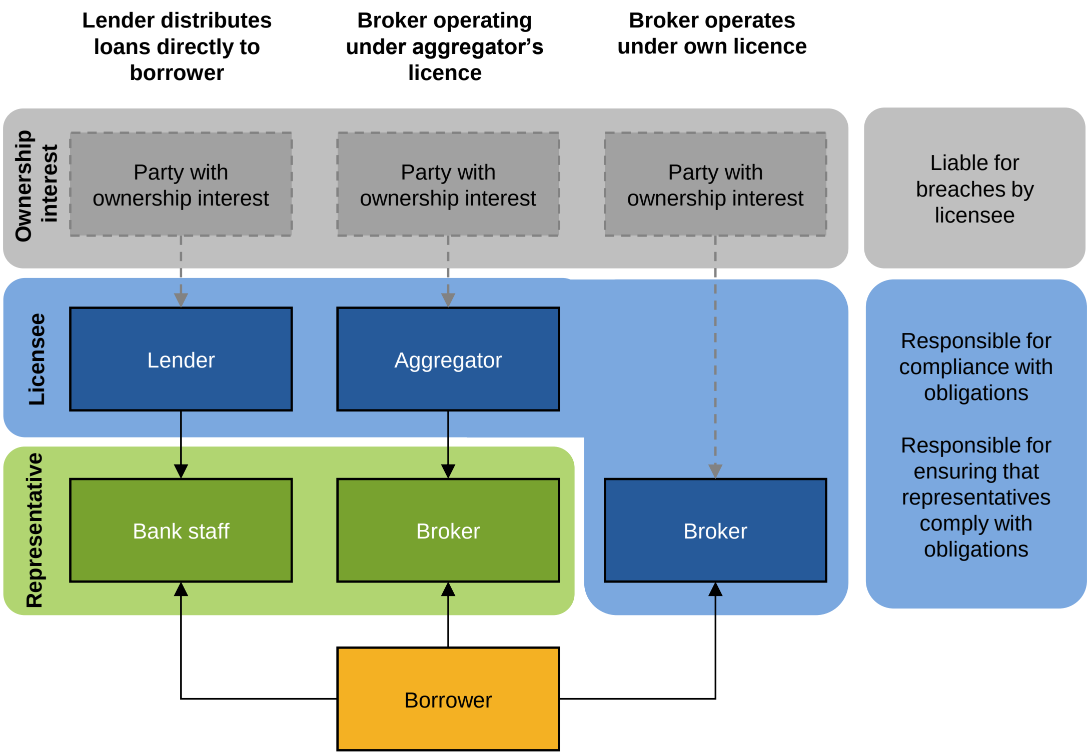
Source: Adapted from Paterson and Howell (2018); ASIC (2017l); *National Consumer Credit Protection Act 2009* (Cth).

While the commonly used categories reflect the practical role that parties play in the distribution chain, the legal designations under the Credit Act reflect how those parties have chosen to allocate accountability along that chain. For example, under some business models, brokers operate under a credit licence held by an aggregator; as such, the aggregator is responsible for ensuring that those brokers comply with the requirements and obligations imposed by the licence. In other models, brokers hold their own licences and as such have primary responsibility for compliance.

For this reason, the Commission considers that the new best interest obligation should cover licensees that provide credit assistance services in relation to home loans. These licensees would also be responsible for ensuring that its representatives comply with these obligations. In broad terms, this would cover all mortgage brokers (either directly or as representatives of the licence holder), as well as lenders who provide credit assistance services.

Depending on the relevant business model, the responsibility for discharging or ensuring discharge of the best interest obligation will fall to different parties (figure 11.7).

Figure 11.7 **The best interest obligations under different business models**



In this way, who is responsible will depend on licence holdings, regardless of the employment relationship between the broker and the aggregator. In particular, where a mortgage broker holds their own licence, they will be directly responsible for meeting the best interest obligation. Where a broker operates under the licence of an aggregator, the obligations will fall on the aggregator. In these instances, the mortgage broker would be acting as a representative of the aggregator, so the aggregator is responsible for ensuring that the mortgage broker (as its representative) meets the obligation when they act on its behalf.

In line with our proposal to extend the duty to lenders more generally, the Commission also recommends that the obligation should also be imposed on credit providers and other types of credit service providers. Again, these licensees will be responsible for compliance by their representatives (such as staff).

RECOMMENDATION 11.4 BEST INTEREST OBLIGATION FOR CREDIT LICENSEES THAT FACILITATE HOME LOANS

The Australian Government should amend the *National Consumer Credit Protection Act 2009* (Cth) to impose best interest obligations on licensees that provide credit or credit services in relation to home loans.

These best interest obligations should comprise:

- a duty to act in the best interests of the client
- a requirement that any resulting recommendations must be appropriate to the client, having regard to the duty to act in the best interest of the client
- a duty to prioritise the interests of the client, in the event of a conflict
- a duty to ensure that certain information is disclosed to the client.

Where lenders have an ownership interest in firms that provide the credit assistance services, those lenders should also have a legal responsibility to ensure that the licensee discharges its best interest obligations.

12 More transparent home loan pricing

Key points

- Consumers need to have access to simple, timely, easily understood information about home loans to be able to assert competitive pressure on lenders and to choose a loan that offers the best value to them. The price of a home loan is vital in this process.
- At present, the main piece of price information available in the home loan market is the standard variable rate (SVR). But the SVR bears little resemblance to the actual home loan interest rate offered, as the vast majority of consumers pay less than this rate.
  - Actual home loan interest rates and the discounts offered on the SVR are generally not easily and simply made available to consumers.
  - And even when a consumer knows their actual rate, they have no way of knowing how that rate compares with the rates offered to others in similar circumstances.
- With access to digital data, *actual* home loan interest rates recently negotiated can and should be collected by APRA, and made accessible to consumers by ASIC via an online calculator (with a lag of no more than 6 weeks).
- An online calculator would provide a consumer with the median interest rate offered to home loan borrowers in similar circumstances to them.
  - The median interest rate represents the ‘middle’ rate, with half of home loan recipients receiving an interest rate either above or below that rate. The use of a median rate limits scope for gaming of the data supplied by lenders.
- The specific loan and borrower characteristics that are included in the online calculator should be developed through consultation and consumer testing.
  - Initially, the number of loan and borrower characteristics should be kept to a minimum to facilitate timely development of the calculator and to consciously avoid overwhelming consumers with options and information requirements.
- Concerns about price signalling are real, but capacity to do this already exists today via the broker channel. For this reason, the Commission recommends a single aggregated median interest rate across ADIs for a small number of borrower and loan characteristics.

This chapter examines the nature and quality of price information, in particular interest rates, available to consumers when seeking to apply for or refinance a home loan. It investigates how consumers assess the information available to them and whether the sources of 'help' are really that helpful. It then outlines an online tool proposed to provide consumers with greater clarity of actual home loan interest rates.

12.1 Poor price information in the home loan market

Consumers need to have access to information and some level of understanding about a product or service to know that they are choosing the right one, or to be able to effectively convey to a lender that what is being offered is not competitive.

Being able to say 'No, thanks mate, I'm off down the road' can be a very effective message for a consumer to give to a lender (Harper 2016). Knowing the price of the relevant product is vital in this process.

The main piece of price information currently available in the home loan market is an artificial price known as the standard variable rate (SVR).

A SVR is an interest rate that each lender sets by taking into account their cost of funds, operating costs and target profit margins.[85] Lenders make reference to their own SVR when pricing home loans and advertising home loan interest rates. They use it as their benchmark rate to which a margin may be added or (more usually) subtracted when making offers to consumers. Linking actual home loan interest rates to an SVR in this way allows lenders to easily increase or decrease prices on all variable rate loans on their books in response to changes in business or regulatory conditions.

The SVR provides a useful mechanism for each bank to control its entire book of variable rate mortgages while price discriminating between customers. While SVRs are individually set by each bank, they are public information and the SVRs set by different ADIs are closely related.

But the SVR is a source of misinformation for consumers

The SVR is the advertised price of a home loan. But it is not the true market price, for almost anyone. Moreover, this 'rate' provides consumers with little useful information. It does not provide a meaningful price benchmark for the consumer regarding the actual price of home loans being offered in the market, as most home loans are priced below the SVR (figure 12.1). The RBA highlighted these issues:

[85] Some lenders use the term SVR to describe only the indicator rate for loans to owner occupiers with principal-and-interest repayments. Other lenders have different SVRs depending on the type of borrower, repayment type and loan-to-value ratio (LVR).

> Another form of information problem is that customers might not have full information about the products and prices offered by other providers, preventing them from making an informed choice. For instance, transparency in the small business and home loan markets can be poor given the prevalence of unadvertised discounts to the standard variable rate, in many cases negotiated directly. Under these circumstances a customer will have difficulty determining the competitive price without incurring large search costs. (sub. 29, p. 7)

Almost no-one has to pay the SVR

From unpublished data on actual home loan interest rates, we found that:

- the overall discounting relative to the SVR is more prevalent among major lenders
- discounting is slightly more widespread for loans issued to investors compared to owner-occupiers; this is more pronounced for non-major lenders.
- the shares of investor and owner-occupier loans at or below the SVR issued by non-major lenders have been similar in more recent years (figure 12.1)

This strongly suggest there is no ‘discount’, just a hidden price that varies between consumers at the discretion of the lender. At our Inquiry public hearings, ASIC noted:

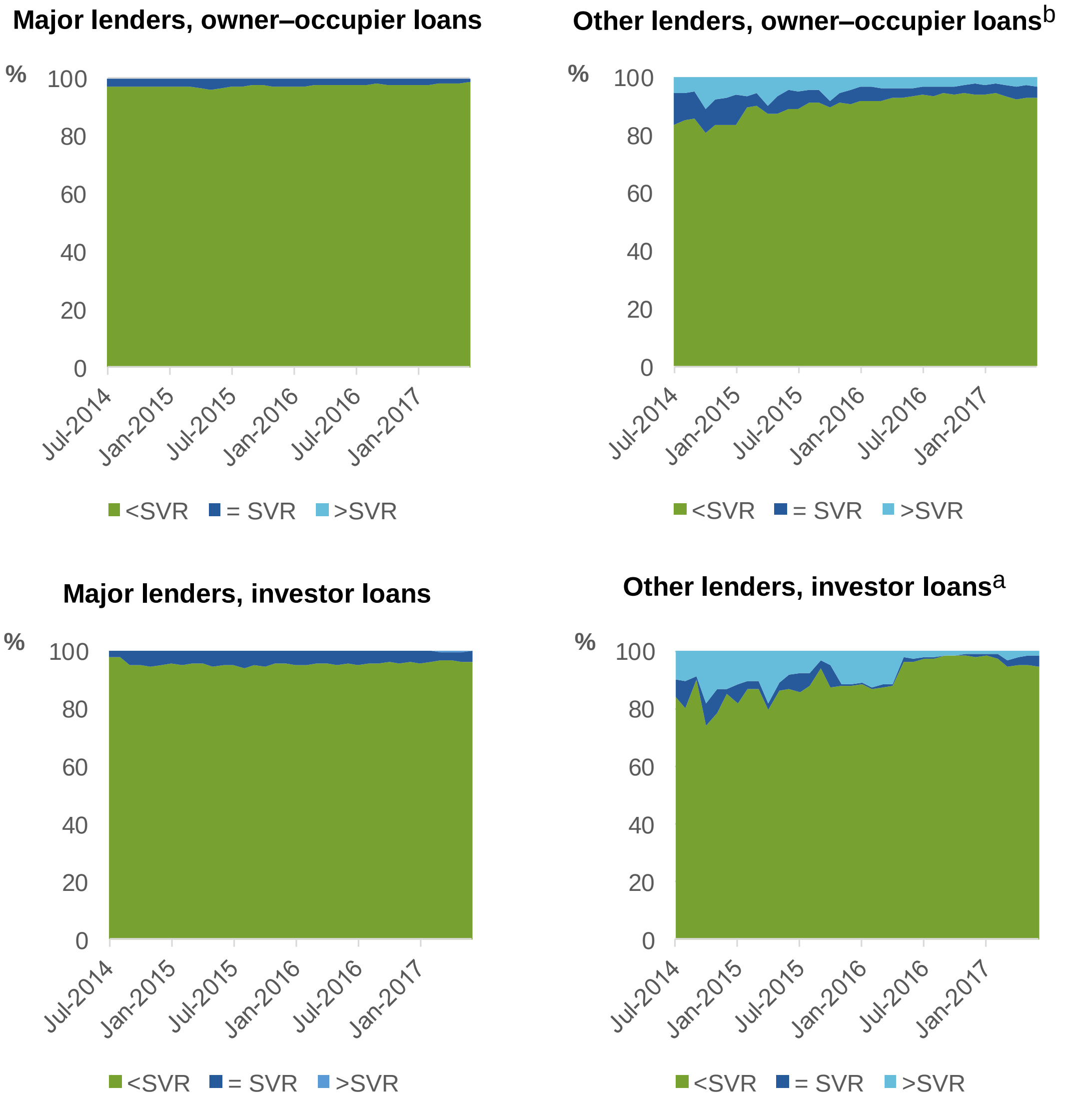
> … that pricing and comparative pricing of mortgages is somewhat opaque at the moment, partly because the standard variable rate is not what a lot of people get, and it’s hard to know whether the discount you’re getting is the same as the discount other people are getting. (PC transcript, 2018, p. 319)

Such unpublished discretionary discounts can apply to a substantial portion of loans — for example, NAB (sub. 31) submitted that, as at June 2017, discretionary pricing was being applied to up to 70% of new NAB-branded home loans.

With the majority of successful home loan applicants offered a lower rate than the SVR, this suggests that the discretionary ‘discounts’ being offered by lenders, including those offered as part of a home loan package, are potentially being used to lull consumers into feeling good about accepting the offer without further negotiation on price or other aspects of the home loan.

Figure 12.1 **Who pays the standard variable rate anyway?**

Share of new loans (by number) at, above and below the SVR[a]



[a] Comparison of interest rate and SVR is at the time the loan is originated. [b] Some lenders did not provide data for all years. Hence there is some variation in the mix of lenders included over time.

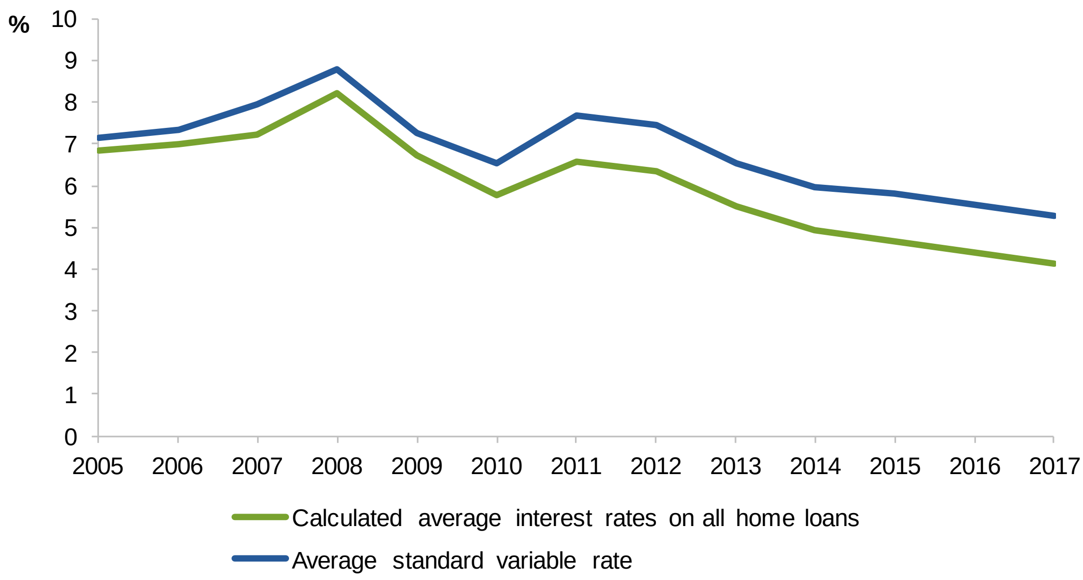
Source: Unpublished data from 14 ADIs.

How different are actual home loan interest rates from the SVR?

In terms of the level of ‘discounts’, Deloitte (2017) noted that the long-term average discount on lenders’ back books was about 70 basis points. The ACCC reported that discounts on the headline interest rate on home loans by the four largest banks range from 78 to 139 basis points, over the period of 30 June 2015 to 30 June 2017 (ACCC 2018).

For major banks, **the gap** between SVRs and actual interest rates **has increased** over time (figure 12.2). While only some of this gap is likely due to discounts on SVR, the gap nevertheless is in line with ASIC's (2017x) finding that, for most banks, the discount margin for home loans was larger in 2015 than in 2012. Similarly, RBA research found that interest rate discounts increased between 2014 and 2017, with home loan discounts higher for newer and larger loans (Bergmann and Tran 2018).

Figure 12.2 **Major banks' average interest rates and SVRs[a]**



[a] Average interest rates include the interest rates on fixed rate loans. Data are for years ending 30 June.
Source: APRA (2017s); RBA (2017r)

Difficult to discover the true interest rate paid by consumers

In addition to most consumers paying below the SVR, it is difficult for consumers to reliably discover the actual price for the loan they anticipate seeking, as few of the discounts offered to consumers are public. While anecdotes, apps and websites abound, there is no benchmark against which to genuinely judge the market price.

Information about individually-negotiated or discretionary discounts are usually not published. The ACCC noted that 'lenders know the size of discounts they are prepared to offer and the type of borrowers they are prepared to offer them to but this information is not publicly available' (ACCC 2018, p. 18).

Furthermore, since the decision criteria for discretionary discounts vary across lenders, borrowers may find it difficult to identify and assess the discounts for which they are eligible (ACCC 2018). But the potential savings from the total discounts are significant with borrowers potentially saving almost $4000 in the first year of the loan — highlighting the need for price transparency.[86]

Despite the empirical evidence to the contrary (figure 12.1), at least one bank sought to claim that the information available is indicative of the rate received.

> It is important to note that this information already exists in the market for fixed and basic products. The rates advertised by banks and numerous comparison websites are closely aligned to end rates that customers receive. (CBA, sub. DR79, p. 58)

The discussion above has outlined how difficult it is for consumers to discover actual interest rates. The CBA's linkage of advertised rates, comparison websites and the actual end rates paid by customers implies an ease of access to information that cannot be observed in practice.

To the contrary, brokers in discussion with the Commission confirmed that consumers are generally only able to be certain of the actual size of their 'discount' once they have formally had their home loan application assessed. For a complex product, the idea of starting again, if the offer is unattractive, is a substantial barrier to pro-competitive customer behaviour (despite potentially being the best course of action) (appendix D). A consumer's main focus is buying the property, the home loan facilitates this goal.

Bundling increases complexity of pricing

Many financial institutions offer package home loans: a bundle of products that usually includes a home loan, a transaction, offset or savings account, a credit card, and some types of insurance.

Consumers are attracted to home loan packages as lenders offer 'discounts' on the interest rate, including the SVR, or waive fees on some or all of the components of the package.[87] However, bundling of a number of products into a home loan package can obscure the price of individual products making it difficult for consumers to assess the value of each individual component (ASIC, sub. 40). It can also lock consumers into ongoing use of products that become less competitive over time as financial circumstances change (chapter 5). The Reserve Bank of Australia (RBA) submitted that:

> … product bundling and a lack of transparency in the pricing of mortgages (with the prevalence of large unadvertised discounts in interest rates from advertised standard variable rates), are impediments to competitive outcomes. (sub. 29, p. 23)

---

86 This scenario is based on the average total discount received by owner-occupier borrowers making principle and interest repayments on a variable interest rate loan of 103 basis points below the headline interest rate and a home loan amount of $375 000.

87 Many consumers are also attracted to bundling their home loan with other financial and credit products as they have strong preferences to keep all their financial commitments with one institution. For example, a CHOICE survey found that half of all Australians who have a transaction account, home loan and credit card have all three products with the same institution (chapter 5).

Comparison rates are meaningless

The *National Consumer Credit Protection Act* (Cth) (NCCP Act) requires that when advertising home loan products, lenders provide a comparison rate that includes the interest rate as well as most fees and charges.[88] The purpose of comparison rates is to allow consumers to compare products with different fees and charges (ASIC 2016f).

However, comparison rates are calculated using SVRs as the base interest rate. While comparison rates could potentially improve the competitiveness of the home loan market, they are only as useful as the interest rates on which they are based. As discussed above, for more than 90% of customers, SVRs (or the advertised rate) are not the market rate.

At our Inquiry public hearings, ASIC highlighted this issue:

> But moreover, the comparison rate is based on the advertised rate, not on the rate that people get when they either talk to a broker or a lender. So again, it's not a very good guide as to whether the rate you are being offered is a good rate. It also doesn't include other things that, you know, affect the cost of the loan like LMI, because the requirement is that a comparison rate include mandatory fees, but not contingent fees, and LMI, being a contingent fee is not included within the comparison rate. (PC transcript, 2018, pp. 319–20)

The P&N Bank also noted the lack of relevance of the comparison rate:

> While the home loan comparison rate methodology was a way of demonstrating comparability across product rates and fees, we acknowledge that it may not reflect real life scenarios based on borrower type, LVR, actual loan terms/amounts — or how pricing strategies are applied over the duration of that loan. (sub. DR88, p. 6)

Home Loan Experts, a specialist mortgage broker, further noted the lack of understanding of comparison rates among consumers:

> We have not seen a customer use comparison rates or one that understands them. They are largely ignored by the industry and customers alike. For this reason, we recommend scrapping them altogether. (sub. DR70, p. 7)

Canstar noted additional problems with the comparison rate — the assumptions used in formulating the rate are no longer representative of the lending market (including the loan amount and term) (sub. DR73).

[88] Part 10 of the Credit Act requires that credit providers provide a comparison rate when advertising fixed-term credit that is for, or mainly for, personal domestic or household purposes. Comparison rates include the interest rate as well as most fees and charges (such as government charges). But their purpose is ultimately subverted if the dominant input – the interest rate – is not the most recent actual rate.

12.2 How do consumers choose the best home loan?

Consumers seek assistance from mortgage brokers

In an increasingly complex home loan market, consumers seek specialised assistance when choosing and applying for a home loan (chapter 11).

The motivations for consumers using mortgage brokers is a perception that brokers will deliver a better outcome (by having access to a wider range of loans or ability to obtain a better interest rate) as well as factors relating to quality of service (such as saving time, more convenient, more likely to get a loan approved and personalised service) (ASIC 2017x).

Brokers can help educate consumers, improving their financial literacy of an infrequently purchased product, by providing information about the home loan market and the process for obtaining a home loan. They can also save consumers time by efficiently navigating the application process (chapter 11).

However, consumers are usually not able to assess from the information provided the extent to which they are gaining access to a wide range of products on the market through brokers (a common motivation for going to brokers). For example:

- For smaller and independent brokers, the loan products that they can offer may potentially be limited to only those to which a lender is prepared to accredit them.
- Vertical ownership of the broker's aggregator and lender may limit the range of products that a broker actively chooses from: either because of conflicted remuneration or because the panel of home loans on offer is restricted.

Ultimately there is always a limited product list no matter what type of broker a consumer consults.

The lack of a close alignment between published rates and actual rates and uncertainty around discretionary discounts offered can only advantage a broker. Whether that advantage is exploited depends on the incentives offered. Lenders themselves are responsible for paying these incentives.

Chapter 11 examines how brokers and aggregators benefit consumers, including whether consumers receive lower interest rates through brokers; how lender ownership of aggregators affects the competitive dynamic and how the payment of commissions can influence broker behaviour and consumer outcomes.

Consumers use comparison websites to assess home loans

Comparison websites provide an interactive tool for many financial and credit products, including home loans, from a number of different retailers. They allow consumers to search and compare products based on price, features, reviews and other criteria. They are generally a free service.

Comparison sites are only as good as the input they use. The commercial arrangements (such as ownership, commission or advertising revenue) between comparison websites, the issuers and distributors of financial and credit products may mean that consumers are accessing information that only covers a portion of the market. For example, only products from commercially-related parties may be included in search comparisons (ASIC, sub. 40).

Commercial arrangements may also affect the way information is framed or presented, in order to influence consumer choices in a particular direction (ASIC, sub. 40; ACCC 2015a). Algorithms are used to narrow down the number of products presented to consumers. But there is potential for algorithms to be manipulated to display results based on commercial objectives rather than purely on the consumer's stated preferences. One such example may be presenting different comparison results depending on whether or not consumers identify their current supplier from the outset. The ACCC have issued guidelines for comparison website operators regarding the use of algorithms to minimise consumers being misled (ACCC 2015a).

Consumers resort to behavioural strategies

When decisions are complex and overwhelming, consumers resort to strategies to help make the decision making processes simpler (for example, Fletcher 2016; ASIC, sub. 40; COBA, sub. 21) (appendix D). ASIC noted the following observations about consumer decisions:

> Decisions themselves are often made using heuristics or 'shortcuts' — for example, unconscious rules of thumb, which may lead people to choose options that appear familiar or unambiguous without weighing up all the options. (2014b, p. 172)

While these behaviours can be useful in making decisions under constraint, they can also introduce significant and systematic biases into decision making (ASIC 2017y). These 'behavioural biases' mean that people do not take account of all relevant and available information, making it difficult to act in their best interests. This applies to all financial and credit products, not just consumers of home loans.

This does not imply that consumers are incapable of understanding the important features of financial and credit products. Rather, these actions are quite normal when faced with large costs (in terms of effort, time and fees) or consumers are time constrained:

> Consumers will vary in the extent to which they exhibit these various biases, and the impact of these biases will also vary according to the context. However, it is important to remember that such biases do not imply stupidity or laziness, or even a special level of consumer vulnerability; all of us exhibit such cognitive limitations and biases, in one circumstance or another. … there is no such thing as a consumer who makes decisions in a careful, contemplative … way at all times. Life is too short. (Fletcher 2016, p. 17)

Appendix D examines the strategies consumers use to make decisions and other factors that may influence this decision making process, such as financial literacy.

12.3 Access to actual home loan interest rates via an online calculator

The absence of a genuine real-time benchmark against which to judge the deal offered to you by a bank branch or a mortgage broker is characteristic of a flawed market.

Modern digital data management is well able to provide information to consumers on actual rates offered to other borrowers seeking the same type of loan — it could even do so in near real time. But lenders are not required to do so and consequently they do not provide this information. Such rates would provide a more accurate and consistent benchmark than the SVR, allowing consumers to compare across different products. No submission to this Inquiry made a convincing case why such data should not be made available.

Therefore, the Commission recommends that consumers should be able to obtain an indicator interest rate based on different loan and borrower characteristics via an online calculator, with an elapsed time of no more than six weeks.

The published rate should be a median of actual rates offered to consumers

The indicator rate made available to consumers should be the market median. The median is a 'middle' rate with half of home loan recipients receiving an interest rate either above or below that rate (in a given home loan market).

A benefit of using the median is that it is hard to 'game', even if an institution sought to use this new indicator as a way of sending false information into the market or gain a competitive advantage from the data.

Published median interest rates may enable ADIs to see where they are too competitive — that is, they might be able to raise rates and not lose market share. But that involves risk. A median rate (unlike an 'average') does not show the depth of rivals' discounts. An attempt by one ADI to 'match' the market median may simply leave it 'out of the market' for most loans. Also, with many ADIs contributing to the data pool, there will be constant shifts by competitors that may make a decision against a fixed reference point unwise. As long as there are many contributors to the data pool, there will be constant shifts by competitors as well that may make a decision against a fixed reference point unwise. Unless we consider that collusion is rife and unmanageable by competition law despite recent reforms, this publication based on last month's real world rates should do little to induce reversion to the mean — in part because this opportunity exists today as far as ADIs are concerned; and in part because this is not a mean, but a median.

The published rate should vary by loan and borrower characteristics

As interest rates differ according to a range of factors, it is important that consumers have access to information that is relevant to their circumstances (box 12.1 and figure 12.3).

The specific loan and borrower characteristics that are included in the online calculator should be developed through consultation and consumer testing. In doing so, consideration should be given to the trade-off between:

- the benefit to consumers of being able to obtain prices for loans that match their specific needs and circumstances
- the cost to consumers of specifying a range of different variables and the cost to lenders of providing increasingly granular data.[89]

Box 12.1 There is no one price for a home loan: publishing actual prices should reflect this, if they are to be useful

Home loan interest rates are influenced by a myriad of borrower and loan characteristics.

- Lenders usually take into account borrower type (owner–occupier or investor), repayment type (principal-and-interest or interest only), loan to value ratio and size of the loan. Lenders may also consider more specific borrower characteristics such as income, occupation, industry of employment and credit history.
- Prices vary with types of products. For example, lenders may offer introductory rates or package discounts when consumers bundle several products.
- Prices can also differ depending on who the customer interacts with when obtaining their loan. For example, some lenders allow brokers and staff at various levels of seniority to discount prices within a certain range, if customers meet particular criteria.
- Prices also depend on the ability of consumers to negotiate, with those who are financially savvy or who have effective negotiating skills more likely to obtain lower interest rates.

Different borrower characteristics can result in wide variations in the interest rates paid for the same product within the same institution. For example, using data obtained from ASIC, actual interest rates offered for owner-occupier loans with principal-and-interest repayments ranged from 3.15% to 5.74%, for just one ADI lender in 2015.

In 2015, those who purchased property through a trust, those with interest-only loans, those aged 65 and over, and those who were widowed obtained interest rates that were higher than the overall population. Owner-occupiers, those with larger loans, and those of certain professions received lower interest rates (figure 12.3).

Source: Productivity Commission analysis based on ASIC unpublished data on lenders' self-reporting of loans (2017x)

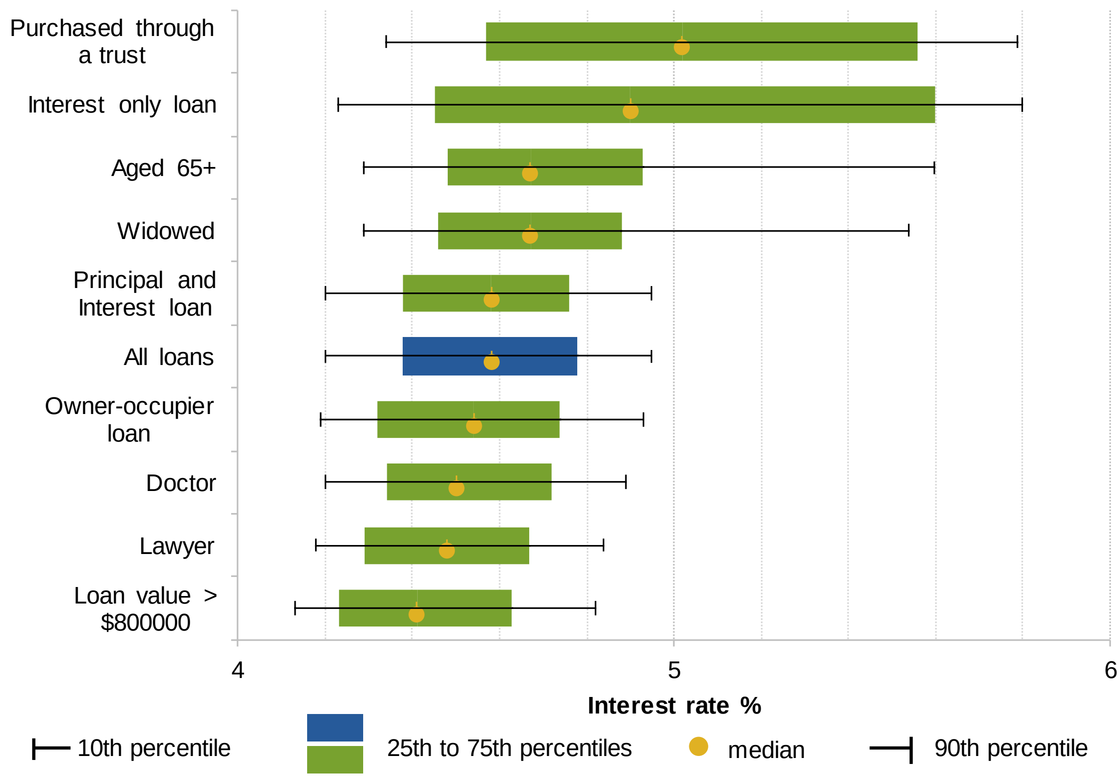
As a first step, we recommend that the number of loan and borrower characteristics are kept to a minimum to facilitate timely development of the calculator and to ensure that it is useful

[89] There is likely to be a level of granularity at which it is no longer meaningful for consumers to specify search criteria or at which lenders have not issued loans that match those characteristics.

to consumers — not overwhelming with options and information requirements, like home loan products themselves. Once the calculator is established, refinement of consumers and product characteristics could be investigated. Basic information likely to be required in the first instance would be the postcode or suburb of the property being purchased, and an indicator of the security being offered by the consumer against the loan, such as the ratio of the loan sought relative to the property value.

The underlying data should be published in a way that is accessible to third parties such as web application developers, so that these parties are able to develop additional tools, if there is a commercial benefit in doing so. Making data accessible would, at a minimum, require it to be published in a machine-readable format. The use of the publicly available data would also need to be monitored over time to determine the continuing need for ASIC to publish the interest rate calculator. (Monitoring for competition purposes is discussed below.)

Figure 12.3 **How interest rates vary with borrower and loan characteristics — 2015[a]**



[a] Loans may have more than one of the characteristics listed, and as such may be represented in more than one distribution. For example, a loan may be both interest-only and above $800 000.

Source: Productivity Commission analysis based on ASIC unpublished data on lenders' self-reporting of loans (2017x).

Concerns over greater transparency

A number of participants did not support increased transparency of home loan interest rates via an online calculator on a range of grounds: that consumer choice would be decreased; the mortgage broking business model would become unviable; the regulatory burden would be high; and tools already exist with comparison websites (box 12.2).

Primarily, it was suggested that the information produced by a calculator would be too much of an aggregate rate to benefit consumers and potentially be misleading (a criticism that must equally apply in the current market of SVRs, which are unreflective of any borrower, timing or location characteristics). This implies a version of a calculator that has no awareness of the capabilities of digital data and software analytics.

Box 12.2 Stakeholder claims an online calculator will mislead or confuse consumers

Canstar:

> Canstar would promote caution in using averages or median interest rates for comparison rate calculations. The advertised interest rate used now provides a reference point which is available to all borrowers. Adjusting this to an interest rate which is based on a median (i.e. the middle interest rate) will make the comparison rate more opaque. (sub. DR73, p. 5)

CommBank:

> Alternatively, price information provided at a high level runs the risk of misleading customers who have different risk or security characteristics to the median, and therefore mean that they cannot receive the price quoted. (sub. DR79, p. 58)

Regional Banks:

> While this has the potential to improve competitive pressure from the demand-side of the market, it may also involve considerable practical difficulties. More importantly, it may mislead customers as to the true cost of a product. The main problem with such tools is that they have a tendency to lead to 'gaming', whereby suppliers develop products that rate well on the tool, but have shortcomings in other areas.
>
> For example, comparison tools have difficulty capturing the full benefits of a 'bundle' of services offered by a financial institution. They also provide an incentive for suppliers to increase costs for services outside the scope of required disclosures. For example, in the case of mortgages, suppliers could shift costs to account closing or switching fees. (sub. DR107, p. 24)

Westpac:

> Historical median interest rates are of limited use to customers, since interest rates are dependent on individual circumstances and vary from customer to customer. The proposed tool would also be unable to take into account point-in-time changes in interest rates or promotional rates. (sub. DR125, p. 20)

FBAA:

> … whilst this information may be of interest to some consumers, the percentages would be very low – from both an engagement and comprehension perspective. The amount of work required to maintain this data is unlikely in our view to justify the service. (sub. DR85, p. 7)

In contrast, what we propose is a calculator based on actual interest rates charged. The online calculator can draw on the vast amounts of data collected by lenders, to provide a timely and customised estimate of home loan interest rates based on actual price data. It is much more likely, in our judgment, that media and consumer group analysis that is headlined as 'What borrowers negotiated last month' is far less likely to mislead than the current SVR that bears little resemblance to actual rates offered to borrowers.

Concern about price signalling and convergence of home loan pricing

A number of stakeholders raised concerns that the price transparency tool, as outlined in the Draft Report, would remove price uncertainty in the market for competing lenders as well as for consumers, ultimately leading to convergence of price outcomes. For example, ANZ Bank highlighted that:

> … banks currently operate under a condition of price uncertainty as to the level of interest rate offered by their competitors. This type of comparison site would remove some of that price uncertainty. (sub. DR74, p. 24)

The ACCC submitted that publication of 'detailed, contemporary interest rate data' could provide 'a more effective signal' to lenders, making it easier for them to compete less vigorously on price or detect when rivals attempt to deviate from the current 'tacit consensus' not to compete aggressively (sub. DR129, p. 3). However, the ACCC does note that this outcome is contingent on lenders not already knowing this information (sub. DR129). It is highly likely that lenders do already know who is offering more competitive rates than them (should that happen) through feedback, in part, from the mortgage broker channel (owing to widespread vertical integration of lenders and aggregators).

Nevertheless, to minimise the possibility of price signalling, the Commission considers it preferable to recommend an aggregated median interest rate across ADIs for a limited number of borrower and loan characteristics. Using a median does not disclose specific discounting below the median and using an aggregate measure means that competitors cannot quickly identify and target that discounting entity.

ACCC has noted a potential role for price monitoring to look for signs of misuse. They currently have the ability to undertake this monitoring within their existing functions. If they were to initiate price monitoring, the task would be enhanced by the data collected by APRA for the online home loan interest calculator.

Support for greater price transparency

Following the Draft Report, some participants were supportive of improving price transparency of home loan interest rates.[90] APRA highlight that their own internal data

[90] For example, RBA, sub. DR82; APRA, sub DR116; ASIC, sub. DR123; ACCC, sub. DR129; CHOICE, sub. DR97; P&N Bank sub. DR88.

improvement program had synergies with our recommendation, particularly online access to data:

> APRA would support working with ASIC to improve the access to, and usability of, collected home loan data by consumers. In this regard, APRA has commenced a data transformation program which encompasses a comprehensive modernisation of how APRA collects, stores, analyses and provides access to data. The 'Access to Data' stream of the program is focused on delivering the capability to produce analytics outputs that deliver data and insight to stakeholders. This includes the modernisation of APRA's public dissemination of non-confidential data, including, online access to data and data sets. (APRA, sub. DR116, p. 24)

The ACCC supported the objective of removing information asymmetry between lenders and consumers:

> Any measures developed as a result of the Productivity Commission's recommendations should be designed with the objective of addressing the information asymmetry between mortgage lenders on the one hand, and consumers on the other. (ACCC, sub. DR129, p. 4)

ASIC, while supportive of greater price transparency and an online calculator, considers consumer testing would assist to refine the approached used in the calculator (sub. DR123). The ACCC has also welcomed the opportunity to participate in such a consultation process (sub. DR129). We agree that careful consumer testing should be undertaken in the development of the online calculator to ensure consumers obtain the intended benefit. But timeliness of data availability is essential.

RECOMMENDATION 12.1 INTEREST RATE TRANSPARENCY FOR HOME LOANS

APRA should continuously collect data from mortgage lenders (authorised deposit-taking institutions (ADIs) only) on interest rates of new residential home loans by borrower and loan characteristics. Consideration should be given to adding non-ADIs to the data set, once the collection process from ADIs has become streamlined.

Using this data, ASIC should develop an online calculator that reports, with an elapsed time of no more than 6 weeks, median interest rates for loans issued according to different combinations of loan and borrower characteristics.

The underlying data should be published in a way that is accessible to third parties such as web application developers. At a minimum, data should be published in a machine-readable format.

13 Lenders mortgage insurance

Key points

- Lenders mortgage insurance (LMI) provides a way for lenders — particularly smaller lenders — to manage their risks, and makes them more willing to lend to higher-risk borrowers. This can encourage competition in the home loan market.
- LMI may also provide additional stability to the banking system, although the sheer breadth of current coverage — approximately a fifth of all loans — may still expose vulnerabilities.
- LMI enables some borrowers to obtain a home loan without having saved a 20% deposit.
  - However, the benefits of LMI accrue mainly to middle- and high-income earners, not low-income earners.
  - LMI also enables borrowers to take out larger loans as they are less constrained by a high loan-to-value ratio. This may contribute to a higher level of defaults than otherwise.
- Although the market for LMI is concentrated, lenders have access to alternative solutions for managing the risk of borrower default, which introduces an element of competitive pressure on the independent LMI providers.
- This competition can benefit lenders, but does not necessarily benefit the borrowers who invariably pay for the cost of premiums.
  - Lenders receive a range of non-claim payments from LMI providers, including for entering into exclusive contracts. These payments do not appear to be passed on to borrowers through lower LMI fees, and hence borrowers appear to be paying higher than necessary premiums for LMI.
- For borrowers who switch lenders while remaining over the 80% loan-to-value threshold, a new LMI premium is required in full. Refundable LMI premiums would desirably reduce the cost of switching.
  - The overwhelming majority of LMI claims occur between three and six years into a policy. However, refunds are currently only available within the first two years of an LMI policy, if at all. The proportion of borrowers receiving a refund after this time is negligible.
  - There are no insurmountable legal or practical barriers to extending refunds.
  - Extending the refund period will increase the cost of LMI and could discourage some borrowers from taking out home loans. But governments have other tools to assist these borrowers to enter the housing market if they desire.
- Offering borrowers the option to pay periodic premiums for LMI (rather than a lump-sum) could also reduce the cost of switching home loans.

Lenders mortgage insurance (LMI) is a type of credit protection insurance that protects a lender from losses in the event of a borrower defaulting on a home loan. Lenders choose whether to purchase LMI when extending credit to a borrower, and usually do so when loans have a high loan-to-value ratio (LVR) (usually more than 80%). This is because high-LVR loans have a higher risk of default (Blood 2009; Read, Stewart and La Cava 2014; QBE, sub. DR131). Some lenders also purchase LMI for loans with LVRs of less than 80%, but this is less common.

Almost a fifth of all home loans in Australia are covered by LMI, including almost a quarter of owner-occupier loans (table 13.1). This is slightly lower than the proportion of new loans with LVRs greater than 80% originated in 2017 (Genworth, sub. DR121).

Table 13.1 **Home loans supported by LMI**
2017

Type of borrower	*Proportion of loans with LMI (%)*
Owner–occupier	23
Investor	13
All loans	19

Source: Unpublished data from 14 ADIs.

LMI premiums are levied as a lump-sum when the policy is originated. Lenders pay these premiums to insurers, but it is common practice for them to recoup this cost directly from borrowers. Borrowers can pay for this cost upfront, but in many cases have the choice to capitalise it into the value of their loan.

Once the premium has been paid, the policy is active for the life of the loan. However, if the loan is terminated (for example, through a refinance), the policy ceases to be in effect. If the loan is refinanced and the new lender wishes to insure the loan, a new policy must be taken out (with the associated premium paid). Insurers said that this was because the risk of a loan depended not only on the characteristics of the borrower, but also the characteristics of the lender (for example, QBE, sub. DR131).

These arrangements give rise to a number of concerns, including about how the structure of the LMI market, the nature of the evolved product, and the incentives for lenders to use particular LMI providers and policies affect competition in the home loan market, as well as outcomes for those borrowers who have home loans covered by LMI.

13.1 What roles does LMI perform in the financial system?

A risk management tool for lenders

LMI transfers the risk of borrower default from lenders to LMI providers. As such, it helps lenders manage potential losses. As the Australian Prudential Regulation Authority (APRA) explained:

> LMI can be used by ADIs as a risk mitigant, to smooth out the normal variability of losses that occurs over time and to diversify regional concentrations of risk. (APRA 2017o, p. 27)

This allows lenders to enter into, or write more business in, high-LVR segments.

> Failure to offer LMI would require an increase in interest rates or (alternatively) make extension of credit difficult or (in some cases) impossible. (CBA, sub. DR79, p. 58)

The ability to insure against the cost of defaults is particularly relevant for smaller lenders, who are generally less able to bear the risk of high-LVR loans. The Insurance Council of Australia said that:

> The support provided by LMI is significant for small and regional lenders as they cannot carry as much risk on their smaller balance sheets as larger ADIs. These lenders typically are often more geographically concentrated in particular regions due to local economic conditions. (sub. 33, p. 4)

We consider that the largest value to the Australian community from the risk management aspect of LMI is that it can encourage smaller lenders to more fully compete in the home loan market — particularly for higher LVR loans.

Does better risk management result in lower prices?

Lenders also said that LMI allows them to offer loans to highly-leveraged borrowers at similar interest rates to borrowers with the required deposits.

> … given the protection provided by LMI, these higher risk borrowers are able to obtain the loan at an interest rate that is comparable to borrowers who have a 20% or greater deposit. (Westpac, sub. DR 125, p. 19)

> … if you're going to lend in that market without LMI, the risk weights go up materially and therefore the price would need to go up materially. LMI does support a better price for the duration of the loan for the customer. (Suncorp, PC transcript, 2018, p. 197)

However, this view was not universally held. For example, Rigoni (sub. 46, p. 5) said that borrowers who had paid for LMI also tended to pay a higher interest rate.

We analysed whether borrowers paying for LMI are also paying higher interest rates. Using data from the Australian Securities and Investments Commission, we found that, after taking into account factors such as the borrower's age and the loan amount, borrowers with LMI were on average charged a slightly higher interest rate, amounting to 0.00066% of the average interest rate for all borrowers. This means that, if the average interest rate for all borrowers was 5%, the average interest rate for borrowers with LMI would be approximately 5.003%. Albeit small, this difference is statistically significant.

But even a small difference is hard to justify — LMI already protects lenders from the additional risk of loss arising from borrower default where there is a high LVR ratio, and lenders should not need to charge a higher interest rate as well to protect themselves against the higher risk. Since prices in a competitive market reflect negotiations between lenders and borrower, this provides evidence that at least some borrowers have little scope to negotiate or influence the overall cost of their home loan purchase.

A way of increasing stability?

While LMI provides individual lenders with protection against possible losses arising from default, it can also contribute to stability of the financial sector or the economy as a whole.

During times of economic stress, the probability of borrowers defaulting on their loans can be highly correlated. For example, increasing unemployment can mean a large number of borrowers are simultaneously unable to meet their repayments. In addition, if this is accompanied by a decline in house prices, lenders may not be able to recover losses from selling the properties underlying the mortgages in default. If enough mortgages go into default, the stability of the financial system — and the entire economy — can be jeopardised.

LMI providers claimed that LMI increases stability in the financial system by absorbing losses from borrower default. For example, the Insurance Council of Australia submitted that:

> LMI is designed and priced for a long term “through-the-cycle” view and contributes to absorbing the effects of economic downturns (such as in the aftermath of the global financial crisis). (sub. DR120, p. 2)

QBE also stated that:

> LMI provides a fungible independent layer of capital that specifically supports credit default risk and the costs associated with that default in the Australian home lending market. (sub. DR121, p. 9)

There is likely to be some truth to these claims. LMI providers are prudentially-regulated entities, and must hold regulatory capital to withstand a 1-in-200-year stress event. LMI providers are also required by APRA to be monoline insurers (that is, they can only write one type of insurance), which ensures that the potential effects of the highly-correlated risks they insure does not affect other insurance sectors (RBA 2013b).

Moreover, APRA conducts industry stress tests on a periodic basis, which takes into account the effect of ADIs' LMI arrangements on the ability to withstand certain stress scenarios. From its 2014 stress test, APRA concluded that:

> … the Australian banking industry appears reasonably resilient to the immediate impacts of a severe downturn impacting the housing market … But … this comes with a potentially significant capital cost and with question marks over the ease of the recovery. Our conclusion is, therefore, that there is scope to further improve the resilience of the system. (Byres 2014, p. 10)

APRA said that results from its stress tests were helpful in informing its supervisory assessment of capital, although it did not determine them (Byres 2014, p. 4). Stress test results were used in 2017 as inputs in formulating benchmarks for new 'unquestionably strong' capital ratios for authorised deposit-taking institutions (RBA 2017q), and could conceivably also be used to inform APRA's view of capital requirements for LMI providers.

Maintaining lending standards through the economic cycle

Inquiry participants also proposed that LMI increased stability by maintaining lending standards through the economic cycle (ICA, sub. DR120; QBE, sub. DR131). For example, the Reserve Bank of Australia (RBA) observed that:

> During buoyant times when risk appetite among lenders rises, [lenders mortgage insurers] could limit the extent that lending standards weaken because they provide a 'second set of eyes' in the loan origination process. Conversely, when risk appetite subsides during downturns, a well-capitalised LMI industry could increase at least some lenders' willingness to continue writing high-LVR loans, helping to smooth changes in lending standards. (RBA 2013b, p. 39)

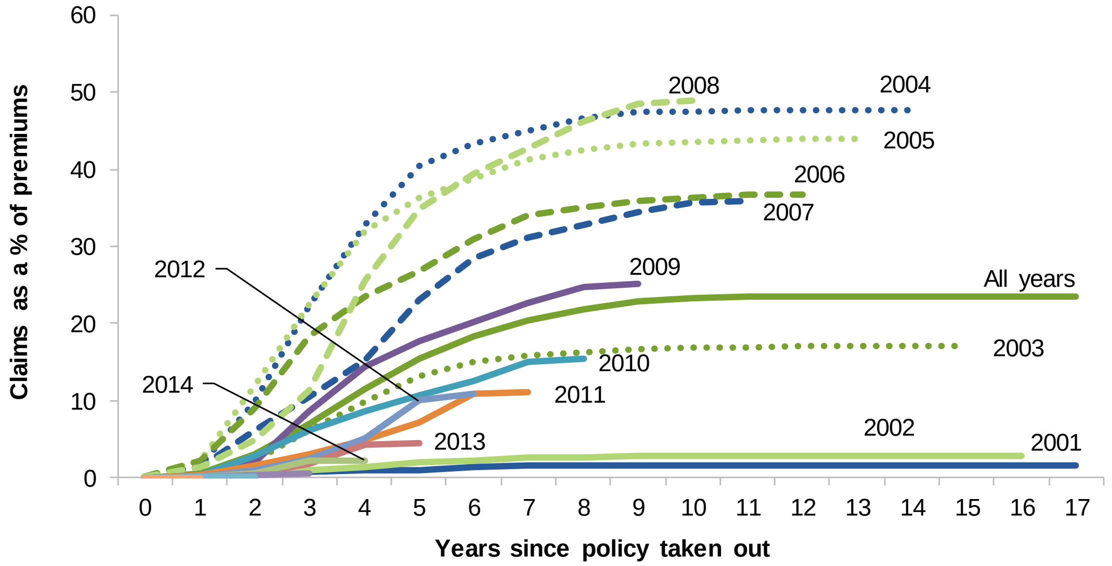
It is difficult to assess the veracity of these claims.

To begin with, it is unclear whether LMI providers have been effective in maintaining lending standards during periods of strong economic conditions. In the early 2000s, the Australian mortgage market saw an increase in investor loans, interest-only loans, low-documentation loans and loans with high LVRs (APRA 2008c). While the RBA and APRA did not consider that these changes represented a significant risk to the stability of the sector (Littrell 2003; RBA and APRA 2009), there was a clear and dramatic increase in claims on LMI for loans taken out immediately before the global financial crisis (figure 13.1). APRA has reminded lenders that LMI is not an alternative to loan origination due diligence, and ADIs should not rely solely on the audit and compliance regimes of LMI providers (APRA 2017o).

It is also difficult to assess the effect of LMI on lenders' willingness to extend credit at the bottom of the cycle, given the absence of a counterfactual. As would be expected, the number of new LMI policies taken out and the value of the properties insured has decreased since the global financial crisis (figure 13.2).

Figure 13.1 **Cumulative claims paid on lenders mortgage insurance[a]**

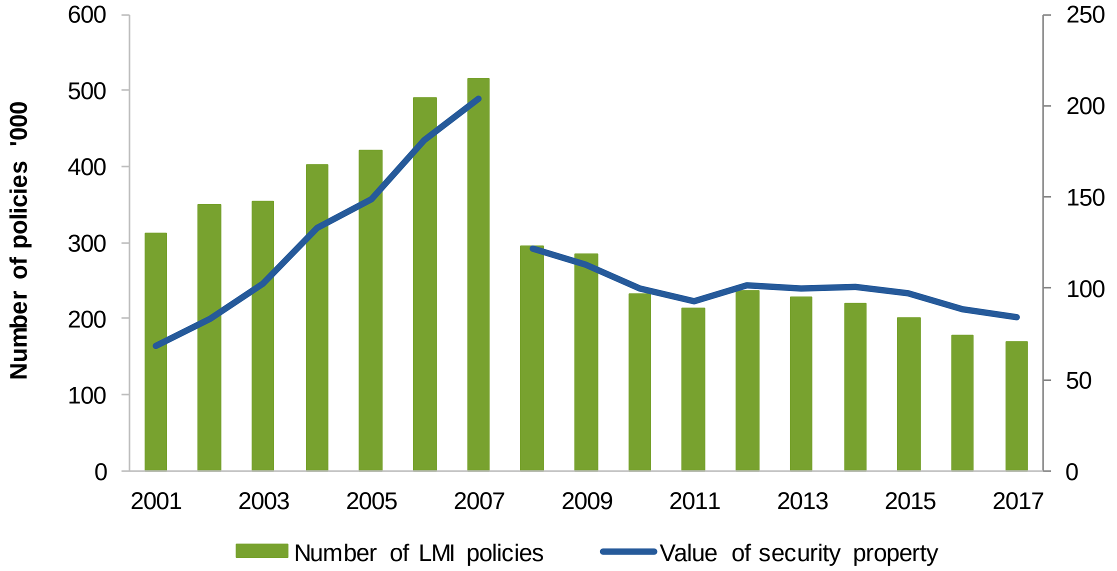
Cumulative claims as a % of premiums for all LMI providers



[a] Total claims made against LMI policies, attributed to the year the policy was taken out.

Source: Productivity Commission estimates based on unpublished industry data

Figure 13.2 **Number of new LMI policies and value of insured properties[a]**



[a] Number of new LMI premiums and value of security property for LMI policies taken out in a given year.

Source: Productivity Commission estimates based on unpublished industry data

An aid to entering the housing market?

Lenders and LMI providers emphasised the benefit of LMI in helping borrowers — and particularly first home buyers — enter the property market sooner, especially in an environment of high or rising house prices (box 13.1). The ability of borrowers to purchase a home more easily is a direct consequence of lenders' increased willingness to extend credit to highly-leveraged borrowers.

Box 13.1 **Participants emphasised the role of LMI in helping borrowers enter the property market sooner**

Genworth:

> LMI plays an important role in making it easier for more Australians to realise the dream of home ownership. (sub. 44, p. 2)

QBE:

> One of the greatest concerns expressed by borrowers who would like to achieve the dream of home ownership, is that by waiting to save a deposit, they are "going backwards" as they must continue to pay rent or because house prices may rise faster than their deposit accumulates.
>
> By de-risking the loan for a lender, LMI enables higher risk borrowers (often first home buyers) to access financing, that otherwise may not be available. (sub. DR131, p. 10)

ICA:

> With the median house price transacted in Sydney exceeding $1,000,000 and the average gross salary (before tax) being approximately $80,000, the significant challenge for a first home buyer is to save for a 20 per cent deposit, a challenge that may take many years to accomplish without LMI. (sub. 33, p. 2)

Westpac:

> LMI … enables customers who have not saved a deposit of 20% (plus government charges) to purchase a property that they would otherwise not be able to acquire, given the higher risk profile of such loans. (sub. DR125, p. 19)

The role of LMI in helping certain types of borrowers enter the property market is borne out in Australia's history. In 1965, the Australian Government established the Housing Loans Insurance Corporation, which provided mortgage insurance to assist low-income earners obtain housing finance (Parliament of the Commonwealth of Australia 2006). The provision of LMI was privatised in 1997 when it was considered that the market was able to provide LMI for itself. Overseas, mortgage insurance has also often been provided by governments, with the aim of supporting access to home ownership (box 13.2).

Box 13.2 Internationally, governments often support the provision of LMI

In **Canada**, mortgage insurance is provided by three institutions: the Canada Mortgage and Housing Corporation (CMHC) (state-owned), Genworth (privately owned) and Canada Guaranty (privately owned). The Government backs 100% of the mortgage insurance obligations of CMHC and 90% of the private insurers' obligations (lenders are expected to meet 10%) (Londerville 2010). The Government guarantee is intended to support access to home ownership for creditworthy buyers and promote stability in the housing market, financial system and economy (DoF (CA) 2016).

In **Hong Kong**, mortgage insurance has been provided by Hong Kong Mortgage Corporation Insurance Ltd, which is wholly-owned by the Hong Kong Government, since 1999. The objectives of the program are to promote home ownership and maintain banking stability (HKMC 2018). Private mortgage insurers (including Arch MI Asia and QBE Asia) also operate in the Hong Kong mortgage insurance market.

In the **Netherlands**, mortgage insurance is administered by the Homeowner Guarantee Fund and backed by a government guarantee, the *Nationale Hypotheek Garantie* (NHG). The NHG is available for mortgages on properties with a maximum value of EUR 245 000 (A$390 000). Mortgages guaranteed by the NHG must meet the criteria for responsible lending and borrowing set by the Netherlands National Institute for Family Finance (NHG (NL) 2017). In 2016, 73% of the housing stock had been bought by private individuals under the price ceiling and financed with an NHG-backed mortgage. However, the share of new mortgages backed by the NHG has been declining as the property value cap has not kept pace with rising house prices.

In the **United Kingdom**, the Government operated a 'help to buy' mortgage guarantee scheme from October 2013 to June 2017. The scheme offered lenders the option to purchase a guarantee on mortgage loans where the borrower had a deposit of 5% to 20%, and was limited to owner-occupied homes with a maximum value of £600 000 ($A1.09m). The guarantee compensated participating mortgage lenders for 95% of net losses suffered in the event of a repossession, down to 80% of the purchase value. Ten lenders participated in the scheme, covering 2.7% of all residential mortgage completions in the UK over that period (HMT (UK) 2017).

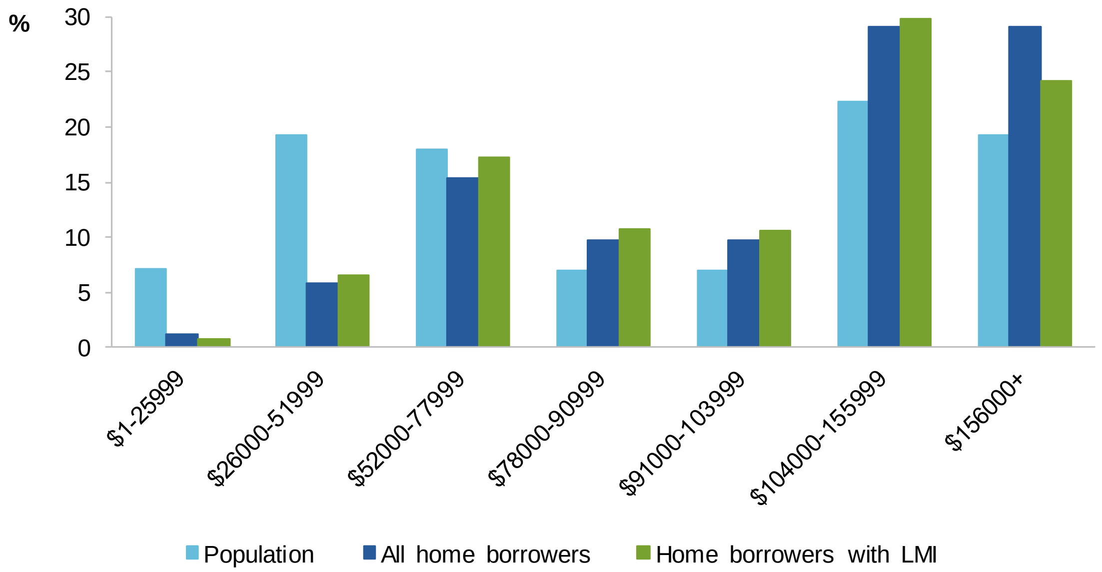
In the **United States**, there is a mixed market for mortgage insurance, with the Federal Housing Administration, the Department of Agriculture and the Department of Veterans Affairs having 65% of the market and six private insurers sharing the remaining 35%. The main driver of LMI is the requirement on Fannie Mae and Freddie Mac, the government-sponsored enterprises, to obtain credit enhancement for mortgages with LVRs above 80% (Goodman and Kaul 2017). The federal agencies and private insurers have different conditions and pricing for mortgage insurance.

Today, however, LMI is no longer a tool that that particularly assists low-income earners enter the property market. In fact, most of the benefits of LMI are likely to accrue to middle- and high-income earners. Data from 2016 show that the income distribution of families taking out a mortgage with LMI was very similar to all families who took out a mortgage, and that very few low-income families took out mortgages, even with LMI (figure 13.3). LMI is thus more accurately described as a tool that assists borrowers at all income levels to purchase more expensive housing than they might otherwise be able to afford, rather than a way in which low-income earners are assisted to enter the housing market.

Moreover, the widespread use of LMI has a negative aggregate effect on low-income earners' abilities to enter the housing market. By increasing the availability of credit, LMI contributes to increases in property prices, putting home ownership further out of reach for these borrowers. LMI can thus contribute to the problem it purports to overcome, with this self-reinforcing cycle benefitting those who are able to service large loans, at the expense of those who are not.

LMI therefore has limited usefulness in addressing housing affordability, and should not be relied on to do so. To the extent that there is a policy concern about lower-income or higher-risk borrowers accessing housing market, governments have more appropriate tools to call upon, including reforms to taxation, land use and foreign investment (for example). Concerted reform is likely to be needed across multiple policy areas.

Figure 13.3 **LMI is used mostly by medium and high income borrowers**[a]



[a] Distributions are calculated as a proportion of reported family incomes that were positive. The distribution of pre-tax incomes of borrowers is 2015 ASIC-collected data. The distribution of incomes in the population is 2016 Census data.

Source: ABS (2018a); Productivity Commission estimates based on ASIC Mortgage Broker Remuneration Dataset 2015 (ASIC 2017x)

LMI can also contribute to higher default rates

In addition, by facilitating higher-risk borrowers obtaining a home loan, LMI will necessarily lead to a higher level of defaults. Westpac (sub. DR125) submitted that, as at 30 September 2017, its 90+ day delinquency rate for loans written at above 80% LVR was 1.05%, approximately double that for loans written at 80% LVR or below (0.58%). The 90+ day delinquency rate for its overall mortgage portfolio was 0.69%.

Data provided by LMI providers also showed that, since 2001, over 32 000 claims on LMI premiums have been paid, with outstanding debts averaging over $70 000 each. Each of these claims represent a household that has lost their property and still had outstanding debts to repay. Of course, LMI also makes it possible for high-risk borrowers who do not default to purchase housing.

13.2 Competition in the LMI market

In the LMI market, lenders are 'consumers' of the insurance, and undertake negotiations with LMI providers in relation to the pricing and features of the product. However, they do not pay for the product, in contrast to a standard market. Instead, the cost of premiums are passed on to borrowers, who are neither able to claim on the policy nor directly influence prices.

The extent to which borrowers enjoy a fair price on LMI premiums therefore depends on the intensity of competition in the market comprising LMI providers and lenders. This section assesses the nature and extent of such competition.

The LMI market is concentrated, but lenders have other options

The market for LMI is characterised by four providers: Genworth and QBE (the two independent providers), and two wholly-owned subsidiaries of major banks that are licensed to only provide LMI to their parent banks (ANZ LMI and Westpac LMI). The market share of the two independent providers was estimated by UBS to be approximately 64% in March 2018 (Genworth, sub. DR121).

A small number of LMI insurers and high levels of concentration does not necessarily mean that the market is uncompetitive. A range of alternatives to LMI exist for lenders to manage default risk (box 13.3), and this *could* impose some discipline on the market and enable competition (QBE, sub. DR131; Genworth, sub. DR121).

The independent providers do appear to face pressure to offer lenders products and prices that are attractive relative to the alternatives (box 13.3). These pressures primarily arise from the capacity of lenders to exercise some discretion in their operations over the use of LMI.

- There is no requirement for lenders to insure all their loans. This means that insurers face incentives to offer products that induce lenders to insure as much of their book as possible.
- Lenders often undertake competitive tenders in selecting their LMI provider. Lenders usually invite tenders when their existing LMI contracts are due to expire, approximately every three to five years (Suncorp, PC transcript, 2018, p. 197). The tender process would generally encourage insurers to put forward their most attractive (to lenders) offer.

But the very small nature of the market (with just two independent providers) and the absence of Westpac and ANZ as potential clients also raises the stakes for QBE and Genworth to secure contracts with the remaining lenders. As a result, the independent providers attempt to compete by offering lenders payments for entering into exclusive contracts. These payments do not necessarily benefit borrowers, as discussed below.

Box 13.3 **Alternative ways to manage default risk**

Do not purchase LMI

Rather than purchase LMI to mitigate losses in the event of default, lenders could bear the risk themselves. They may charge borrowers a higher interest rate to compensate for the higher risk, and may also seek re-insurance for all or part of their portfolio.

Charge borrowers a low-deposit fee, reduced equity fee or similar charge

Lenders may also choose to create provisions for losses through charging a low-deposit fee, reduced equity fee or similar charge. The funds obtained through these charges are generally kept by the lender rather than being used to purchase an LMI policy, and the risk associated with the loans are retained on the lender's books. This is sometimes known as 'self-insurance'.

In some cases, lenders may use part of the fees to purchase re-insurance, thereby also transferring some of the risk to reinsurers. CBA, for example, charges some borrowers a low-deposit premium and retains the risk associated with these loans on its books, with some catastrophic risk transferred to re-insurers (Genworth, sub. DR121).

Purchase LMI from an independent provider

Lenders may choose to enter into agreements with one or both of the independent providers, QBE and Genworth.

Set up an LMI provider as a subsidiary

As noted in the introduction to this section, ANZ and Westpac have chosen to set up LMI providers as wholly-owned subsidiaries of the respective banks.

The competitive pressures felt by LMI insurers benefit lenders, but do not necessarily feed through to borrowers.

On the one hand, insurers can compete for lenders' business by offering them *products*, prices and other services that result in a better deal for borrowers. If competition for home loans were strong, such offers would be attractive to lenders on the basis that it would enable them to win a greater share of the home loan market.

On the other hand, however, insurers can compete by offering lenders *benefits* that do not flow through to the borrower, and could even make borrowers worse off by increasing the premiums they are required to pay. Our analysis suggests that this type of competition can be observed, meaning that there is greater scope for competition in the LMI market to benefit borrowers.

What's important to lenders when choosing their LMI arrangements?

When choosing their LMI arrangements, lenders assess the costs and benefits of each alternative: not purchasing LMI, self-insuring, setting up a captive LMI provider or purchasing LMI from an external provider (box 13.3).

- Remaining uninsured can leave a lender vulnerable to large losses in the event of a downturn, especially given the correlated nature of the risks. Lenders are therefore unlikely to remain uninsured unless the risk of default is demonstrably lower compared to other high-LVR loans. LMI is sometimes not purchased for loans to borrowers who are members of certain medical professions, for example.
  - The fact that the cost of the premium is passed on to the borrower (and that it is unlikely to be the primary driver of borrowers' home loan decisions, as discussed below) further lowers the likelihood that lenders will not purchase LMI on a high-LVR loan or otherwise seek to mitigate this risk.
- Using self-insurance rather than LMI means that, if claims are lower than expected, provisions that were made for losses (which would otherwise have been used to pay LMI premiums) can be used for other purposes. However, in the event of a severe economic downturn, lenders are still exposed to large losses. Lenders may thus seek to obtain reinsurance. The Commonwealth Bank retains some of the risk associated with loans where a low-deposit premium was charged, and transfers some catastrophic risks to reinsurers (Genworth, sub. DR121).
- Lenders may prefer LMI over self-insurance because of the capital benefits associated with using LMI. Under the standardised prudential framework, lenders can hold less regulatory capital if loans are insured by LMI (chapter 6).

The main consideration is risk management

When selecting between LMI providers (including captive providers), lenders appear to be primarily concerned with the ability and willingness of the different insurers to manage the relevant risks.

> LMI competition is not just about LMI premiums – it is also a question of risk appetite and willingness to accept credit risk. (QBE, sub. DR131, p. 16)

In this vein, ANZ said that its decision to establish its own LMI provider was based on concerns that the independent providers would not be able to meet their payout obligations in the event of a significant economic downturn.

> The problem you get into with external providers … . In a smaller market like Australia, it's a concentration risk: if everybody insures with the same provider for that insurance, when things go bad, that insurance is worthless. (PC transcript, 2018, p. 301)

Lenders' concern with LMI providers' ability to honour their obligations is understandable, given that its purpose as an insurance product is to mitigate losses that a lender might incur. However, in the LMI market, the usual incentives of a product purchaser to consider the trade-off between price and quality is diluted, since borrowers bear the cost of LMI premiums. This can lead to lenders overemphasising the ability of insurers to manage risks, at the expense of obtaining a value-for-money insurance policy.

The price of LMI is secondary

QBE claimed that lenders have an incentive to keep premiums as low as possible even though borrowers ultimately pay for premiums, since this contributed to their ability to attract more home loan customers.

> The fact that the cost of the premium is paid by the borrower does not reduce the lender's overriding commercial imperative: to maintain and increase market share. (sub. DR131, p. 16)

However, the extent to which this is true depends on whether the cost of LMI actually influences borrowers' decisions about which home loan to acquire, as well as whether borrowers would seek to reduce the cost of the premium if they considered it to be too high. We consider that borrowers are unlikely to walk away from a home loan offer on the basis of the LMI cost, because:

- borrowers are primarily concerned with obtaining a loan (as opposed to LMI), and are unlikely to search elsewhere once they have been offered a loan that satisfies other (more important) criteria
- the cost of the premium is usually small relative to the size of the loan
- borrowers can capitalise the LMI fee into their loan, which means they do not face this cost immediately.

Although borrowers *do* consider price to be an important factor in selecting their home loan (chapter 11), it is likely that they would seek to reduce the cost of their home loan through negotiating a lower interest, rather than bargaining down the LMI fee. And although brokers can negotiate on the price of LMI on borrowers' behalf (AFG, sub. DR132), or facilitate price comparison on the cost of LMI (ME Bank, PC transcript, 2018, p. 335), we consider that this only occurs at the margin.

Thus, lenders face weak incentives to compete on the price of LMI, particularly if they already have substantial market share in home loans. This is not to say that they have *no* incentives at all to deliver borrowers a good deal on LMI — for example, ME Bank (PC transcript, 2018, p. 335) said that it passed on the lower LMI prices it was able to obtain to its customers. However, evidence that lenders do not pass on the full benefits offered to them by insurers (discussed below) suggests that the cost of LMI is not an important way in which lenders attempt to win market share.

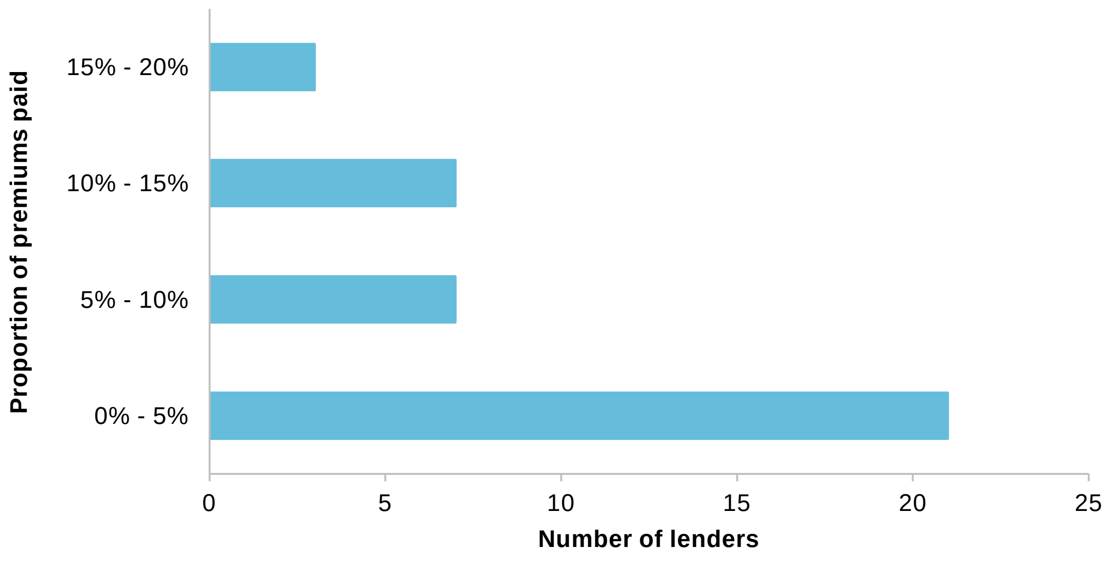
Insurers offer lenders a range of benefits

We found that insurers offer lenders a range of benefits, including:

- benefits for entering into exclusive contracts
- payments for costs incurred by lenders, such as marketing, IT, valuation and delegated underwriting costs, which may be conditional on the existence of an exclusive contract (Suncorp, PC transcript, 2018, p. 200)
- discounts that depended on the volume on loans insured
- rebates that rewarded lenders for low claims.

Some of these were explicit payments from insurers to lenders, while others were discounts that were deducted before premiums were paid or contract terms that did not have associated payments. Between 2015 and 2017, approximately 26% of lenders that purchased LMI from Genworth and/or QBE received monetary payments for items other than claims from at least one of these insurers. Ten of the 38 lenders that received such payments received more than 10% of the premiums that they had paid over those years (figure 13.4).

Figure 13.4 **How much did lenders receive in non-claim payments?[a]**
2015–2017[b]



[a] Where lenders purchased insurance from both providers but only received payments from one, non-claim payments were calculated as a proportion of the premiums paid to the insurer that made the non-claim payments. Where lenders received payments from both insurers, they are represented twice in the sample. [b] This timeframe does not necessarily match the contract periods of the different lenders — for example, a contract may last more than three years, or may begin partway through the examined period. Proportions calculated over the length of individual contracts may therefore differ from the proportions shown in this chart.

Source: Productivity Commission estimates based on data provided by Genworth and QBE

These benefits naturally influence lenders' LMI arrangements, including their choice of provider. For example, ME Bank (PC transcript, 2018, p. 334) said that it had LMI arrangements with only one insurer because this enabled it to have enough volume to obtain more favourable pricing. For lenders that used more than one provider, each provider usually only insured loans carrying a particular brand or originated through a particular channel (such as brokers), allowing the lender to enjoy the benefits of exclusive contracting.

We also found that insurers appeared to make payments to lenders for merely entering into a LMI contract with them, variously called 'sign-on payments' and 'exclusivity fees'. In one case, the payments made over the three years from 2015 to 2017 equated to approximately 15% of the premiums paid by that lender over that period.

It is difficult to see how such arrangements could benefit a borrower, or how they could be interpreted as anything other than a sweetener for lenders to sign the deal. Exclusive arrangements are particularly problematic in the LMI market because, as mentioned above, a borrower's purchase of LMI is secondary to their purchase of a home loan, and payments for exclusive arrangements can tempt lenders to make decisions based on payments rather than the value of the insurance. Borrowers can therefore be left with a sub-par LMI product if they want the home loan being offered to them by a lender.

In addition, the cost of offering such payments must necessarily be factored into insurers' cost of doing business, leading to higher premiums. While lenders can pass on the benefits of these payments through lower LMI fees to borrowers, it appears that they do not always do this. From our analysis, headline premium amounts paid by lenders to insurers were generally in line with the amounts charged to borrowers, meaning that lenders were passing on the full amount of premiums to borrowers, rather than the amount net of exclusive (and other) payments. Borrowers are therefore likely to be paying prices that are higher than necessary to reimburse lenders for the cost of LMI.

Increasing transparency regarding non-claim payments offered by insurers to lenders could offer a partial solution to this issue, as discussed in section 13.3.

13.3 LMI and borrowers

Borrowers pay for LMI, but they can't negotiate the price

Despite the fact that they bear the cost of LMI, borrowers are not party to negotiations relating to the price or terms of the LMI arrangement that covers their home loan. This means that the interests of those who actually pay for LMI are not represented in the LMI market. And, from the perspective of borrowers, negotiations and arrangements between insurers and lenders about LMI prices and terms are a black box.

For this reason, the Commission considers that regulatory intervention is required to account for the interests of borrowers. The Khoury review put forward two possible solutions: regulate the commercial arrangements between banks and lenders, or mandate greater disclosure of the amounts paid by insurers to lenders (box 13.4).

Box 13.4 **The Khoury review's recommendations on charging for LMI**

In 2017, an independent review of the Code of Banking Practice (the Khoury review) reported that fairness issues had been raised in relation to the costs of LMI passed on by banks to their customers. It recommended possible approaches to dealing with how lenders pass on LMI costs to borrowers.

> a) restrict signatory banks from charging a home loan customer for lenders mortgage insurance more than the actual cost incurred by the signatory bank net of any discount or commission paid by the insurer to the signatory bank and require a signatory bank to pass on to a home loan customer any rebate of premium that the signatory bank receives if the customer repays or refinances their loan; or
>
> b) impose a disclosure regime whereby signatory banks disclose to their customers any discount, commission or rebate obtained by the bank at the inception of the policy and at the time of cancellation of the policy. (Khoury 2017, pp. 163–164)

In its response to the review, the Australian Banking Association (ABA) argued that additional time was needed to consider these options, because:

> … these recommendations imply that these discounts and rebates exist at an individual policy level. It is imperative that no ambiguity exists regarding the objective of this recommendation. The industry will need to be mindful of its legal obligations, including competition law. For example, inclusion of any provision of this nature may require regulatory approval. (ABA 2017a, p. 26)

Since that time, the ABA has released a new Draft Code of Banking Practice, which contains the following commitment.

> We will not charge you more for lenders mortgage insurance than the actual cost we incur for that policy. We will not receive a commission on your lenders mortgage insurance policy. (ABA 2018b, p. 15)

However, this does not address payments that are not attached to individual policies, but that nevertheless have a significant effect on the costs incurred by lenders.

An intervention in the commercial arrangements between insurers and lenders could, in theory, reduce the prices paid by borrowers, although some of the costs currently borne by insurers (for example for IT or valuations) would have to be met by the lender instead and recovered in another way. But this would be a major intervention and difficult to police.

The alternative to direct intervention (requiring lenders only to charge borrowers the cost incurred) would be to build on the existing requirement for LMI insurers to report their operating expenses in returns to APRA, which are subsequently published. Providing more detail about these expenses would increase understanding about the overall costs of the LMI sector and support competition.

RECOMMENDATION 13.1 LENDERS MORTGAGE INSURERS SHOULD DISCLOSE INFORMATION ABOUT PAYMENTS TO LENDERS

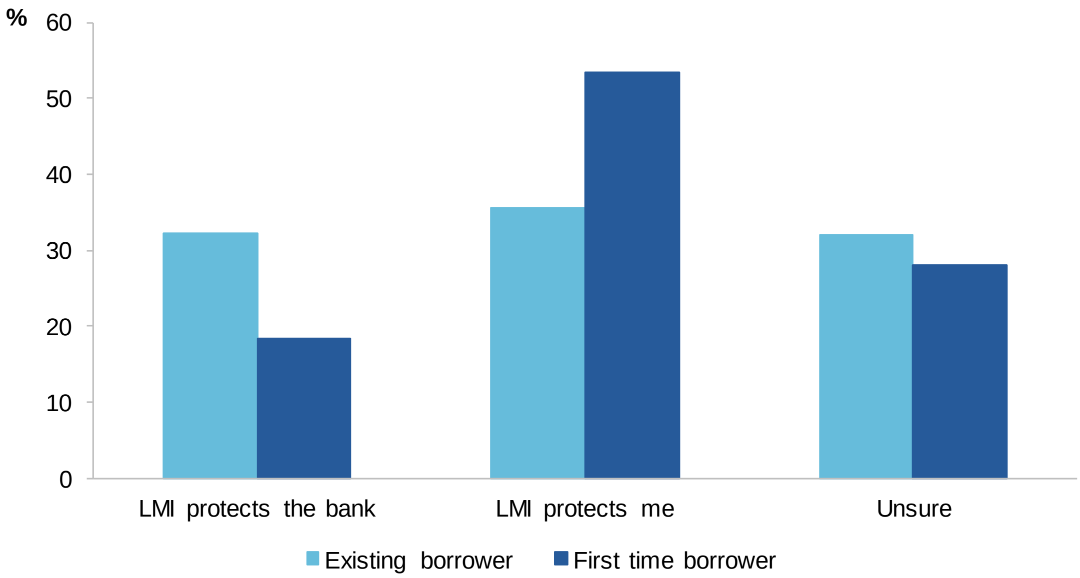
APRA should update its disclosure requirements for lenders mortgage insurers to require them to disclose the amount and purpose of all payments made to lenders.

Many borrowers do not understand the nature of LMI

The nature of LMI is not well understood by borrowers, with widespread misconceptions about what LMI covers and what happens with LMI when the borrower wants to refinance or close their loan early. For example, many borrowers mistakenly believe that LMI covers them if they are unable to meet their loan repayments (figure 13.5).

Figure 13.5 **Borrowers mistakenly believe LMI covers them**

Results from a 2018 survey conducted by Digital Finance Analytics[a]



[a] Sample includes 6158 existing borrowers and 1185 first time borrowers. All borrowers surveyed held loans that were covered by LMI.

Source: Digital Finance Analytics, pers. comm., 9 May 2018

Given the higher risk profile of borrowers with highly-leveraged loans that require LMI, it is important that potential borrowers have access to clear and reliable information on the product. One area where there has been discussion has been the use of LMI factsheets (box 13.2). We recognise the efforts that lenders and LMI insurers have so far invested in producing LMI factsheets, and consider provision of such factsheets to be a step that all lenders should take. To this end, the Australian Banking Association should adopt the recommendation of the Khoury review into the revised Code of Banking Practice (box 13.5) to provide home loan borrowers with consumer tested factsheets explaining LMI.

Box 13.5 **LMI fact sheets**

In August 2011, the then Treasurer announced that the Australian Government would require lenders to produce one-page factsheets to help borrowers understand the costs and benefits of LMI.

> The aim is to allow consumers to compare quotes side-by-side, including the difference in premiums and rebate schedules, helping them get the deal that's right for them.
>
> This will help home buyers compare apples with apples when it comes to shopping for lenders' mortgage insurance, which is critical for making the dream of homeownership a reality for many Australian families, particularly first-home buyers. (Swan 2011)

This proposal was not implemented. However, the two independent LMI providers and many lenders have voluntarily prepared such factsheets (Genworth 2017b; QBE LMI 2017; CBA 2017e; ING 2017; NAB 2016). The Insurance Council of Australia has also developed a factsheet (ICA 2017b).

In 2017, the review of the Code of Banking Practice (the Khoury review) recommended that home loan borrowers be provided with factsheets explaining LMI.

> The ABA and signatory banks should develop a fact sheet that explains lenders mortgage insurance to home loan borrowers. The Code should require this to be provided to a Code customer who is required by a signatory bank, as a condition of their home loan, to obtain lenders mortgage insurance. (Khoury 2017, p. 163).

The ABA responded that:

> The industry supports providing home loan borrowers with information explaining lenders mortgage insurance (LMI).
>
> However, a uniform fact sheet (even with some ability to customise) is not recommended. The preference is for signatories to be able to design and maintain LMI customer fact sheets individually and independently given the nuances that will exist across the industry. (ABA 2017a, p. 26)

Since that time, the ABA has released a new draft Code of Banking Practice, which contains the following commitment to borrowers:

> We may require you to pay for lenders mortgage insurance in connection with a loan you have. If we do this, we will give you a fact sheet about lenders mortgage insurance. The fact sheet will contain information outlining the key policy features. (ABA 2018b, p. 15)

It is unclear if each institution would design its own fact sheet, or if a template or guidelines would be developed jointly by lenders and the ABA.

LMI is a barrier to refinancing

At present, if a borrower refinances their loan with another lender, the original LMI policy ceases to be in force. As a result, a new LMI policy may be required on the refinanced loan, depending on the requirements of the new lender. The decision of whether a new LMI premium is required will largely be based on the amount of loan principal that has been repaid and the value of the property at the time the loan is being refinanced. Typically, LMI is required if the LVR of the loan remains above 80% or if the loan is otherwise assessed to be higher-risk. We consider that the possibility of a borrower being asked to pay another LMI premium when they refinance (without receiving a refund on their previous LMI premium) creates a barrier to switching.

In some instances, a borrower may receive a refund on the cancelled LMI policy, which would lower the cost of refinancing. Whether a borrower receives a refund generally depends on whether the lender receives a refund from the insurer that it is able to pass through. Insurers usually offer lenders refunds only if cancellation occurred within one or two years of the loan being originated.

- Genworth offered a 40% refund to lenders when loans are repaid within the first year, and a 20% refund if loans were repaid between one and two years, subject to other criteria being met (for example, the loan must not have been in arrears while the policy was active) (Genworth 2017a).
- QBE only offered a refund for the first year of the loan (QBE LMI 2018).

However, specific arrangements between LMI providers and lenders can preclude refunds altogether. The Commonwealth Bank (sub. DR79) said that its agreements with LMI providers did not permit it to receive refunds for loans terminated before maturity.

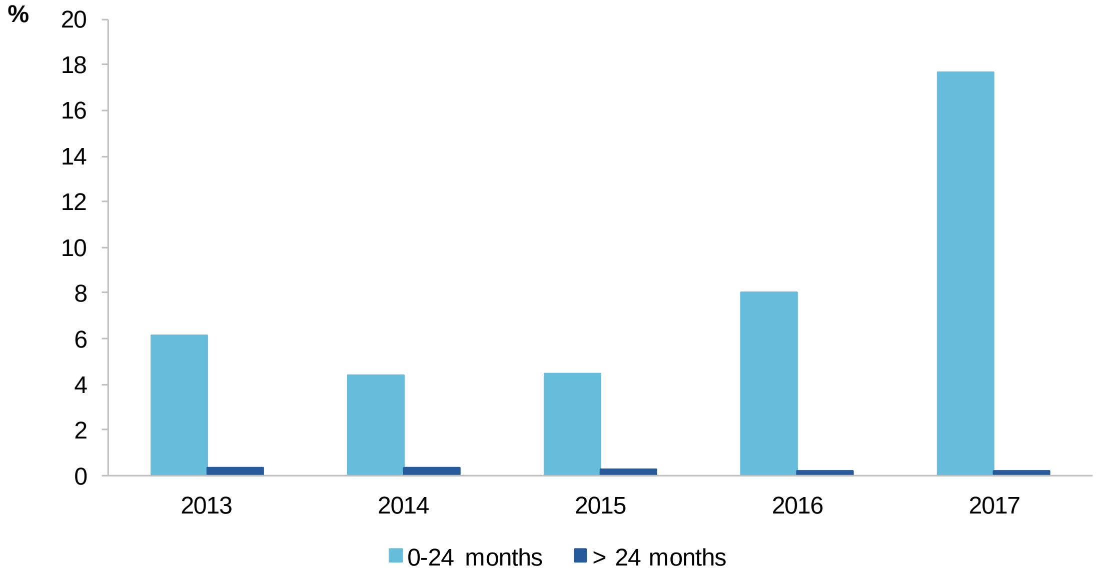
Data show that borrowers often do not receive refunds on LMI premiums when they refinance or pay out their loan (figure 13.6). The number of borrowers receiving refunds may increase in the future, as ANZ, which has generally not provided refunds of LMI premiums to borrowers, is implementing a new policy that makes refunds automatically payable when a loan is repaid in full within two years from origination (sub. DR74). However, the new policy will still only benefit borrowers that refinance or repay their loan within a very short time from origination.

We have explored three policy options to ameliorate the disincentive to refinance caused by the need for additional LMI policies:

- make LMI policies portable
- extend the refundability of LMI premiums
- institute periodic payments for LMI

Figure 13.6 **Very few borrowers get a refund for their LMI fee**

Proportion of borrowers who terminate their loan and receive a refund, by time since loan origination



Source: Productivity Commission estimates based on data provided by 3 of the 4 major banks

Portability of LMI

One option to reduce the cost of refinancing is to allow LMI policies on the same property to be transferred between lenders. From a borrower's point of view such portability of LMI would appear to be a valid option in overcoming the disincentives to refinance. The initial LMI premium they paid to the previous lender would have been sufficient for the life of the loan if they had not refinanced. The fact that they have refinanced has not decreased their ability to repay the loan, and may even have increased — as they have likely increased the equity stake in the property, and they may have been able to negotiate a lower interest rate.

However, there are two main barriers to portability of LMI, which limit its viability as a policy reform. First, the size of the loan could change, and portability of LMI would be difficult for loans where the principal has been increased. In 2011, The Treasury examined options for portability of LMI (The Treasury 2011). It found that most (up to 90%) refinanced loans that required a new LMI premium had an increased principal. As a result, it concluded that:

> LMI portability would be expensive and extremely complex to implement and administer and would benefit less than one per cent of all borrowers. (The Treasury 2011, p. 1)

While the data used by Treasury is likely to understate the demand for refinancing at the same or lower level of principal (because the current lack of portability and limited refunds for LMI discourage switching early in the life of a loan), the demand for refinancing where the principal is increased is likely to be sizeable.

Second, risk preferences vary between lenders. LMI premiums are currently determined based on the expected risk factors that prevail. This includes the characteristics of the loan, the characteristics of the lender and the conditions in the housing market. For example, LMI insurers explained:

> …all lenders are not the same. Different lenders constitute different risks for an LMI provider, as does the type of loans and processes they use to originate them. (QBE, sub. DR131, p. 17)

The 'new' risk represented by the refinanced loan may substantially deviate from the original LMI premium which was paid.

Extending refundability of LMI premiums

In explaining the rationale for current refund arrangements, QBE said that:

> The current limitation on refund availability (partial, for termination early in the life of the loan) has a sound economic justification: the premium is not simply pocketed by the LMI provider and cannot easily be separated from the cost of covering the whole pool.
>
> Expressed in another way, a farmer could not get a refund for the delivery cost of a load of feed if, six months later, she chose to graze her cattle on neighbouring land. While she might complain that the feed delivery charge was no longer of value to her now that she was not using the feed, that does not change the fact that, at the time of purchasing the load, the delivery fee was a fair and necessary cost. (sub. DR131, p. 14)

The view that LMI is a cost of extending credit was also put forward by Genworth:

> … LMI premiums are set in the context of capital requirements for lenders and effectively represent "sunk costs" upfront for such items as capital, expenses and losses which feature more extensively in the earlier years of a policy … (sub. DR121, p. 10)

However, according to this logic, refunds should not be given at all. This therefore does not explain why refunds *are* currently offered, but only for a limited amount of time. We consider that premiums do not necessarily represent a sunk cost, and are able to be (and should be) refunded to borrowers beyond the time period for which they are currently offered.

A number of participants also said that the reason that refunds were only offered for two years was because reinsurance arrangements assumed that there would be no refunds beyond this time. For example, Westpac said that:

> From the bank's perspective it's tail risk. It's insurance for tail risk in the mortgage portfolio. We re-insure a lot of that risk and the reinsurance arrangements that are currently in place assume that there's no refunds beyond two years. (PC transcript, 2018, p. 49)

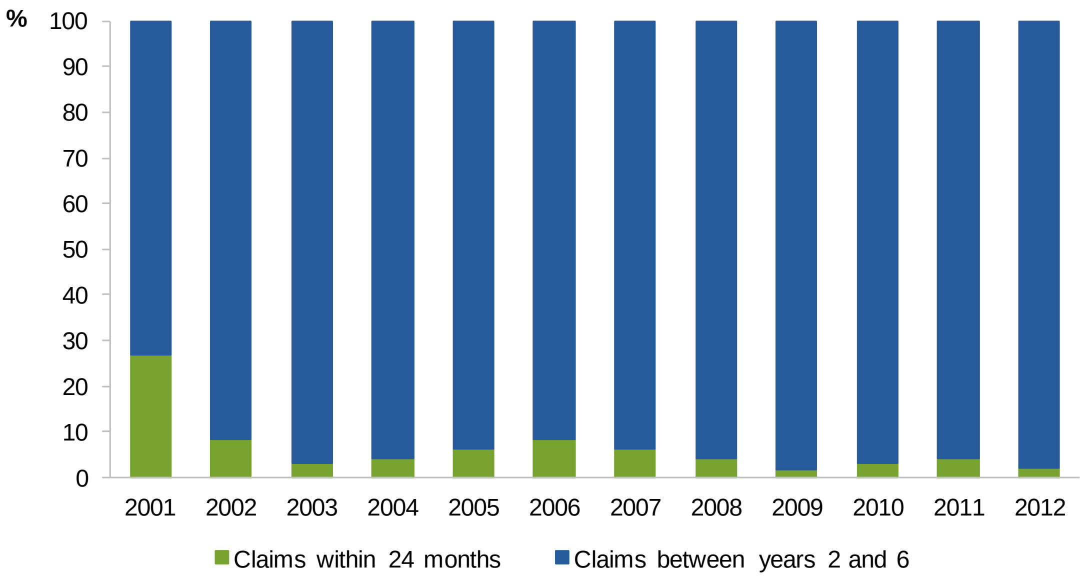
Reinsurance arrangements are able to be altered to accommodate a longer refund period.

CHOICE (PC transcript, 2018, p. 19) said it had been suggested to them that the time period for refunds reflected the amount of time after which the insurance product was essentially 'used up' — that is, refunds ceased when the risk of default began to decrease substantially. However, data obtained from LMI providers showed that cumulative claims appeared to increase substantially for at least six years after policies were originated (figure 13.1), and that within this time, only a small proportion of payouts were made within the first two years (figure 13.7).

If the value of the LMI refunds is based on the benefits yet to accrue to the policyholder, refunds should be given for at least up to this time. This is in line with other types of insurance (for example, car insurance), where a refund is given if a policyholder pays an annual premium at the start of the year but chooses to cancel the policy at any time over the course of that year.

Figure 13.7 **Distribution of LMI claims over the first six years of policies[a,b]**

By year that LMI policies were initially taken out



[a] By value of claims. [b] Claims usually occur approximately 18 to 24 months after a loan shows signs of delinquency. As such, this figure may underestimate the extent to which borrowers may experience hardship repaying their loan within the first two years.

Source: Productivity Commission estimates based on unpublished industry data

The Commission therefore considers that the time horizon for lenders offering borrowers refunds for LMI premiums should be extended to at least six years. Westpac (sub. DR125) suggested that it may even be possible for refunds to be available for up to eight to ten years.

We acknowledge that offering refunds might mean that LMI premiums at the outset are likely to be higher, and that the risk represented by the pool of borrowers is likely to be changed — more expensive LMI means that higher risk customers are unlikely to be able to afford loans. Whether or not this is desirable depends on a subjective judgment of whether higher risk borrowers should be obtaining loans in the first place.

Periodic payments for LMI

LMI in Australia is unique among insurance products in that premiums are levied upfront, rather than on an ongoing basis over the life of the policy. In this sense, it is more akin to a warranty than an insurance policy. An alternative to extending refunds on lump-sum premiums could be for borrowers to make periodic payments over the life of the policy.

This model can be observed overseas. For example, in the United States, mortgage insurance is usually paid as a monthly premium. The Homeowners Protection Act 1998 requires the payment of premiums to be terminated automatically once the LVR reaches 78%, based on the original value of the property. Borrowers may also apply for a termination of their premiums when the LVR reaches 80% (FDIC 2015).

There is no in-principle reason why similar arrangements could not exist in Australia. As part of our analysis, we constructed a stylised model of how periodic payments could work, in order to verify its feasibility (box 13.6).

There would be costs in moving to LMI by periodic payments, such as:

- the need for new contract arrangements between lenders and LMI providers and between LMI providers and reinsurers, which could include the need to have more granular and transparent risk ratings for different lenders
- changes may be required to the regulatory reporting arrangements and the regulation of prudential standards for lenders and LMI providers
- arrangements to deal with house price fluctuations would need to be developed
- lenders would need to monitor and enforce the payment of LMI premiums
- there would need to be a transition period where some LMI policies will be for the life of the loan, and others will be based on periodic payments, and there will be costs associated with dealing with this complexity.

However, we consider that these are all manageable, and that there would be benefits to giving borrowers the *option* of making periodic payments. This option is likely to be taken up by borrowers who, despite not having a sufficient deposit to avoid the need for LMI, envisage that they are likely to be able to pay off their loan relatively quickly, thus paying LMI for a shorter period of time. Periodic payments would also increase transparency around the cost of LMI and remove a barrier that discourages borrowers from shopping around for a better deal on their home loan.

Arrangements between lenders and LMI providers would be open for negotiation between those parties, which could introduce an additional point of competition into the market.

RECOMMENDATION 13.2 OFFERING BORROWERS MORE CHOICE FOR LENDERS MORTGAGE INSURANCE

ASIC should require all lenders to provide those borrowers that are levied with lenders mortgage insurance (LMI) with the option of being levied once at the commencement of their home loan (whether paid as a lump sum or as deferred payments) or being levied annually over the first 6 years of their loan, with transparency around the comparison of these options.

Where LMI is levied at the commencement of the home loan, all lenders should be required to set a schedule of refunds on the cost of LMI when borrowers choose to refinance or pay out their loan within 6 years of the loan being originated. The refund schedule should be made available to the borrower before any fee or charge is levied.

14 General insurance providers and products

Key points

- As with the banking sector, the general insurance sector is dominated by big four providers, followed by a long tail of much smaller companies. In the markets for home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance, reinsurance, and the overall market for general insurance, the largest four insurers (which are not always the same companies) hold in excess of 70% of market share.
  - Concentration has increased in recent years, driven primarily by consolidation activity.
- General insurers tend to underwrite many different brands, creating the illusion of more competition than actually exists.
  - The two largest insurers underwrite more than 25 different brands between them and two smaller insurers underwrite more than 50 brands between them (with one underwriting 23 brands of pet insurance alone).
- Prospective entrants face high barriers to entry. Thirty insurers have entered the market since 2007, including foreign insurers, insurers with links to banks and other large retailers, and niche providers that specialise in particular insurance lines. But none have seriously challenged the dominance of the 'big four' insurers.
- While prices of general insurance products have risen over the past decade, these price rises have been cost-reflective and are not, in the main, indicative of weakening competition.
- Australia appears to be lagging behind other countries in terms of insurance product innovation. While there have been some recent innovations to general insurance products, they appear mostly limited to the relatively less concentrated home and contents market.
- As a consequence of excessive product and brand proliferation, consumers struggle to compare the vast array of products in front of them or to exert competitive pressure on insurers.
- Providers should be required to include the previous year's premium on insurance renewal notices to improve pricing transparency for consumers.
- Insurance brands should provide a full list of the other brands underwritten by the same insurer on their websites and ASIC should publish a list of each insurers' brands in order to increase transparency.
- State and territory stamp duties on general insurance are inefficient taxes that discourage consumers from purchasing insurance and should be phased out.

Insurance is a risk management tool designed to protect policy holders from financial loss when things go wrong. Policy holders pay premiums to an insurer, which entitles them to compensation (a claim) if an insured event occurs (box 14.1).

Box 14.1 Insurance, reinsurance and retrocession are tools used to pool, transfer and spread risk

Insurance works by pooling and spreading risks to mitigate their impact. An insurer collects (relatively small) premiums from each of its policyholders and pays out (relatively large) claims if insured events occur, and in this way insured risks are mitigated. Insurers also earn investment income by investing funds that are not required to cover their expected liabilities from claims.

Policyholders can decide how much risk to take on by adjusting the terms and conditions of their policies. By agreeing to pay an excess out of their own pocket when making a claim or by excluding certain risks from the policy (such as windscreen replacement from their motor vehicle insurance), they can opt to take on more risk themselves and reduce the premium they pay for the insurance.

Insurance business is defined in the *Insurance Contracts Act 1973* (Cth) as follows.

> The business of undertaking liability, by way of insurance (including reinsurance), in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event, and includes any business incidental to insurance business as so defined, but does not include [12 exemptions including life and health insurance business].

Insurance lines are often delineated according to the usual time taken between the insured event occurring and the policyholder making a claim.

- *Short-tail liabilities* — claims are usually known and settled within 12 months of the event. Examples include motor vehicle insurance and home insurance.
- *Long-tail liabilities* — claims are usually known and settled more than 12 months after the event, and sometimes many years later. Examples include employers' liability and professional indemnity insurance.

Insurers need to hold capital reserves in order to meet their claim liabilities. Minimum capital holdings are established by regulation, although many insurers hold more capital than required by law. In order to minimise the risk of significant losses through related claims (and hence maximise their profits), insurers seek to diversify the risks they insure and minimise the correlation between risks.[a] For example, when offering insurance against losses caused by catastrophic weather events, an insurer may seek to insure a geographically diverse pool of policyholders or also insure risks that are not related to weather events.

Insurers can also transfer their risks by purchasing **reinsurance** — effectively insurance for insurers. Most reinsurance is provided by very large global reinsurers that can diversify their risks across countries. Access to reinsurance can enable insurers to set a cap on their maximum possible loss. Reinsurance also allows insurers to specialise in niche markets and allows smaller insurers greater scope to pool risks.

There is a further level — **retrocession** is reinsurance for reinsurers. Reinsurers offer reinsurance to other reinsurers to further diversify the risks they hold.

[a] An exception is mutual insurers, which do not operate on a profit maximisation basis.

There are three broad types of insurance in Australia: general insurance, life insurance and health insurance. This Inquiry focusses solely on general insurance, which protects the value of things that individual or business policyholders own, consume or invest in, and excludes life and health insurance, as:

- more than 70% of life insurance policies are provided through superannuation (Rice Warner 2016), and the Commission is undertaking a concurrent review of the competitiveness and efficiency of the Australian superannuation system
- an investigation of health insurance would need to consider issues that extend well beyond the scope of this Inquiry.

14.1 The general insurance sector

The general insurance sector is a significant element of the financial system — policyholders paid $45 billion in premiums in 2017 (APRA 2018q) and the sector employs around 60 000 people (ICA, sub. 32).

General insurance markets

Both private consumers and businesses purchase general insurance products. In some instances, businesses and consumers are required by law to take out insurance.[91]

- Common personal insurance products (lines) include domestic motor vehicle insurance, home insurance and travel insurance.
- Common insurance lines for businesses include fire and industrial special risks insurance, public and product liability insurance and commercial motor vehicle insurance.
- Consumers may be required by lenders to purchase lenders mortgage insurance (LMI) when taking out a loan (typically when the loan to value ratio exceeds 80%), which insures the lender against default losses.
- General insurance also includes reinsurance — insurance for insurers (box 14.1). In 2017, the four largest insurers spent about 24% of their total premium earnings on reinsurance, while this figure was 29% for their smaller competitors.[92]

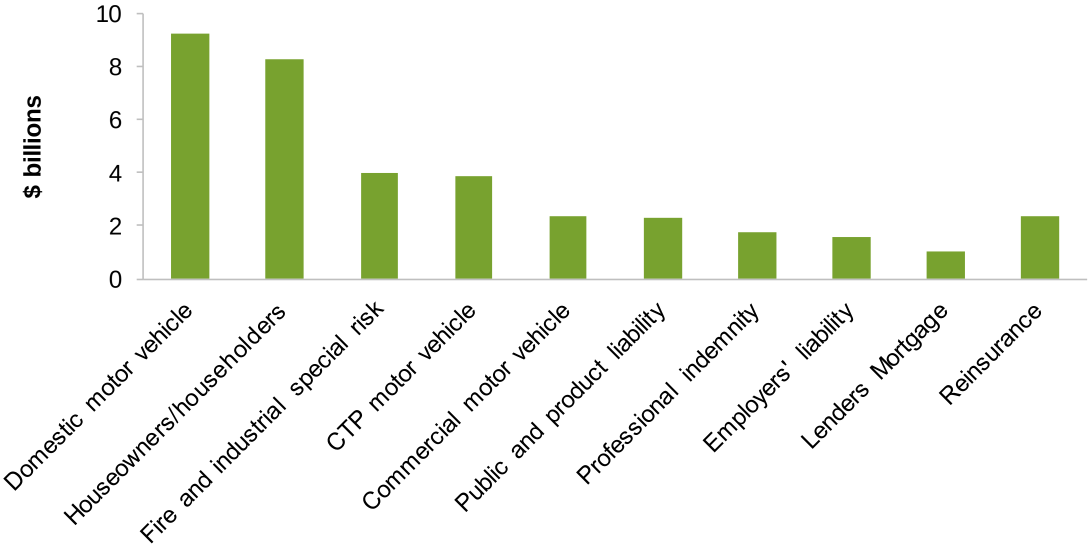
This chapter focusses primarily on personal insurance lines. Chapter 15 focusses on add-on insurance for individuals — personal insurance products that are sold alongside another product. Lenders mortgage insurance is discussed briefly this chapter and in more detail in chapter 13.

91 For example, owners of motor vehicles are required (by state or territory law) to take out compulsory third party insurance, which insures the owner and/or driver of the vehicle against compensation claims if they injure others in an accident.

92 Productivity Commission estimate based on APRA (2018b). .Excludes lenders' mortgage insurers and insurers in run-off. The four largest insurers are IAG, AAI, QBE and Allianz.

In 2017, the largest general insurance market was domestic motor vehicle insurance, followed by householders' insurance (figure 14.1).

Figure 14.1 **Size of general insurance markets**
Gross written premiums, 2017



Source: APRA (2018q)

14.2 Who are the providers of general insurance?

General insurance has its own 'big four'

Australia's general insurance industry is dominated by four large insurers — IAG, AAI, QBE and Allianz — each with roots stretching over 100 years (table 14.1). These insurers have expanded through mergers and acquisitions over more recent years, which has seen a reduction in the long tail of remaining insurers.

There has also been a reduction in the number of insurers in run-off[93] and limited new entry. The number of APRA-authorised general insurers fell from 171 to 104 between 1999 and 2017, and the number of reinsurers (a subset of this group) fluctuated between 9 and 12 over the past decade (APRA 1999, 2017b; sub. 22).[94] At 30 June 2017 there were 81 direct insurers, 9 reinsurers and 14 insurers in run-off, with each of these at their lowest level over the past decade (figure 14.2).

93 Run-off insurers are not licensed to write new or renewal policies, but handle claims from legacy policies. Most of Australia's run-off insurers have been in run-off for a number of years, including one since 1985.

94 There are currently nine reinsurers, seven of which are branches of reinsurers based abroad — including four of the five largest reinsurers in the world (McKinsey and Company 2017).

Table 14.1 The 'big four' general insurers

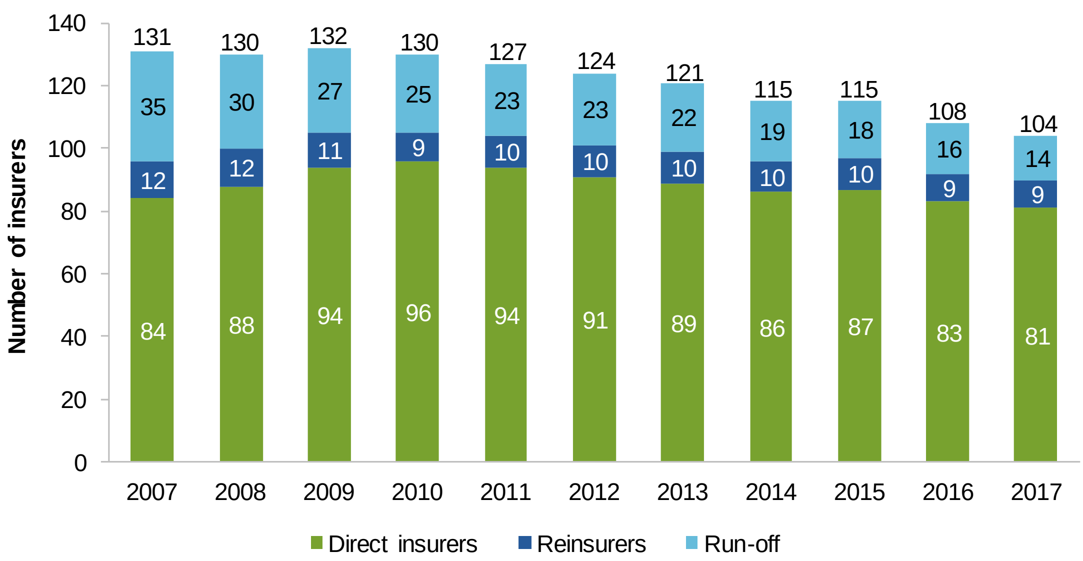
Insurer	*Gross written premium*[a]	*Origin*	*Notes*
Insurance Australia Group Limited (IAG)	$11.0b	Established indirectly as CGU insurance in 1851, and more directly in 1925 as NRMA insurance.	IAG has two licensed entities: Insurance Australia Limited and Manufacturers of Australia Pty. Limited
AAI Limited (AAI)	$8.0b	Established as the State Accident Insurance Office in 1916.	Member of the Suncorp group.
QBE Insurance Australia Limited (QBE)	$4.9b	Established as the North Queensland Insurance Company in 1886.	Member of the QBE insurance group
Allianz Australia Insurance Limited (Allianz)	$4.6b	Established as the Manufacturers' Mutual Accident Insurance Association Limited in 1914 and renamed to Allianz in 2000.	Member of the Allianz Australia insurance group

[a] IAG and AAI premiums are for 2016-17, QBE and Allianz premiums are for calendar year 2017.

Source: APRA (2018b); IAG (2014, 2017a); Suncorp Group Limited (2017); QBE (2017); Wu (2017b)

Figure 14.2 The number of APRA-regulated general insurers has fallen

At 30 June



Source: APRA (pers. comm., 5 December 2017; various Annual Reports)

The larger direct insurers are active in a wide range of insurance markets, while some of the smaller insurers are niche providers that specialise in particular markets. In addition, some are licenced to provide only a certain type of insurance — for example, to ensure that systemic risks in lenders mortgage insurance are not cross-linked to other types of insurance, APRA requires lenders mortgage insurers to be 'monoline' insurers that are not permitted to provide other types of insurance. Lenders mortgage insurance is discussed in chapter 13.

Other players

Other insurers also operate in Australia — Lloyd's of London (Lloyd's), unauthorised foreign insurers (UFIs) and several government–owned insurers. These comprise only a very small share of the general insurance sector.

Lloyd's

Lloyd's underwrites general insurance and reinsurance. It is a corporate body (rather than an insurer) governed by United Kingdom legislation that operates a marketplace where its underwriting members — known as syndicates — come together to pool and spread risk (Lloyd's 2017).

Lloyd's underwriters are authorised to write Australian insurance business under the *Insurance Act 1973* (Cth). The Act, administered by APRA, provides for special Australian policyholder protection provisions associated with Lloyd's (APRA 2017m).

Australian business placed with Lloyd's through intermediaries in 2017 equated to less than 6% of total general insurance business (table 14.2).

Table 14.2 **Business placed with Lloyd's and UFIs is only a small proportion of total general insurance business**

	Lloyd's[a]	*UFIs*	*APRA-authorised general insurers*[b]
Business invoiced in 2017	$2.0b	$1.1b	$38.7b
Number of intermediaries placing business[c]	261	74	753

[a] Only includes business placed through intermediaries. [b] Gross written premiums; excludes business placed with Lloyd's. [c] Second half of 2017 only.

Source: Productivity Commission estimates based on APRA (2017i, 2018l)

Unauthorised foreign insurers

UFIs are foreign domiciled insurers that are permitted to carry on insurance business in Australia under the limited exemption arrangements contained in the Insurance Act. UFIs are only permitted to insure atypical risks, high-value insureds[95] and other risks that cannot reasonably be placed in Australia (APRA 2018k). UFIs are not prudentially regulated by

95 High-value insureds are policyholders (individuals or entities) with assets in Australia of at least $200m, operating revenue derived in Australia of at least $200m, or employing at least 500 employees.

APRA and their consumers do not have access to the protections of the Australian regulatory system.

In 2017, Australian business placed with UFIs amounted to less than 3% of total general insurance business (table 14.2). Fire and industrial special risk amounted to 57% of the business placed with UFIs, and 79% was from UFIs based in Singapore and the United Kingdom (APRA 2018l).

Government

Governments also participate in the general insurance market. For example, the Australian Government owns the Australian Reinsurance Pool Corporation, a reinsurance agency established under the *Terrorism Insurance Act 2003* (Cth).

Some governments also provide compulsory insurance policies. The governments of the Northern Territory, Tasmania, Victoria and Western Australia provide compulsory third party insurance for motor accident personal injury, while the governments of NSW, Queensland, South Australia and Victoria provide workers' compensation (Oracle Group 2017; Thompson 2017).

Governments also provide comparator websites (such as that for North Queensland home insurance) (ASIC 2016g).

Distribution channels

General insurance is sold either directly from the insurer or through an intermediary (such as an agent or broker). The share sold through an intermediary remains significant, but has declined from 47% in 2010-11 to 43% in the 2016-17.[96] Personal insurance is increasingly being written directly (often via online channels), while brokers hold a strong share of the commercial insurance market due to the greater product complexity (Wu 2017b) — about one quarter of personal insurance is sold through a broker, compared with over 60% of commercial insurance.[97]

In order to conduct general insurance business, intermediaries must hold an Australian Financial Services Licence and be authorised to deal in general interest products (appendix B). At the end of December 2017, there were 1653 intermediaries licensed to conduct general insurance business (APRA 2018l).

Other intermediary distribution channels include:

- insurance sold by banks (also known as 'bancassurance') — which involves an arrangement between a retail bank and an insurer whereby the bank acts as the insurer's agent

96 Productivity Commission estimates based on APRA (2018b, 2018l).

97 Productivity Commission estimate based on APRA (APRA 2018b, 2018l) and Wu (2017a, 2017b).

- add-on insurance sold alongside credit cards, personal loans and home loans (discussed in chapter 15)
- add-on insurance sold at car dealerships (discussed in chapter 15).

Chapter 9 discusses integration in the financial sector more broadly.

14.3 State of competition in general insurance

In accordance with the framework set out in chapter 2, this chapter assesses competition by examining the extent to which:

- rivalry between providers seeking market share and the capacity for entry by new firms is resulting in innovation and efficiencies that improve community outcomes
- consumers are able to put material competitive pressure on providers.

Concentration in general insurance

General insurance markets are concentrated — the four largest insurers account for over 70% of each product market and Herfindahl-Hirschman Index (chapter 2) calculations indicate that many markets are concentrated (figure 14.3). The LMI and reinsurance markets are particularly concentrated, as there are only four providers of LMI and the two largest reinsurers account for just under 80% of the reinsurance market.

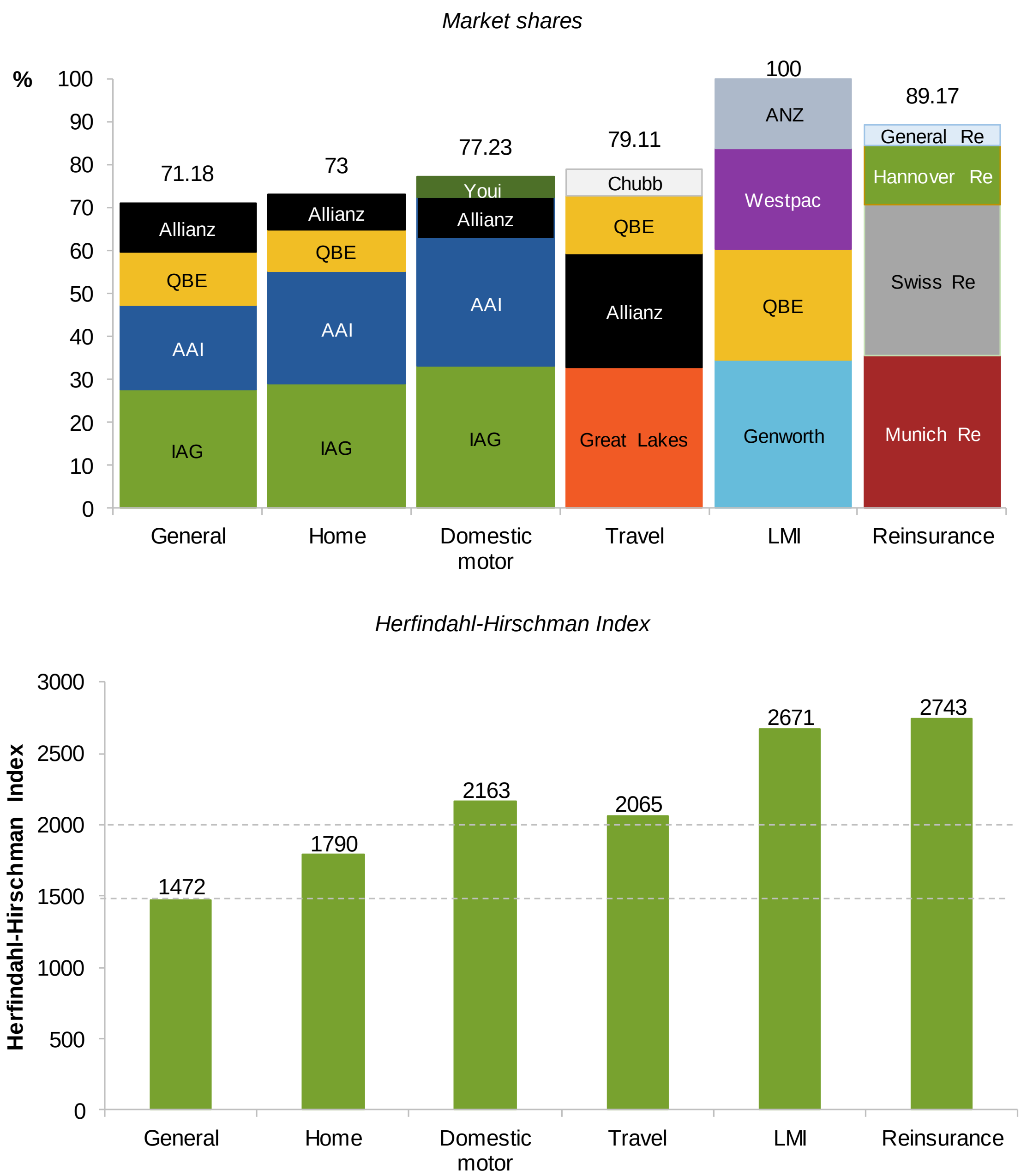
With the exception of the LMI market (which features only four insurers), the dominance of the largest four insurers stands in contrast to the long tail of smaller insurers. In the general insurance market (excluding LMI and reinsurance), the largest insurer after the big four (Zurich) accounts for only 2.5% of the market.

Concentration has increased slightly in recent years, mostly as a result of consolidation activity (APRA, sub. 22). Excluding reinsurance and LMI, the market share of the four largest insurers grew from 70% in 2012 to 71% in 2017 — travel insurance increased from 75% to 79%, while domestic motor vehicle insurance fell from 81% to 79% and home insurance remained flat at 73%. The LMI market was similarly composed of only four providers in 2012 and the share of the reinsurance market occupied by the four largest reinsurers grew from 88% to 89%.[98]

The Grattan Institute similarly found that the top five general insurers hold almost 90% of the market in Australia, noting ‘this is high compared to most other high-income economies, which range from 25 per cent to 81 per cent’ (Grattan Institute 2017, p. 14).

98 Market shares are Productivity Commission estimates based on APRA (2018b; unpublished data for home, domestic motor and travel insurance).

Figure 14.3 **General insurance markets are concentrated**[a,b,c,d]



[a] General insurance excludes LMI and reinsurance. [b] General insurance, LMI and reinsurance calculations based on gross written premiums from years ended in the 12 months to December 2017; home, domestic motor and travel insurance based on 2016-17 gross earned premiums. [c] Calculated at the level 1 insurer level, with level 1 insurers within the IAG insurance group aggregated and IAG Re excluded from all measures. [d] As noted in chapter 2, a Herfindahl-Hirschman Index of 1500 is commonly viewed as indicative of an acceptably concentrated market, but 2000 or more is generally viewed as problematic.

Source: Productivity Commission estimates based on APRA (2018b; unpublished data for home, domestic motor and travel insurance)

Branding obscures the degree of market concentration

Many insurers provide insurance under multiple brands. The big four insurers underwrite more than 30 brands (figure 14.4), while two of the smaller insurers (The Hollard Insurance Company and Auto and General Insurance Company) underwrite more than 50 brands between them,[99] with The Hollard Insurance Company offering 23 of 25 identified[100] brands of pet insurance alone (table 14.3).

Table 14.3 **There are lots of pet insurance brands, but few underwriters**

Insurer	*Number of brands*
The Hollard Insurance Company	23[a]
MS Amlin Syndicate 2001 at Lloyd's	1[b]
RACQ Insurance	1[c]

[a] Brands are: 1300 insurance, Australia Post Pet Insurance, Australian Seniors Insurance Agency, Bow Wow Meow Pet Insurance, Bupa Pet Insurance, Bondi Vet Pet Insurance, Guardian Insurance, Guide Dogs Pet Insurance, HCF Pet Insurance, HIF Pet Insurance, Insuranceline, Medibank Pet Insurance, Mipet Insurance, Pet Insurance Australia, Petbarn Pet Insurance, Petinsurance.com.au, Petmed, Petsecure, Prime Pet Insurance, Prosure, Real Insurance, RSPCA Pet Insurance, Woolworths Pet Insurance. [b] Brand is Pet Plan. [c] Brand is RACQ.

Source: Hollard Insurance (2018); Petplan (2018); PetSure (sub. DR66), RACQ (2018); and brands' product disclosure statements and websites as at 18 January 2018

Some of these brands are wholly owned by their underwriting insurer (including at least 25 of the brands underwritten by the big four insurers), while others belong to a product distributor, intermediary or other third party that is not owned by the insurer — for example, The Hollard Insurance Company owns only 2 of the 23 pet insurance brands that it underwrites (PetSure, sub. DR66).

NIBA (sub. DR56) and PetSure (sub. DR66) submitted that independently-owned brands underwritten by the same insurer are in competition with one another, with PetSure noting that:

> Ownership of the brands vests in the particular brand partners, who each have a distinct market presence and work hard to innovate product benefits and features to appeal to their specific markets. In essence, this means that they are in competition with each other. (sub. DR66, p. 3)

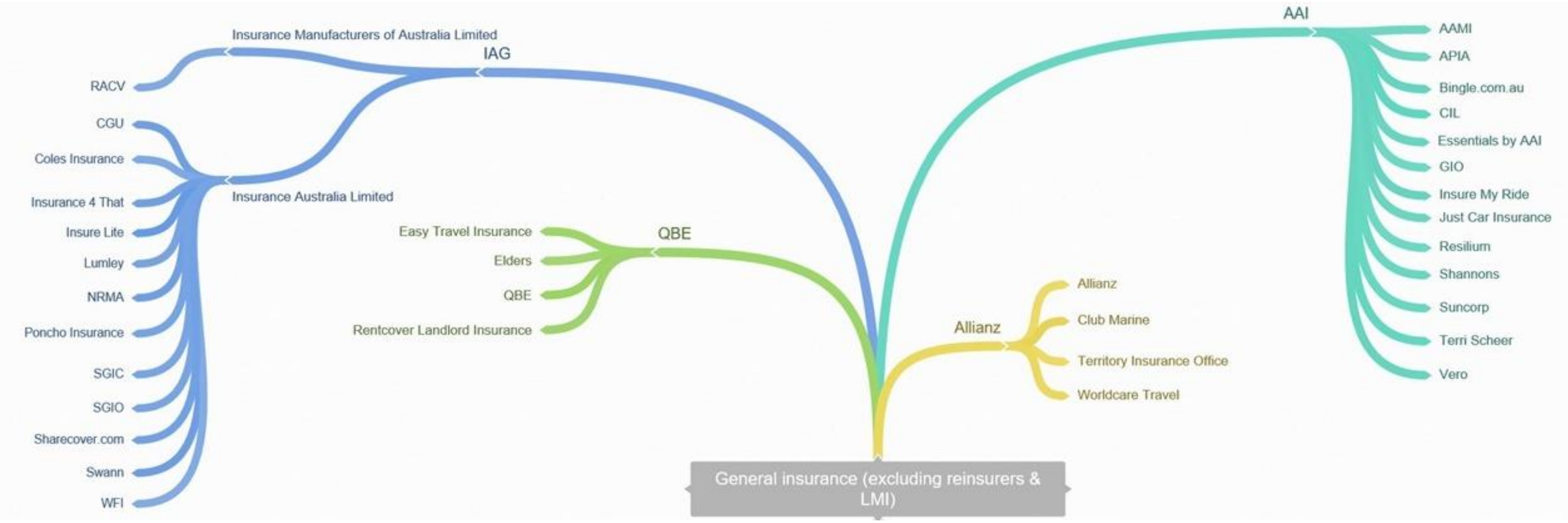
---

99 The Hollard Insurance Company's brands are: AI Insurance, ATL insurance group, Blue Badge Insurance Australia, Club 4x4, Fastcover, Huddle, Kogan Insurance, Progressive Direct Insurance Company, Velosure, Woolworths Insurance, and the brands listed in table 14.3. Auto & General Insurance Company's brands are 1 Cover Direct Insurance, 1st for Women Insurance, Aussie, Australia Post, Best Buy Insurance, Budget Direct, Cashback Car Insurance, Dodo Insurance, HIA Insurance Services, IBuyEco Car Insurance, ING, Lattitude, Macquarie, Maxxia Insurance, Over60, Ozicare Insurance, Retireease Insurance, Virgin Money, YourShare.

100 The Draft Report identified 22 brands of pet insurance, 20 of which were underwritten by The Hollard Insurance Company. PetSure (sub. DR66) subsequently informed the Commission of three additional pet insurance brands.

Figure 14.4 **The illusion of competition in general insurance**

The four largest insurers provide insurance via more than 30 brands



Source: ICA (pers. comm., 21 December 2017)

While the Commission accepts that there is a degree of competition between such brands, they have limited scope on which to compete with one another as they ultimately source their products from the same insurer. That insurer does not compete against itself, but will seek to maximise its profits across the portfolio of brands that it underwrites. Although underwriting arrangements are identified in the 'small print' on brands' websites and in their Product Disclosure Statements, these branding arrangements ultimately obscure the concentrated underlying market structure and create the impression of more competition than actually exists.

Consolidation

Fifty-seven insurers have exited the general insurance sector since 2007 (APRA, pers. comm., 8 January 2018), with many the result of mergers, acquisitions and restructures.

As noted by Wu (2017a, p. 18), 'the gap between the biggest insurers and other smaller insurance companies is growing as the major players pursue inorganic growth through acquisitions'. Several new entrants have been acquired or have had their underwriting functions assumed by larger insurers. For example, in 2017:

- QBE became the underwriter for Realcover, a professional indemnity insurer that joined the market in 2008
- The Hollard Insurance Company acquired the portfolio of Progressive Direct Insurance Company, an online car insurer that joined the market in 2009.

FINDING 14.1 MARKET POWER IN GENERAL INSURANCE PROVISION

General insurance markets are concentrated. In the home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets, the largest four firms (which are not always the same four) hold market shares in excess of 70%. This concentration has increased slightly in recent years, mostly as a result of consolidation activity.

The domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets are particularly concentrated, and while the domestic home insurance market is less concentrated, the two largest firms still account for more than half the market.

But because many insurers supply their products under multiple brands, consumers may see more an illusion of robust competition than a reality.

Contestability

As set out in chapter 2, new entrants (or even the threat of entry) can increase competition.

Over the decade since 2007, 30 insurers have entered the general insurance sector (APRA, pers. comm., 8 January 2018), including foreign entrants, insurers with links to banks and other large retailers and niche providers that specialise in particular insurance lines.[101]

The Insurance Council of Australia (sub. 32) suggested that barriers to entry in retail short-tail insurance classes (such as home insurance) are relatively low. And in its submission to the Murray Financial System Inquiry, the Treasury (2014) pointed out that several new entrants are offering their products on an online-only basis to lower costs.

In general, however, contestability is limited by the high barriers that potential insurers face. New entrants must obtain authorisation from and regularly report to APRA, must obtain and maintain an Australian Financial Services licence from ASIC, and must hold adequate capital to commence their operations (Wu 2017a). For a new entrant with a small customer base, the minimum capital requirement of $5 million (box. 14.2) may prove challenging.

As noted by iSelect:[102]

> [T]here are substantial barriers to entry for new entrants to the industry. The relatively small size of the Australian market, on a global basis, compared with the costs of regulation and establishment, have proven to be a high burden for new or existing local and offshore insurers.
>
> iSelect has been informed by a major UK insurer that the initial capital required (upwards of A$25 million) and the time commitment (greater than 12 months for licence application and business establishment in Australia to set up sales and marketing, distribution, claim systems, car repairer networks etc.) made the proposition marginal at best on risk-weighted basis. (2017, p. 4)

Moreover, Fels and Cousins (2017) argued that the regulatory barriers to entry have grown as capital adequacy requirements have tightened.

101 For example, Youi Pty Limited is a wholly owned subsidiary of OUTsurance International Holdings Pty Limited, part of the Rand Merchant Insurance Holdings (RMIH) Group (Youi 2017); TT Club Mutual Insurance Limited was previously a direct offshore foreign insurer (Insurance News 2009); Southern Cross Benefits Limited specialises in travel insurance (SCTI 2017); and Pacific International Insurance Pty Limited offers professional indemnity and general/public liability insurance to the carpet cleaning, agricultural, urban pest, weed control and building inspection industries (Pacific International 2017).

102 The stated initial capital requirement of $25 million is significantly greater than the $5 million minimum prudential capital requirement set out by APRA (box 14.2). This may reflect the scale that a prospective entrant needs to compete in the market and the capital buffer that it holds over and above its prudential capital requirement.

Box 14.2 Prudential regulation of general insurers

Prudential regulation of insurers is intended to reduce the chance that a general insurer will be unable to meet its obligations to its policyholders.

General insurance has been prudentially regulated in Australia since 1973, but requirements tightened significantly following the collapse of HIH Insurance in 2001. The subsequent Royal Commission into the collapse found that HIH had 'grossly underestimated its liabilities, overestimated its assets, charged premiums that were too low, and under-reserved (under-provisioned) for future claims, particularly 'long-tail' claims' (The Treasury 2015a), and recommended that APRA move away from 'light touch' supervision to 'develop a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers' (HIH Royal Commission 2003, recommendation 26). APRA responded by increasing entry-level capital requirements for general insurers, and was given powers to set prudential standards for general insurance (The Treasury 2015a).

The current regulatory framework is largely the product of these reforms. In line with APRA's Prudential Standard GPS 110, APRA-authorised general insurers are required to hold adequate capital to balance the risks associated with the insurer's activities in accordance with a documented process that is approved by the Board (which has the ultimate responsibility for capital adequacy).

The required level of capital (known as the prudential capital requirement), is determined by the insurer, but may be adjusted by APRA if deemed insufficient. The requirement is intended to be robust to the level that, in a given year, the probability of the insurer being able to meet its liabilities is at least 99.5%. Alternatively, an insurer may determine its prudential capital requirement by using an internal model that has been approved by APRA (analogous to the internal ratings-based approach for banks, which is discussed in chapter 6). Allianz is the only insurer that uses this method. Regardless of the method employed, the requirement is subject to a floor of $5 million, which is binding for 14 insurers (or $2 million in the case of captive insurers, which is binding for 4 insurers).

In practice, insurers hold substantially more capital than their prudential capital requirement, in accordance with the risk preferences of their boards. At their the most recent reporting period in the 12 months to June 2017, the big four insurers held a capital base of 169% of their prescribed capital requirement, while the smaller insurers held a base of 214% of their prescribed capital requirement (Productivity Commission estimates based on APRA (2018b)).

Impact of new entrants

Several relatively recent entrants have grown their market shares in recent years.[103]

- The Hollard Insurance Company (part of the international Hollard Group, established in South Africa in the 1980s), which entered in 1999 and grew its market share from 0.7% to 1.4% between 2012 and 2017 (Hollard 2017).
- Auto and General Insurance Company (part of the United Kingdom-headquartered Budget Insurance group), which entered in 2000 and grew its market share from 0.7% to 1.3% between 2012 and 2017 (Auto & General Insurance Company 2017).

103 Market share calculations are Productivity Commission estimates based on APRA (2018b).

- Youi (a subsidiary of a member of the South African-headquartered Rand Merchant Investment Holdings Group), which entered in 2008 and grew its market share from 0.5% to 1.7% between 2012 and 2017 (OUTsurance 2017; Youi 2017).

However, these increases have been relatively small and there has been a notable lack of new entrants that have seriously challenged the dominance of the big four insurers.

Performance

Pricing

The prices of many retail general insurance products have increased in recent years. Looking Australia-wide, the Insurance Council of Australia (ICA, sub. 32) reports that home insurance premiums increased at an average rate of 8% per annum over the 15 years to June 2017 — well above growth in motor insurance premiums of 2% per annum over the same period and the economy's average annual inflation rate of about 2.5% (ABS 2018b).

This geographic average obscures vast regional differences. While the Australian Government Actuary (2014a) found that between 2005-06 and 2012-13, home and contents insurance premiums grew by 25% across Australia, rises were of 80% in North Queensland, 45% in Brisbane and 12% in Sydney and Melbourne. The Australian Government Actuary (2014b) also found that residential strata title insurance premiums in North Queensland were about 5 times higher than in Brisbane, the Gold Coast, Sydney, Melbourne and Adelaide in 2012-13.

For the most part, these price increases and regional price differentials appear to reflect industry-wide cost increases, and hence are not indicative of weakening competition.

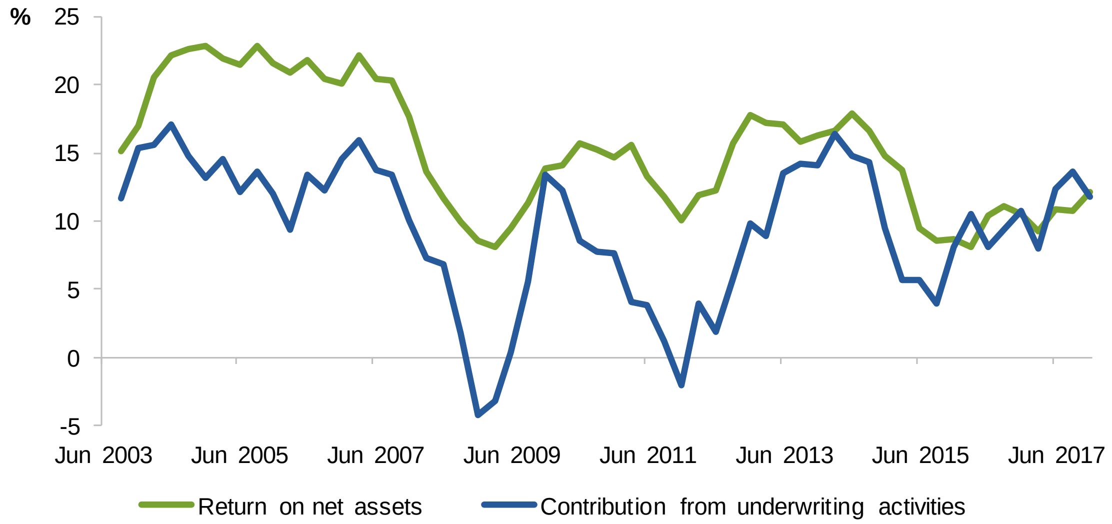
- The ICA (sub. 32) noted that the average claim size for home insurance grew at 11% per annum and the average sum insured (the maximum payout allowed under the insurance policy) grew at 5% per annum over the 15 years to June 2017.
- The Australian Government Actuary (2014a, 2014b) found that higher cyclone risk and previous under-pricing of this risk were the primary sources of the sharp differential between home and contents and strata insurance premiums in North Queensland relative to other population centres and the more rapid growth of premiums in North Queensland. That said, both reports also noted that weaker competition in North Queensland insurance markets may have contributed somewhat to premium growth.
- Modelling commissioned by the Northern Australia Insurance Premiums Taskforce did not suggest that premium rates in North Queensland are out of step with estimates of the magnitude of risk (The Treasury 2015c).

The Australian Competition and Consumer Commission (ACCC) commenced an inquiry into the supply of residential building (home), contents and strata insurance in Northern Australia in July 2017 (ACCC 2017e). It will provide interim reports by November 2018 and November 2019 and a final report by November 2020. The inquiry is considering a range of issues including pricing, competitiveness, consumer engagement and regulatory issues.

Profitability

Despite this growth in premiums, insurers' returns from underwriting activities have not grown over the past 15 years and aggregate profitability has fallen since the global financial crisis (GFC) of 2007 (figure 14.5).

Figure 14.5 **Aggregate profitability of general insurers[a]**
Rolling annual returns



[a] Data for quarters prior to September 2010 include estimates of future incurred claims, while data for quarters after September 2010 do not.

Source: Productivity Commission estimates based on APRA (2018q)

APRA noted that profitability (measured by return on net assets) rose marginally in 2016-17 but remains below the industry's ten-year average. It attributed the lower profitability of the last several years to:

> … a deterioration in the underwriting results in the property classes of business, with higher net loss ratios resulting from subdued premium growth and increased claims costs from severe weather events, including Cyclone Debbie in March 2017. The low interest rate environment has also contributed to the decline in profitability, with the interest income generated on insurers' substantial interest rate investment portfolios steadily falling in recent years. (sub. 22, p. 15)

And APRA recently noted that the sector does not appear to be earning excess returns (SERC 2017).

That said, there are significant differences in profitability between large and small insurers. While the big four insurers have been more profitable than their smaller competitors in recent years, the smaller insurers have performed better on underwriting measures (box 14.3).

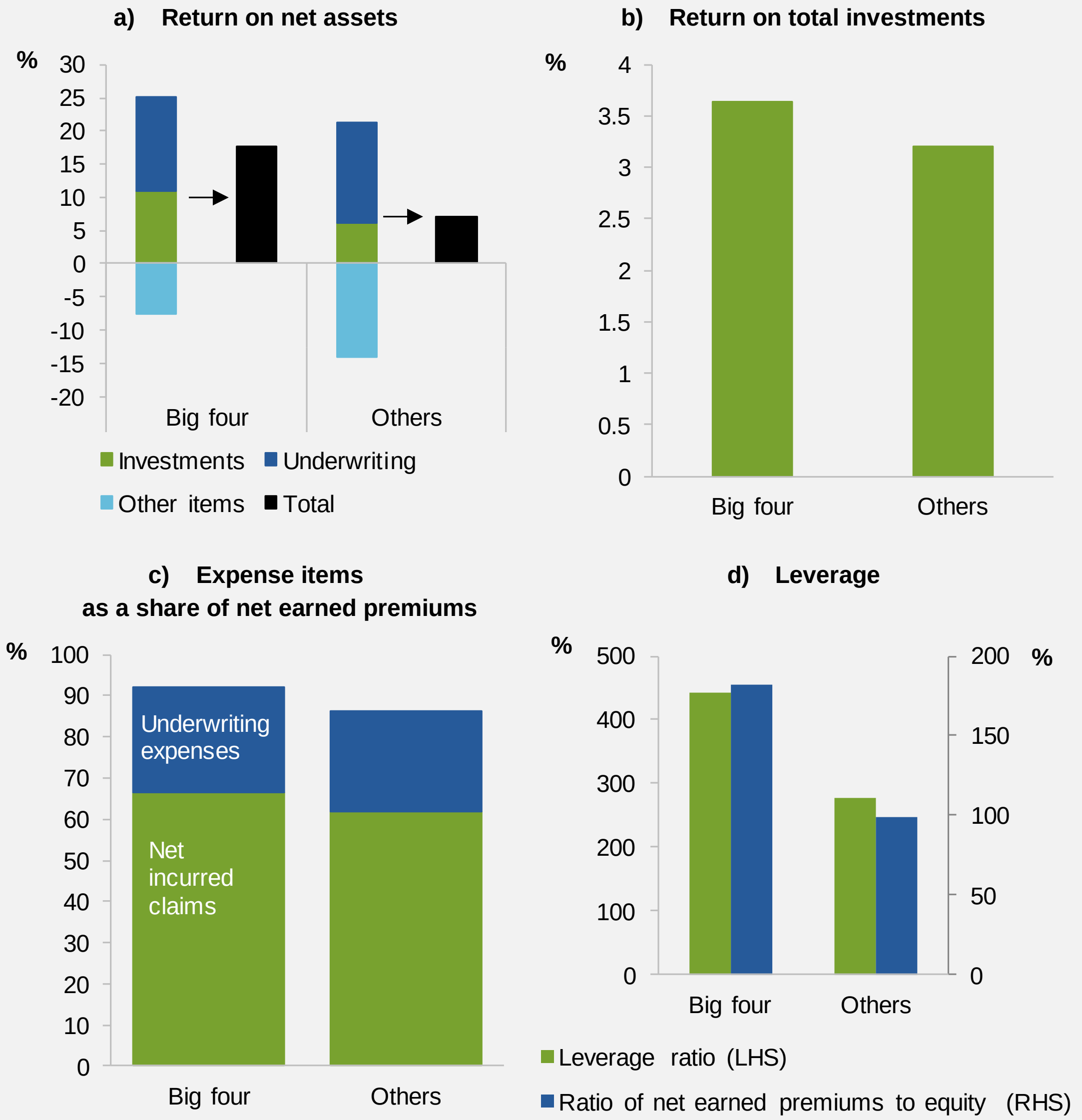
Box 14.3 **Size and profitability**

The 'big four' general insurers have been significantly more profitable than their smaller competitors in recent years, with aggregate returns on net assets of 18% versus 7% (panel a). Smaller insurers actually earned higher returns from underwriting activities, but earned lower returns from investment and suffered greater losses attributable to 'other items'.

The smaller insurers' underwriting performance exceeded the big four, underpinned by both lower incurred claims and lower underwriting expenses, while the larger insurers earned slightly higher returns on their investments (panels b and c). The more leveraged position of the big four insurers also bolstered their profitability (panel d).

The big four vs the others[a,b]

Year ending at some point in the 12 months to 31 December 2017



[a] Excludes LMI providers, reinsurers, and insurers in run-off. 'Big four' refers to Allianz, IAG, QBE and AAI. [b] Data items are aggregated across all insurers in each group before ratios are calculated.

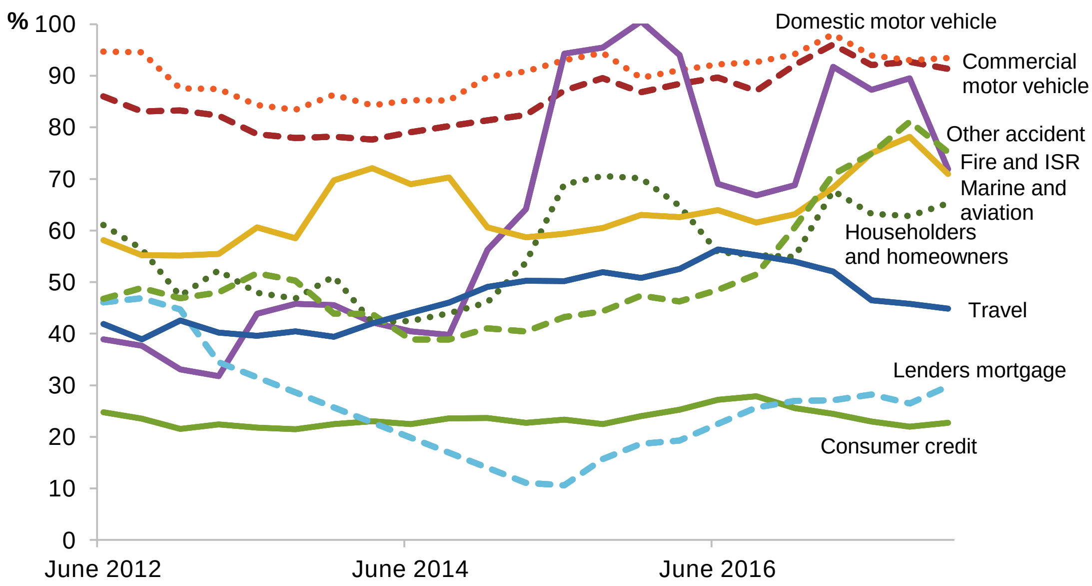
Source: Productivity Commission estimates based on APRA (2018b)

Claims performance

The share of premiums returned in claims has varied across insurance classes since 2012, with domestic and commercial motor vehicle insurance consistently returning the highest share of premiums in claims and consumer credit insurance (chapter 15) and LMI (chapter 13) generally returning the lowest (figure 14.6).

Figure 14.6 **'Value for money' varies across insurance classes**

Rolling annual share of premiums returned in claims for selected insurance classes[a]



[a] Calculated as annual gross earned premiums divided by annual gross incurred claims (also known as the gross loss ratio).

Source: Productivity Commission estimates based on APRA (2018q)

This spread is largely mirrored in claim acceptance rates. Across personal insurance products, 95.8% of claims were accepted in 2016-17, with the highest rates of acceptance in motor vehicle insurance (99.5%) and residential strata insurance (98.1%), and the lowest rates in consumer credit insurance (89.9%) and travel insurance (87.9%) (General Insurance Code Governance Committee 2018).

The total volume of disputes lodged with the Financial Ombudsman Service about insurers' claim decisions is only about 3% of the volume of declined claims, suggesting that consumers rarely challenge decisions that are ruled against them (FOS 2017a; General Insurance Code Governance Committee 2018).

Delays by insurers in processing claims is an issue. There were 6561 breaches of the General Insurance Code of Practice[104] in relation to claims in 2016-17, amounting to about three quarters of all breaches (General Insurance Code Governance Committee 2018). These mostly related to various instances where insurers failed to progress claims within the specified timeframes (table 14.4).

Table 14.4 **Claim-related breaches of the General Insurance Code of Practice[a]**
2016-17

Code requirement	*Number of breaches*
If further information or assessment is needed, the insurer must notify the policyholder, appoint loss assess/adjuster, and provide an initial estimate of the timetable to process the claim within 10 business days.	2 283
The insurer must provide progress updates at least every 20 business days.	1 407
On completion of information gathering and enquiries, the insurer must decide whether to accept or deny the claim and notify the policyholder within 10 business days.	1 070
If no further information is needed, the insurer must notify the policyholder within 10 business days of claim acceptance/denial.	579
Total breaches	6 561

[a] Column does not sum to total as not all breaches are listed.

Source: General Insurance Code Governance Committee (2018)

Product innovation

There is an old cliché that innovation and insurance are found together only in the dictionary (Barbeler 2016). That said, some commentators — such as PwC (2016b) — consider that new digital technologies will enable significant innovations in insurance products, typically centred on ubiquitous data collection and improved data processing capabilities. For example, data collected by sensors installed in cars and industrial equipment could allow for tailored policies based on more sophisticated risk assessment techniques, and a more active, preventative approach to insurance.

While not all consumers will benefit from innovations that expand insurers’ data collection and analysis capabilities, many will (box 14.4).

104 The Code of Practice sets out voluntary standards that members of the ICA agree to abide by when offering personal general insurance products. There are 43 code subscribers, including the big four insurers.

Box 14.4 **Impact of data on insurance market outcomes and competition**

The increase in data collection and use is affecting nearly every part of the economy:

> We are in an era of 'big data', in which businesses are able to collect, store, analyse and use a much greater range of data on consumers — for example, to tailor products to their needs and market the products in a way that will appeal to consumers. (ASIC, sub. 40, p. 96).

To the extent that insurers can collect and analyse rich data about their customers, they can better distinguish between consumers with different risk profiles, and can offer cheaper insurance products to low risk consumers who may otherwise have decided not to purchase insurance. Insurers can also penalise risk-taking behaviour by consumers (or, alternatively, encourage risk-avoiding behaviour). Both of these effects will improve the efficiency of the insurance markets.

That said, not all customers would benefit. Some consumers will be inherently high risk. For example, home insurance consumers that live in more risky neighbourhoods. Such consumers may already face higher premiums, and any move to use more personalised data to set cost-reflective prices could see those consumers paying even higher premiums than previously.

Big data also impacts on competition. Data that is privately held by established insurers can generate a degree of 'informational monopoly' about their clients, increasing barriers to entry for new insurers. However, as the Commission recently noted in its *Data Availability and Use* Inquiry (PC 2017c), growth in the volume and variety of sources of data is helping to lower barriers to entry for new providers — particularly those that can make innovative use of new sources and types of data.

On balance, it is likely that access to data provides some degree of competitive advantage for incumbents, although the materiality of any advantage might diminish over time as data becomes increasingly available. To the extent that governments can encourage data availability, there could be scope for increased competition and improved consumer outcomes in insurance markets.

However, the Australian insurance industry has not witnessed significant innovation in recent years. As noted by Wu, the general insurance industry is mature and innovation has been limited.

> Product innovation within the industry has been largely cosmetic, with no major breakthroughs occurring to spur industry demand, which is indicative of a mature industry. Many general insurers are trying to make their products more flexible and customisable, and are increasingly distributing insurance through online platforms. However, the underlying product features remain largely unchanged. Online sales and other technology use have been focused on operational efficiency. These include reducing reliance on manual labour to cut wage costs and introducing low-cost distribution channels to minimise expenses. (2017a, p. 11)

Where innovations have occurred, they have usually been backed by the largest insurers — sometimes operating in conjunction with 'insuretech' start-ups or microfinance providers. Examples include:

- *on-demand insurance for common electrical items* — in 2016, AAI, in conjunction with Silicon Valley insuretech start-up Trōv Protection, introduced on-demand insurance for common electronic items that can be turned on and off with a smartphone app (Trōv 2017)

- *single item insurance* — in 2015, IAG, in conjunction with Good Shepherd Microfinance, launched a single item insurance program called ‘Insurance 4 That’. It allows policyholders to protect selected items in their home, including computers, appliances and furniture, against loss or damage and also includes an option to cover portable items, such as laptops and cameras, against theft and accidental damage outside of the home (IAG 2017b)
- *big events insurance* — low-cost home building insurance that only applies to significant events (when a minimum damage threshold is reached). An example is IAG’s InsureLite product, which only covers the home (not garages, sheds, pools or fences) and is only triggered when the damage exceeds either $3950 or $7900 (IAG 2016)
- *insurance for low income earners* — such as ‘Essentials by AAI’ (developed in conjunction with Good Shepherd Microfinance) which is available to those with a healthcare card, receiving Centrelink payments or with household income under $48 000 (AAI Limited 2015).

Many of these developments occurred alongside the increased scrutiny brought about by the Northern Australia Insurance Premiums Taskforce that was set up in response to the significant growth in insurance premiums in the region and reported in 2016. While they are positive developments, they appear to be mostly limited to the home building and contents insurance markets — the least concentrated of general insurance markets.

There have also been some limited instances of insurance products being developed to meet new products. For example:

- Tesla Motors introduced its ‘InsureMyTesla’ product — underwritten by QBE — in 2016. The insurance includes coverage for attributes unique to electric cars, such as the home charging station (Insurance News 2016), and features lower premiums as it factors in the vehicles’ driver assistance safety features (Muoio 2017). KPMG (2015) suggested this trend will continue, with the rise of autonomous vehicles causing the personal motor insurance industry to shrink to 40% of its current size within 25 years
- several insurers are now offering insurance against cyber security threats. That said, in September 2017 ASIC Commissioner John Price described the market as ‘still in its infancy’(Price 2017, p. 1), and Doepel (2017) noted that Australian businesses have been slow adopters of cyber insurance.

Compared with other developed countries, innovation in Australian insurance markets is lagging. In the United Kingdom, recent innovations include:

- hourly insurance for borrowed cars
- coverage for three valuable items for a £15 premium

- an app that allows customers to directly purchase insurance and manage all of their policies (from £14 travel cover to £20 000-plus premium business insurance)
- another app that monitors customers' driving skills, scores them on the safety of their driving, and rewards safer drivers with reduced premiums (Aviva 2016; Carey 2017).

Moreover, a recent study found that only 1% of global venture capital deals involving insuretech start-ups went to Australian based companies, compared with 59% to the United States, 6% to Germany, 5% to the United Kingdom and 3% to Canada (CB Insights 2017).

Are consumers a force for competition?

Many general insurance lines are characterised by a large range of differentiated products, in part a consequence of the large number of brands on offer. While product differentiation can in theory allow consumers to choose a product that it best tailored to their needs, in practice consumers (as outlined in chapter 3) struggle to compare the vast array of products in front of them — and where products differ in brand only there is little upside to looking further.

The recent Senate inquiry (SERC 2017, p. 13) into the general insurance industry noted that:

> Issues of clarity, transparency and ease of comparability among general insurance products have been a consistent focus of this inquiry. Consumers' ability, particularly in complex transactions like insurance, to understand and make appropriate choices is often hindered by the lack of sufficient understanding or information to compare different insurance products.

The Consumer Action Law Centre, Financial Rights Legal Centre and Financial Counselling Australia (sub. 23, p. 15) expressed similar sentiments, noting that 'the widespread marketing of insurance products, and the complexity and variation of those products, mean that in many ways the insurance market is not competitive from a consumer perspective'.

When faced with this complexity, some consumers adopt a strategy of making decisions on the basis of price (Effective Disclosure Taskforce 2015). However, this approach will not yield the best product in many circumstances as consumers may choose policies with fewer features rather than genuinely better value policies.

The prevalence of comparison websites was also said to encourage this behaviour, as they tend to promote price as the primary variable for comparison (CALC, FCA and FRLC, sub. 22). Comparison websites may also provide a skewed comparison service if they are owned by an insurer or do not cover all products on offer (box 14.5). That said, when effectively administered, they can provide valuable assistance to consumers.

Highlighting the information asymmetry between consumers and insurers in how insurance is priced and the very low prevalence of consumers switching between insurers, former ACCC chair Professor Allan Fels recently argued that competition in the general insurance market 'is not fully effective' due to demand-side weaknesses (SERC 2017, p. 24).

Box 14.5 **Comparison websites do not necessarily provide good advice**

At their best, comparison websites facilitate demand-side competitive pressure assisting consumers to quickly and easily compare products. They may also lower effective barriers to entry for new insurers that do now have access to the distribution channels of established insurers.

But when the comparison website has a financial interest in the products it features (either through ownership or commission structures that allow the website to benefit from recommending a particular product), they have an incentive to push these products over others. These arrangements are common.

- iSelect and Compare the Market receive an upfront commission for each policy purchased through them, and may also receive a trailing commission if the customer remains with the insurer. Compare the Market is also owned by the same holding company as Auto and General Insurance, and features many of its products.
- Canstar and Finder work on a 'cost-per-click' model, where the insurer pays a fee for each customer referred to their website.
- Choosi.com.au is a related company of the Hollard Insurance Company.
- Compareinsurance has directors and shareholders in common with six of the travel insurance brands featured on its site (Bird 2017).

Comparison websites may also not feature all products in the relevant market, weakening the comparison service.

In addition, the Consumer Action Law Centre, Financial Rights Legal Centre and Financial Counselling Australia argued that price comparison websites encourage comparison on price alone:

> In general, comparison websites provide only a very simplistic and often inaccurate overview of different insurance policies and tend to reduce the complex insurance purchasing decision to one based on price alone — disregarding differences in policy cover, product options and claims service capabilities. (sub. 22, p. 21)

To be effective, ASIC (2017y) argued that comparison websites should cover at least a substantial portion of the relevant market, avoid or least manage conflicts of interest, provide clear and accurate information, explain how its rating system works, and provide information about product features other than price.

Summary — how competitive is Australia's general insurance sector?

The Insurance Council of Australia (sub. 32, sub. DR62) argues that the general insurance industry is highly competitive. However, the indicators examined here suggest that competition in general insurance markets is not fully effective. This Inquiry has observed:

- high and slightly increasing levels of concentration across the industry
- significant barriers to entry (particularly regulatory barriers), and no new entrants that have been able to significantly challenge the big four insurers
- the acquisition of new entrants by existing insurers pursuing strategies of growth

- evidence that price rises have, in the aggregate, reflected rising industry-wide costs
- a lack of innovation in comparison to some overseas markets
- consumers struggling to compare products and exert competitive pressure due to excessive product and brand proliferation.

14.4 Reforms to promote competition in general insurance markets

As set out in the previous section, consumers are not generally an effective force for competition in general insurance markets. The reforms recommended in this chapter aim to enhance disclosure by providing consumers with targeted and useful information[105] to assist them to impose competitive pressure on providers.

Require providers to include information about price rises on insurance renewal notices

Including additional information on annual insurance renewal notices may trigger consumers to consider whether their insurance policy is the best value they can receive, and if not then prompt them to renegotiate with their provider or switch to a new insurer.

The renewal notice should include the previous years' premium and the percentage change in price to the current year premium. There is some precedent for this.

- Following a large-scale randomised controlled trial, in April 2017 the UK Financial Conduct Authority introduced a requirement to include the previous years' premium in renewal notices for all general insurance policies (FCA 2016). The trial found that for home insurance customers (who faced average price increases in excess of 5% at renewal), disclosing the previous years' premium increased the number of consumers that switched to a new insurer or negotiated the premium with the insurer by between 11% and 18%. Other trialled methods (such as simplifying the renewal notice or sending a leaflet to encourage consumers to shop around) did not have any impact on consumers (FCA 2015b).
- The Senate Standing Committee on Economics Inquiry into Australia's General Insurance Industry recommended the inclusion of the previous years' premium on insurance renewal notices. The Australian Government's response agreed to the recommendation, noting that it would task the Treasury with assessing the proposal (Australian Government 2017c).

105 As argued by Fletcher (2016), successful disclosure measures involve (among other things) providing consumers with clear and comprehensible information rather than simply more information.

- The industry's 2016 Effective Disclosure Taskforce (2015) report 'Too Long; Didn't Read — Enhancing General Insurance Disclosure' recommended that the ICA coordinate trialling the provision of a reminder of the previous year's premium at each renewal.
  - In response to the recommendation of the Senate Inquiry, the ICA's interim report for the Review of the General Insurance Code of Practice noted that many insurers are already progressing in this direction, that several have moved to provide year-on-year premium comparisons in the context of Emergency Services Levy reform in NSW, and that it regards the measure as best practice (ICA 2017c).

In addition, CHOICE noted that similar changes are being made in the retail energy market with reminder notices serving as positive drivers of competition (sub. 42). Retailers have agreed to write to customers who have reached the end of a discounted plan and outline in plain English alternative offers that are available (Turnbull 2017).

Several industry participants responded to this Inquiry's Draft Report with concerns about this recommendation (in its draft form).

- While it supported the recommendation in-principle, the ICA (sub. DR62) submitted that many insurers' systems are currently not in a position to provide this information on every customer's renewal notice, and suggested that the measure should remain voluntary. The Commission recognises that there may be transitional costs associated with the measure, but these must be exceptionally small in a digital age where data is already so heavily tracked. It is the equivalent of adding another line to a spreadsheet. This measure should become compulsory within 12 to 18 months.
- The National Insurance Broker's Association (NIBA, sub. DR56) submitted that the measure may encourage consumers to switch products based on price alone. While consumers do tend to focus strongly on price as an objective comparator, this measure would provide a direct price comparison between only the current policy and the renewal. If the renewal is not identical in terms of features and coverage, then the insurer could — and should already — explain to the consumer why this has occurred. NIBA instead suggested that consumers be informed at renewal that they can request details on changes to their premium. As we have noted in previous chapters, putting the burden on consumers to winnow the wheat from the chaff in financial product information is unlikely to be pro-competitive. The industry should be aware of this.
  - NIBA also sought clarification on which insurance products the recommendation would apply to. The Commission considers that it should apply to personal insurance products (not commercial insurance) that are distributed through either an intermediary (such as a broker) or directly by the insurer themselves and that are renewable contracts. This mirrors the approach undertaken in the United Kingdom.

The required information should be included near the information about the current premium and in a font no smaller than that for the current year's premium.

RECOMMENDATION 14.1 COMPARATIVE PRICING INFORMATION ON INSURANCE RENEWAL NOTICES

Renewal notices for general insurance products should transparently include the previous year's premium and the percentage change to the new premium. This policy should commence by the end of 2019 and be enforced by ASIC.

Reduce the illusion of competition

Insurers' branding arrangements create the illusion of more competition than actually exists.

When looking to purchase insurance, in addition to knowing which insurer is underwriting the policy they are considering, consumers would benefit from knowing the other brands that are underwritten by that insurer. This would allow them to more easily identify policies underwritten by an entirely different insurer to stimulate more genuine competition between insurers. In this Inquiry's Draft Report, the Commission proposed that a list of any other brands that are underwritten by the same insurer should be published on each brand's website and that a list of brands underwritten by each insurer should be published on ASIC's website.

Several industry participants responded to the Draft Report with a range of concerns about publishing the full list of brands underwritten by that same insurer on each brands' website. They argued that:

- consumers may not benefit from the measure as it may lead to confusion (ICA, sub. DR62; PetSure, sub. DR66) and direct them towards less appropriate products (PetSure, sub. DR66). However, the Commission notes that the measure would not direct consumers to other providers and nor would it suggest that the same product is available from other providers
- the measure would undermine brands' marketing strategies (NIBA, sub. DR56; ICA, sub. DR62; PetSure, sub. DR66). However, the Commission notes that the measure is designed purely to improve transparency — it does not require brand owners to actively promote other brands
- brand owners would incur a significant compliance burden as they would have to continually update their websites (NIBA, sub. DR56; NAB, sub. DR94). The Commission recognises that the measure would carry a compliance burden, but notes that the insurer should be able to supply the necessary information (consistent with their Product Disclosure Statement) and that changes would usually be relatively infrequent. And while the measure may place a small burden on brand owners, it would save time and effort for consumers.

NIBA (sub. DR56) and NAB (sub. DR94) proposed that the obligation should fall only on brands that are owned by the insurer, with third party brands exempt. The Commission's view is that the obligation ought not to distinguish between insurer-owned and third party brands, as there is no meaningful distinction between the two from the point of view of a consumer looking to purchase insurance.

RECOMMENDATION 14.2 TRANSPARENCY ON INSURANCE UNDERWRITING

In addition to specifying which insurer underwrites their products, each insurance brand should specify on their website any other brands that are underwritten by the same insurer, for that particular form of insurance.

Insurers should provide an up-to-date list of the brands they underwrite to ASIC. ASIC should transparently publish this information as a list on its website.

Remove distortionary taxes

Stamp duties on insurance effectively increase the price of purchasing insurance relative to other goods and services. It follows that they are a highly inefficient source of tax revenue because they artificially reduce consumers' demand for insurance.

While the ACT has abolished stamp duty on insurance, stamp duty still applies in other states and the Northern Territory, and in one case (NSW) multiple rates apply (box. 14.6). And while there have been recent moves in some states (including NSW and Victoria) to exempt some forms of insurance, such as crop and livestock insurance and LMI, these add complexity to the system. The solution is to remove all stamp duties on insurance, as the Commission recommended in its 2014 Natural Disaster Funding Inquiry (PC 2014a).

The 2010 report *Australia's Future Tax System* (the Henry review) also recommended that all insurance taxes should be abolished and replaced by more efficient taxes, noting that:

> Imposing specific taxes on insurance deters people from insuring their property and encourages them to bear unnecessary risks, rather than pooling risk with others. Rates of non-insurance (for building and content insurance) generally are higher at lower incomes, yet low-income people are less able to bear the risk. (Henry et al. 2010, p. 58)

Box 14.6 **Stamp duty requirements vary across the country**

- **ACT** — stamp duty on general insurance has been abolished (ACT Government 2017).
- **NSW** — the NSW government has announced a number of stamp duty exemptions, including in relation to lenders mortgage insurance policies from 1 July 2017 and from 1 January 2018 in relation to crop and livestock insurance, along with certain small business insurances. From 1 January 2018 NSW has two rates of stamp duty applying to general insurance, 9% or 5% (NSW Government 2017a, 2017b).
- **Victoria** — from 1 July 2017 the Victorian government has exempted insurance for crops which are being grown, harvested or stored, and for livestock and agricultural machinery. There are also a number of other exemptions to the 10% Victorian stamp duty, including for WorkCover and for the physical hulls of a floating vessel used primarily for commercial purposes (State Revenue Office Victoria 2017).
- **South Australia** — stamp duty at the rate of 11% applies to general insurance in South Australia. Exemptions apply for certain types of insurance including reinsurance, workers compensation and insurance of the hull of a marine craft used primarily for commercial purposes (RevenueSA 2016).
- **Western Australia** — stamp duty of 10% of the premium applies to general insurance in Western Australia. A number of exclusions apply including workers compensation, reinsurance and insurance under the Defence Service Homes Insurance Scheme (Government of Western Australia 2017).
- **Northern Territory** — stamp duty of 10% of the premium applies to general insurance in the Northern Territory. A range of exemptions apply, including to reinsurance and residential building insurance and fidelity certificates taken out as a requirement under the Building Act (Northern Territory Department of Treasury and Finance 2016).
- **Queensland** — stamp duty of 9% of the premium applies to general insurance in Queensland (Queensland Government 2017).
- **Tasmania** — stamp duty of 10% of the premium applies to general insurance in Tasmania (Tasmanian Government 2017).

RECOMMENDATION 14.3 PHASE OUT DISTORTIONARY INSURANCE TAXES

Consistent with the Productivity Commission’s 2014 *Natural Disaster Funding Inquiry* (recommendation 4.8), state and territory taxes and levies on general insurance should be phased out.

15 Add-on financial products

Key points

- Add-on insurance is insurance that is sold alongside (and in relation to) another product. Examples include consumer credit insurance (sold alongside credit cards and loans) and guaranteed asset protection insurance (sold alongside car loans).
- Often, consumers have not given thought to their need for the add-on insurance product ahead of time, but are sold policies of dubious worth after being exposed to high pressure sales tactics by sellers receiving sizeable commissions.
- Consumer outcomes have generally been poor across add-on insurance markets.
  - Consumers receive back in claims only a small share of what they pay in premiums — about 9 cents in every dollar for add-on insurance sold by car dealerships and 21 to 28 cents in every dollar for consumer credit insurance. This is far below the comparable figures for car insurance (83-98 cents) and home insurance (42-71 cents).
  - Around 90% of consumer credit insurance claims are accepted, the second lowest rate among types of personal insurance and below the average rate for retail insurance policies of 96%.
- Some add-on insurance products are only sold by product retailers, and even for those more widely available, product retailers typically remain the main distribution channel. In effect, consumers have few options beyond the policy they are offered by the product retailer.
  - In the market for add-on insurance supplied by car dealerships, insurers compete not for the consumer but for the retailer's favour, by offering large commissions to car dealerships. This phenomenon, known as 'reverse competition', leads to consumers paying higher premiums for add-on insurance.
- Several insurers have now issued (or announced that they will issue) refunds for add-on insurance policies that were of little or no value to the consumers they were sold to. But, beyond this, there has been no apparent penalty for consumer exploitation.
- A 'deferred sales model' for <u>all</u> sales of add-on insurance — involving a mandatory period of at least 7 days separating the primary product and add-on product sales processes — would assist consumers to impose competitive pressure on providers.
  - While ASIC is developing a deferred sales model for add-on insurance sold by car dealerships, and the Australian Banking Association has recently mandated a deferred sales model for credit card-related consumer credit insurance, the picture of insurer versus regulator resembles a game of whack-a-mole.
  - The Australian Government should look to extend the deferred sales model to <u>all</u> add-on insurance products, including home loan and personal loan consumer credit insurance sold by ADIs, and allow ASIC to consider claims for exceptions.
- Retailers that supply credit products are currently exempt from some consumer protection regulatory requirements. The Treasury should complete and publish its review of this exemption, with a view to removing or reforming the exemption in a way that provides consumers with protection when purchasing finance with their consumer products.

‘Add-on financial products’ are financial products — most commonly insurance or finance for the initial product purchase — that are sold alongside (and in relation to) another product. These add-ons are sold by a product retailer acting on behalf of an insurer or credit provider.

Examples of add-on financial products include:

- *Consumer credit insurance (CCI)* — sold to consumers as they take out a credit card, personal loan, car loan or home loan. CCI typically insures a borrower’s capacity to make repayments in the event that they become unemployed, disabled or die. Various parties play the role of the product retailer — the car dealership in the case of a car loan or the credit card issuer in the case of the credit card.
- *Guaranteed asset protection (GAP) insurance* — sold to consumers as they take out a car loan, typically by the car dealership. If the car is written off, GAP insurance covers the difference between what the consumer owes on their car loan and the amount they receive under their comprehensive insurance policy.
- *Point of sale finance* — provided to consumers to allow them to make a major purchase. Provided by car dealerships, other retailers and providers of services such as funeral homes and dentists.

This chapter focuses primarily on add-on insurance. Rather than analysing each add-on insurance product in isolation, this chapter focuses the analysis by product retailers and the way in which they sell add-on insurance policies. The two major markets are:

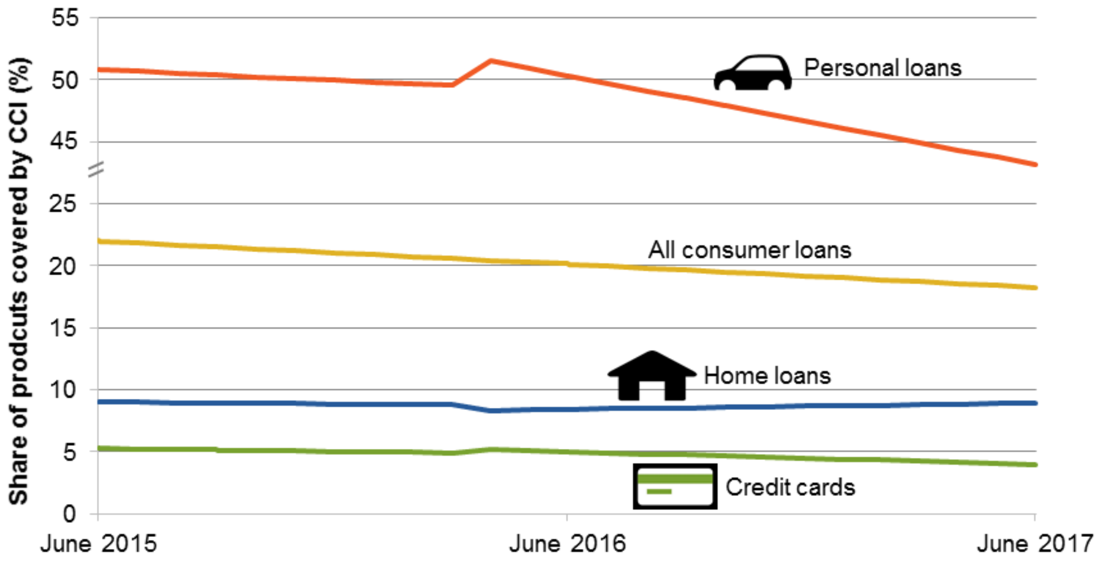
- add-on insurance sold by car dealerships
- add-on insurance sold by authorised deposit-taking institutions (ADIs).

Size of the add-on insurance sector

The CCI market appears to be mature and in slight decline. The number of CCI policies sold (both new business and renewals) peaked at 1.07 million in 2012-13, before declining to 0.83 million by 2016-17 (FOS 2015; General Insurance Code Governance Committee 2018).

Likewise, the share of ADI-issued loans and credit cards that are covered by CCI has declined in recent years. The Australian Securities and Investments Commission (ASIC) found that 46% of personal loans, 17% of credit cards and 8% of home loans issued by ADIs were covered by CCI in 2009 (ASIC 2011a). More recent data supplied by ADIs to this Inquiry indicated that the share of credit cards and loans covered by CCI generally declined over the two years to June 2017 (figure 15.1), and that 6 of the 18 respondent ADIs do not offer CCI with credit products. But the share of personal loans covered by CCI remains significantly higher than the share of credit cards and home loans covered by CCI.

Figure 15.1 **Consumer credit insurance coverage on ADI credit products[a]**
Individual ADIs, June 2015 to June 2017



[a] Unweighted mean of data from all respondent ADIs. 8 ADIs provided data about credit cards, 3 provided disaggregated data about home loans and personal loans, and 6 provided aggregated data about all (home and personal) loans (represented by the 'All consumer loans' series). Excludes ADIs that did not offer CCI.

Source: Unpublished data provided by ADIs

Most CCI policies are sold by ADIs (figure 15.2). Of the (approximately) 0.9 million CCI policies sold (both new business and renewals) in 2009:

- 72% were sold by the 15 ADIs surveyed by ASIC (2011a). Of these, 53% were sold with credit cards, 36% were sold with home loans and 11% were sold with personal loans[106]
- the remaining 28% were sold by other ADIs, non-ADI credit issuers and businesses such as car dealerships.

In terms of the dollar value of the policies, around one third of CCI policies were sold through the car dealership channel across the 2012-13 to 2014-15 financial years.[107]

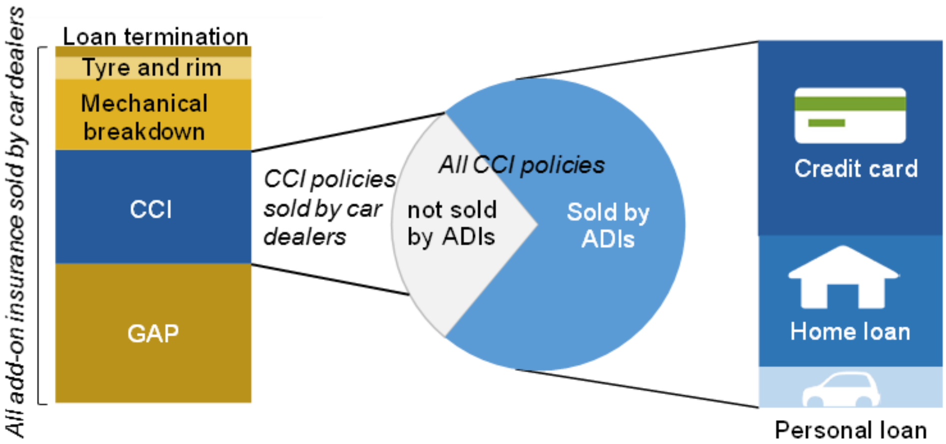
While CCI is the primary form of add-on insurance sold by ADIs, car dealerships sell a wider range of add-on products (figure 15.2). The car dealership add-on market comprises GAP insurance (39%), CCI (32%), mechanical breakdown insurance (20%), loan termination insurance (6%), and tyre and rim insurance (3%) (ASIC 2016a). Overall, 75% of these

106 While a higher percentage of personal loans and home loans are sold with add-on insurance (figure 15.1), ADIs issue sufficiently more credit cards than loans that the majority of ADI-provided CCI is with credit cards.

107 Productivity Commission estimate based on ASIC (2016a) and APRA (2018q).

products are sold through car dealerships, and many are only available for sale through a dealership.[108]

Figure 15.2 **Add-on insurance products and providers**



Source: Productivity Commission estimates based on ASIC (2011a, 2016a)

15.1 Competition concerns with add-on insurance

Across add-on insurance markets, two forces restrict competition.

First, consumers are not well-informed about the insurance products they are purchasing, and are not able to give due consideration to whether products represent value for money. This is for two reasons:

- generally, consumers do not actively seek out add-on insurance — they are often more concerned with acquiring the credit card, loan or product to which it applies. In some instances, consumers are not even aware that they have purchased add-on insurance
- some product retailers engage in pressure-selling tactics, which inhibits consumers' ability to make informed decisions.

Consequently, consumers have even been sold insurance policies that are of no value to them whatsoever.[109]

108 Three of the seven insurers surveyed by ASIC (2016a) only distributed their products through car dealerships, and one other insurer consistently sold at least 99% of their policies through car dealerships.

109 For example, the sale of policies at a dirt-bike riding club to cover medical costs from injuries sustained while riding when the insurer did not offer this cover, and door-to-door sales of sickness and accident policies to consumers not eligible for such cover (Kell 2016).

Second, the distribution channel for add-on insurance — the product retailer — serves to lock out competition from other insurers. In some instances add-on insurance can only be purchased from the product retailer, and where it is available through other channels consumers have difficulty making effective comparisons. And in the context of add-on insurance sold through car dealerships, there is evidence that insurers — rather than compete for customers — compete in commissions paid to intermediaries (a phenomenon known as ‘reverse competition’) for access to their distribution channel (ASIC 2016a). This places upward pressure on the premiums that consumers pay.

Add-on insurance sold by car dealerships

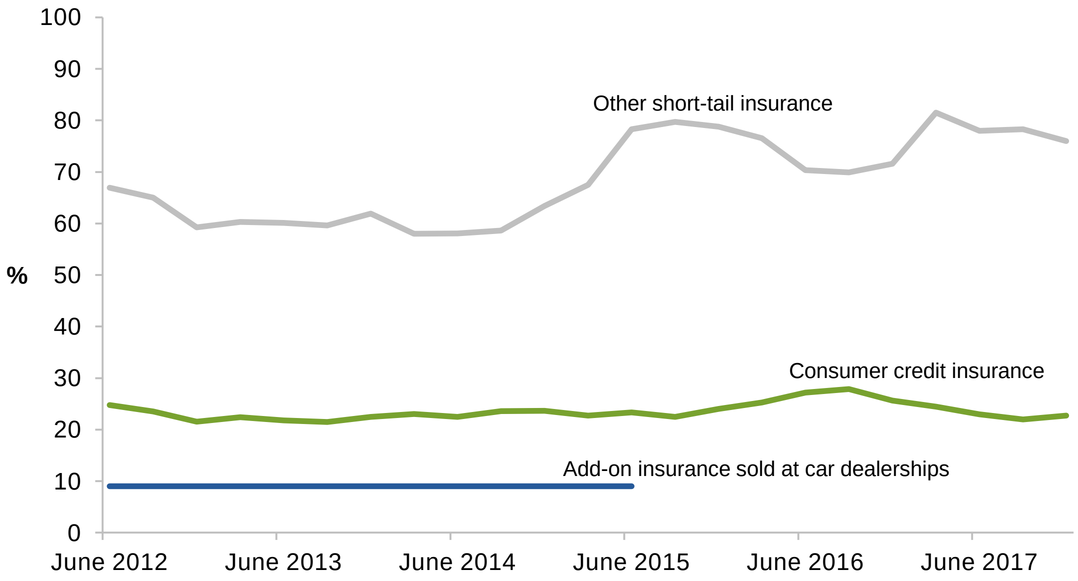
Outcomes in markets for add-on insurance from car dealerships have been especially poor for consumers, with ASIC (2016a) finding that these insurance products are designed in a way that offers very little value to the user. Examples include:

- *Negative and low value policies* — policies where the average claim is less than or similar to the average premium paid. In some instances, consumers pay more in premiums than they could ever claim back. Another example is sales of GAP insurance where there is no ‘gap’ (as the market value of the car did not reduce faster than the outstanding loan value) and it was unlikely that such a gap would ever exist.
- *Restrictions in cover* — policies that include broad exclusions for pre-existing medical conditions and limitations under unemployment cover.
- *Unnecessary additional ‘extras’ cover* — for example, a mechanical breakdown insurance product that also offered cover for identity theft leading to credit card fraud despite this being already covered by most credit card providers.
- *Overlapping and unnecessary cover* — policies that insure the same risk twice, or insure against events already covered by warranties.

Moreover, there is strong evidence that consumers are not receiving value for money. Across five add-on insurance products over 2012-13 to 2014-15 (with about 75% sold through car dealerships), ASIC (2016a) found that consumers paid $1.6 billion in premiums but received only $144 million in claims; only 9 cents in claims for every dollar paid in premiums — well below the return of other insurance products (figure 15.3). These high profit margins for add-on insurance are especially notable given that add-on insurance markets are generally mature, which suggests that insurers and intermediaries have been able to sustain high profits in the long run. This is indicative that the market is not adequately contestable (chapter 2), because otherwise these profits would be competed away as market share is lost to existing firms or new entrants offering better value insurance.

Figure 15.3 **Add-on insurance products are relatively poor value for money**

Annual share of premiums returned in claims by class of insurance[a]



[a] Calculated as annual gross earned premiums divided by annual gross incurred claims (also known as the gross loss ratio). Long-tail insurance policies are excluded because of the potential for inconsistency between the periods in which premiums are registered and claims are made.

Source: ASIC (2016a); Productivity Commission estimates based on APRA (2018q)

Consumers' poor understanding, insufficient consideration of the policy they are purchasing, and lack of direct engagement limits their ability to assert competitive pressure on insurance providers. Many consumers have no awareness of add-on insurance products before entering a car dealership, are actively sold — and sometimes pressured to buy — add-on insurance products while they are in the dealership, and have very poor recollection of the products they have purchased (box 15.1).

Furthermore, the car dealership distribution channel does not provide consumers with adequate capacity to compare different products, such as the cost of an add-on product sold by one dealership to the same or a similar product sold by another dealership. This gives insurers and product retailers that sell add-on insurance price-setting power — ASIC (2016a) found instances of discretionary pricing, with consumers at some car dealerships being charged up to 10 times more for the same product than consumers at other dealerships. In these cases the price is set by the dealership (which does not assume the liability for paying out claims — this is the job of the insurer) within a range proscribed by the insurer, suggesting that the variations in price are not linked to the underlying risk of supplying the insurance.

Box 15.1 'Would you like fries with that?' — consumers' experiences of purchasing add-on insurance through car dealerships

Surveys conducted ASIC (2016c) found that:

- Many consumers had no awareness of add-on insurance products before entering a dealership to buy a motor vehicle.
  - Before entering the dealership, most consumers' focus was on purchasing a vehicle, including how it would be financed, with little thought given to insurance.
  - Most consumers were unaware of the cost of, or cover or value provided by, add-on insurance products. Accordingly, most purchases were made solely on the basis of information provided in the car dealership.
- Many consumers were actively sold, and sometimes pressured to buy, add-on insurance products both through explicit sales techniques and how the sales process is structured.
  - Generally, the purchase of add-on insurance was not driven by the consumers. Sales staff and their actions had a strong influence (both negative and positive) on how the consumer felt and the decisions they made.
  - Many consumers recall being provided with minimal information about add-on insurance products. For many consumers, the information that was provided was unbalanced, promoting potential benefits without explaining exclusions. The bundling of add-on insurance products with finance also caused confusion about the total cost for some consumers.
  - Some consumers felt the dealership used pressure tactics when selling them add-on insurance products. Several consumers reported that sales staff spent up to 40 minutes pre-filling applications forms for these products, even though the consumer had not requested this.
- Many consumers had a very poor recollection of which policies they purchased, how much each policy cost and what it covered. Of those that could recall the purchase, many regretted their decision to purchase add-on insurance. That said, some consumers valued the add-on insurance products they purchased because they considered that having insurance gave them peace of mind.

Source: ASIC (2016c)

Other factors, such as reverse competition, place upward pressure on premiums. ASIC (2016a) found that insurers paid commissions and volume bonuses to car dealerships for selling add-on insurance policies that were well in excess of the value of the policies to consumers. While consumers received just a 9% return on the premiums they paid, average maximum commissions (the average of the maximum commission payable by each insurer to the car dealerships) as a share of total premiums varied between 36 to 58% across insurance product lines, with one insurer paid commissions as high as 79% of the premium value. In addition to increasing the consumers' premiums (box 15.2), this provides incentives for car dealerships to engage in pressure selling tactics.

Box 15.2 Commissions paid to car dealerships and consumers' premiums

Commissions are a cost associated with offering add-on insurance, so (other things being equal) the higher the commission, the higher the cost of issuing the policy, the higher the premium.

A case in point is the sale of personal-use CCI vs. business-use CCI that was examined by ASIC (2016j). While commissions are capped at 20% of premiums for sales of personal-use CCI, there is no restriction on the premiums that can be paid for business-use CCI. Hence, ASIC noted that while the products were identical.

- Insurers paid higher commissions for the sale of business-use CCI than for the sale of personal-use CCI. Most insurers paid the maximum 20% commission for sales of personal-use insurance, while one insurer paid a 50% commission for sales of business-use CCI.
- Consumers paid higher premiums for business-use CCI than for personal-use CCI. The difference in premiums was 33% for two insurers and 80% for one insurer.

Similar issues have arisen in the United Kingdom. A Financial Conduct Authority market study found that the purchase of GAP insurance was generally not planned — almost two-thirds of consumers reported they had not considered it prior to the day of purchase. In addition, almost half of the consumers were unaware they were able to purchase GAP insurance at another time and from another supplier (FCA 2014). However, in the Australian context, ASIC (2017ab) noted that add-on insurance products are generally only available through car dealerships with the sale of a vehicle or loan.

Another United Kingdom investigation reached similar conclusions in the context of add-on insurance sold alongside private motor insurance. The Competition and Markets Authority found that there were information asymmetries between providers and consumers of add-on insurance, and that consumers had difficulty comparing prices and terms of add-on insurance products. It concluded that:

> … these two features together gave rise to an [adverse effect on competition], as they distorted competition by making it more difficult for consumers to identify the best-value offers in the market and to make informed purchasing decisions. (CMA 2014, p. 3)

Consumer credit insurance sold by ADIs

Consumer outcomes in the provision of CCI by ADIs have also been poor. Based on data from the Australian Prudential Regulation Authority, we estimated that the amount consumers received back in claims for every dollar paid in CCI premiums ranged from 21 to 28 cents between June 2012 to June 2017.[110] While this is substantially higher than ASIC's estimates for the car dealership add-on insurance market (9 cents), it has consistently been amongst the poorest value insurance classes over the past several years (figure 15.3).

110 As a delineation by product retailer was not possible, this figure is for *all* CCI policies. However, it is a reasonable proxy for the performance of CCI sold by ADIs, as 15 ADIs intermediated the sale of about 70% of all CCI policies in 2009 (section 15.1).

CCI policies also feature comparatively low claim acceptance rates, limiting their value to consumers. In 2016-17, 90% of consumer credit insurance claims were accepted — an improvement on the 2015-16 figure of 85% but the second lowest among reported categories of retail insurance (behind travel insurance) and well below the retail insurance average rate of 96% (General Insurance Code Governance Committee 2017, 2018). ASIC (2011a) found a claim acceptance rate of 84% among 15 ADIs when reviewing their CCI sales practices in 2009. CCI sold with credit cards had the lowest acceptance rate (79%), followed by that sold with home loans (87%) and personal loans (88%).[111]

A source of these poor outcomes is consumers' lack of understanding and consideration of CCI policies. ASIC (2011a) found that consumers were being sold CCI products without their knowledge or consent, that pressure tactics and harassment were used and potentially misleading representations made during sales and promotion of CCI. Furthermore, consumers have been found to generally have only shallow knowledge of their CCI policy at the time that they take it out, with some being entirely unaware of it (box 15.3). And some of those who try to make a claim are unaware of the tight eligibility criteria.

Box 15.3 Consumers' experiences of ADI-issued consumer credit insurance

Surveys conducted by ASIC (2013c) found that:

- Consumers generally admitted to having only a shallow knowledge of the policy at the time they took it out. Also, most did not recall that they were asked any questions about eligibility when they acquired their policy.
- Most consumers did not know how to go about making a claim on their CCI policy. And while the claim assessment process was smooth for most consumers, some claims took several months to assess because the consumer was asked to supply a large amount of documentation including medical and employment certificates.
- People whose claims were denied because they were ineligible were surprised to discover the existence of eligibility criteria that they had not expected. Some consumers had been ineligible to claim on a feature of the policy since they took the policy out. Some became ineligible to claim on a feature of the policy because, for example, their work status changed or they reached the upper age limit of the policy. Yet the insurance premiums were still collected.

The Consumer Action Law Centre (pers. comm., 9 January 2018) also provided the Commission with examples of consumers who had purchased ADI-issued CCI, but later found that they had been ineligible to claim since taking the policy out.

111 That said, this was not mirrored in high dispute volumes. The proportion of CCI customers that registered a dispute with the Financial Ombudsman Service over their policy was below the comparable figure for five of the six other reported classes of insurance. Across insurers offering CCI, complaints were registered for between 0.004% and 0.014% of policies (FOS 2017b).

The experience in the United Kingdom has been similar. A 2009 investigation by the UK Competition Commission found that intermediaries faced little competition in the sale of add-on payment protection insurance (equivalent to CCI). This led to consumers facing higher prices and less choice than they would if there was effective competition in the market (Competition Commission 2009). There is also evidence from the United Kingdom that the use of opt-out sales techniques has led to poorer value insurance, as claims rates for insurance products sold on an opt-out basis have been found to be inferior to those sold on an opt-in basis (FCA 2015c).

15.2 Improving competition and consumer outcomes

Recent developments

Following its 2011 report, ASIC undertook action to improve ADIs' add-on insurance selling practices (box 15.4), but there is little evidence that consumer outcomes have improved. While the number of CCI policies in force has declined by over 20% since 2012-13 (section 15.1), the claim acceptance rate has fluctuated between 85–90% since 2009-10 and the share of premiums paid out in claims has changed little since 2011-12 (figure 15.3).

More recently, some insurers[112] have refunded or announced that they will refund mis-sold CCI, including the following examples:

- Following ASIC surveillance, Westpac Group wrote to more than 10 600 customers to offer to refund premiums paid for home loan CCI in instances where Westpac collected premiums before a home loan was drawn down, after a home loan was repaid, or where the customer did not go ahead with a home loan (ASIC 2015).
- In 2017, the Commonwealth Bank Group refunded over $10 million in CCI premiums to 65 000 consumers after it identified and reported to ASIC that it sold credit card CCI to consumers who would be unable to claim under the insurance (ASIC 2017k). It also announced, in March 2018, that it would refund $16 million in CCI premiums to 140 000 home loan CCI and personal loan CCI customers and that it would cease selling its credit card and personal loan CCI products (CBA 2018b).
- Latitude Insurance is currently refunding approximately $1.1 million to 905 consumers after it identified and reported to ASIC that it sold personal loan CCI to consumers that would be unable to claim under the insurance and incorrectly denied claims to credit card CCI consumers (ASIC 2017q).

[112] The refunds offered by Westpac and the Commonwealth Bank were of insurance policies underwritten by in-house insurers.

Box 15.4 ASIC’s actions to improve outcomes in ADI-provided consumer credit insurance

ASIC’s 2011 report into the sale of CCI by 15 ADIs made a series of recommendations about CCI selling practices (ASIC 2011a). The recommendations, which were agreed to by all 15 ADIs (ASIC 2013c), pertained to:

- *formal sales scripts* — when CCI is sold over the telephone, distributors should have formal scripts in place for their sales staff
- *evidence of consent* — distributors should obtain adequate evidence that a consumer has consented to purchase CCI
- *disclosure of interest payments* — if a CCI premium is fully funded by the underlying loan, consumers should be informed verbally, and in the loan contract, that they will pay interest on their CCI premium
- *separate quotes* — when CCI is sold with a credit product, staff should quote repayments for the underlying loan separately to the CCI premium
- *disclosure of premium structure* — consumers should be informed how their premiums will be structured, such as whether premiums are to be funded by the underlying loan or paid separately by the consumer
- *duration of CCI policies* — where the duration of a CCI policy is not linked to the duration of the underlying credit product it is sold with, consumers should be informed about the duration of the policy
- *timing of provision of product disclosure statements* — distributors should ensure they provide product disclosure statements to consumers at the appropriate time (in most circumstances, before the consumer acquires the CCI policy)
- *ongoing information* — consumers should be provided with ongoing information about their CCI policy, including a contact number to call if they have any queries or need to make a claim
- *training programs* — distributors should review their training programs to ensure that they are provided to staff on an ongoing basis, and that they adequately address each of the issues raised in this report
- *monitoring systems* — distributors should have documented monitoring systems in place that comprise a range of systems to detect non-compliant sales of CCI.

Refunds have also been issued for add-on insurance sold through car dealerships. QBE Insurance is refunding more than $15.9 million in CCI and GAP insurance premiums to over 35 000 consumers (ASIC 2017v), Swann Insurance is refunding $39 million to almost 68 000 customers (ASIC 2017z), Allianz $45.6 million to around 68 000 customers (ASIC 2018a) and Suncorp $17.2 million to over 41 000 customers (ASIC 2018o). In each instance ASIC found the add-on policies were of little or no value to consumers. In total, ASIC expects that it will see refunds of $122 million paid to over 257 000 customers for poor value add-on insurance (Kell 2018b).

Consumer groups are also working to force refunds of add-on insurance policies of little or no value, for example the Consumer Action Law Centre is currently running a campaign called ‘Demand a refund’ (box 15.5).

The proposed design and distribution obligations and product intervention power for ASIC (a legislation exposure draft for which was circulated in late 2017) may help prevent add-on insurance being sold to customers to whom it offers little or no value. The design and distribution obligations would require insurers to identify an appropriate target market for their products and, together with intermediaries, ensure that the product is sold only to that target market (Australian Government 2017j). The legislation would also give ASIC greater powers to enforce the new arrangements. As set out by ASIC at the Productivity Commission's public hearings:

> [The design and distribution obligations] will really strengthen our toolkit when it comes to sheeting home responsibility to the product manufacturer so that the product manufacturer can't turn a blind eye to how their products are being distributed. (PC transcript 2018, p. 310)

In particular, the new product intervention power may be a useful tool for ASIC in dealing with add-on insurance products that are generally poor value for money, even if they are sold to their target market.

The Draft Explanatory Memorandum describes the new power:

> The intervention power will allow ASIC to regulate, or if necessary, ban potentially harmful financial and credit products where there is a risk of significant consumer detriment. The power is intended to enable ASIC to take action before harm, or further harm is done to consumers. (Australian Government 2017j, p. 34)

We encourage ASIC to proactively use these new powers if and when they become available.

Box 15.5 **DemandARefund.com**

The Consumer Action Law Centre has set up a website that assists consumers to generate a letter of demand to reclaim money from providers that they believe have mis-sold them add-on insurance. The website has so far seen around 400 consumers reclaim more than $1 000 000.

Over a quarter of consumers that have used the website to generate a claim did not know they had bought the insurance, while almost a third mistakenly thought the insurance was mandatory.

Source: CALC (2016); CALC, Financial Counselling Australia and Financial Right Legal Centre (sub. DR130)

Future reform — the deferred sales model

Governments, industry and consumer groups in Australia and abroad have proposed or implemented 'deferred sales models' to assist consumers to impose greater competitive pressure on providers of add-on products. A deferred sales model involves the imposition of a mandatory time delay into the sales process to separate the purchase of the primary and add-on products.

ASIC (2017ab) proposed a deferred sales model for add-on insurance products sold at car dealerships in an August 2017 consultation paper, noting that it could implement such a measure without legislative change because of its power to modify provisions of the *Corporations Act 2001* (Cth). Stakeholders generally supported the deferred sales model proposal, although their views on its design differed (box 15.6).

Box 15.6 **Stakeholders' views on a deferred sales model for car dealerships**

Consumer groups and the Insurance Council of Australia both supported a deferred sales model for add-on insurance products sold by car dealerships, although they proposed different models.

The deferred sales model proposed by consumer groups in relation to add-on insurance included the following features:

- for sales of add-on insurance, a 30 day deferral period would apply commencing at the point that the vehicle has been purchased, finance is approved and the vehicle has been delivered to the consumer and information about the add-on product has been supplied
- consumers would not be permitted to opt-out of the deferral period
- sales of bridging cover (short term add-on insurance to provide cover during the deferral period) would not be permitted.

Meanwhile, the Insurance Council of Australia proposed a more minimalist model for add-on insurance, in line with the UK's deferred sales model for GAP insurance:

- a four day deferral period would apply commencing at the point that information about the add-on product has been supplied to the consumer
- consumers would be permitted to opt out of the deferral period after one day
- the Insurance Council of Australia did not indicate whether sales of bridging cover should be permitted or not, but noted that cost of administering and arranging bridging insurance would make it prohibitively expensive.

Source: CALC et al. (2017); Insurance Council of Australia (2017a)

ASIC received submissions on the consultation paper in October 2017, and commenced further consultation in December 2017. Its preliminary findings include that a deferred sales model is desirable and, in concert with enhanced and individual disclosure, has the opportunity to improve consumer decision making (ASIC, sub. DR123).

The United Kingdom introduced a deferred sales model for GAP insurance sold by car dealerships in 2015. The deferral period of four days is triggered by the point at which the dealership provides mandatory GAP contract information to the consumer. Consumers are also permitted to voluntarily opt-out of the deferred sales process. The United Kingdom Financial Conduct Authority recently commenced an evaluation of the measure, and plans to report its results in the second half of 2018 (Financial Conduct Authority (UK) 2018).

And ADIs that are signatories to the Banking Code of Practice[113] have agreed to implement a deferred sales model for personal loan and credit card CCI sold over the phone and in branches (but not online) by end June 2018 (ABA, pers. comm., 15 May 2018; box 15.7). The model, which is to apply to all ADIs that subscribe to the Banking Code of Practice, does not permit ADIs to sell CCI until at least four days after a credit card or personal loan has been applied for (ABA 2018a). It was developed as the result of a 'CCI Working Group' set up by ASIC that included the ABA, ADIs and consumer advocacy groups.

Box 15.7 **Banking Code of Practice-mandated approach to selling consumer credit insurance**

The new Banking Code Practice (still in draft form at time of completion of this Inquiry) sets out obligations for subscribing banks when selling consumer credit insurance.

The Code also sets out information that should be disclosed (to the extent possible) regardless of the channel through which the insurance is sold:

- The cost of the insurance.
- The period for which the insurance applies and the end date if it differs from the end date of the underlying credit product.
- Limits on key benefits payable under the insurance.

The Code sets out a deferred sales model for credit cards and personal loans (but not home loans) *sold over the phone or in branches*. The banks are not permitted to offer a CCI product to a customer until at least four days after the customer has applied for the credit card or loan.

For credit cards and loans *sold online*, the Code mandates that the banks will refer to the availability of CCI only after the application for the credit product has been completed, but not with any deferral period. The sales process must also use filtering questions to alert the consumer to key policy exclusions, although there is no requirement to include 'knock out' questions that would restrict the sale of the policy to consumers to whom it would offer no significant benefit.

Source: ABA (2018a)

Assessment of the deferred sales models

The Commission considers that — in principle — deferred sales models enhance consumers' ability to impose competitive pressure on insurers and product retailers. They allow consumers to more carefully consider the merits and appropriateness of the add-on product at hand, and to shop around for alternatives from outside of the product retailer distribution channel.

113 Member banks of the Australian Banking Association with a retail presence are required to sign up to the Code (ABA 2018a). The Association's 24 member banks include the 10 largest banks in Australia (ABA 2017c; chapter 3, figure 3.1).

But, in practice, this hinges on the model giving a sufficiently long break between the purchase of the primary product and the point at which the consumer can purchase the add-on product to allow the 'halo effect'[114] to dissipate and the consumer to be able to dispassionately assess their need for insurance and consider the products available to them.

The four day deferral period of the Banking Code of Practice deferred sales model is insufficient to achieve this end. As the deferral period commences at the point at which the credit card application is submitted, the model can potentially allow CCI to be sold prior to credit approval (CALC, FCA and FRLC, sub. DR130).

The Commission's view is that the deferral period should be a minimum of seven days from the point at which the consumer applies for the credit product. This should likewise apply to the car dealership deferred sales model up for consultation.

Extending a deferred sales model further

Other add-on insurance products are sold in environments with similar characteristics to motor vehicle and credit card sales — a sales pitch where the consumer is not anticipating such a decision and so is vulnerable to claims of risks they had not considered in advance.

Evidence of similarly poor consumer outcomes exist in relation to:

- *CCI for ADI-issued home loans* — the sales process for ADI-issued home loans has similarities with the processes for credit cards. Moreover, a higher share of home loans issued by ADIs are covered by CCI than credit cards (figure 15.1), and some of the refunds issued for mis-sold CCI have been in relation to home loans.
- *Travel insurance* — Pedersen-McKinnon (2017b) found that add-on travel insurance (purchased through an airline or travel agent) is of poorer value than travel insurance purchased through an online travel insurance specialist. A 2016 survey found that only about a quarter of travel insurance policies were sold as add-ons — 19% of travel insurance policies were sold through a travel agent, and 6% were sold through an airline. That said, people aged 18-24 were more likely to purchase travel insurance through a travel agent or airline than older travellers (38% of policies compared with less than 25% of policies), and were also less likely to have reviewed the terms and conditions of their policy (Quantum Market Research 2016).
- *Some extended warranties* — ASIC's (sub. DR123) initial inquiries into car dealership-issued warranty products that are functionally similar to add-on insurance but exempted from the regulatory regime for financial products in the *Corporations Act 2001* (Cth) indicated that consumers are being sold warranties with significantly higher prices than functionally-similar insurance products.

[114] A form of behavioural bias where the consumer attributes the qualities of the primary product to the add-on product. Appendix D contains more information on the behavioural biases of consumers.

At present, the regulatory paradigm appears to involve ASIC in a game of whack-a-mole with insurers and their retailing partners. Legislators cannot expect the regulator to be effective in this game. It takes considerable time to gather evidence, and the outcomes are a miserable incentive for that effort — consumers may, if they are fortunate, get their money back. But the developers of the insurance largely escape any substantive cost (at worst, they only give back what they should not have taken in the first place — and after a long delay).

The path forward is to extend a deferred sales model — with a consultation period to deal with solid cases for exceptions — to all add-on insurance products. The Commission considers that a minimum of seven days should pass between when the consumer applies for or purchases the product and when they can be sold add-on insurance.

ASIC and consumer groups have expressed support for extending a deferred sales model to other add-on insurance products. ASIC noted in its submission that 'It would be useful to extend the deferred sales model to all add-on products' (sub. DR123, p. 11). And the Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre (sub. DR130) supported the Commission's draft recommendation on the matter.[115]

The case for exceptions can be made, and ASIC should have the power to grant them. For example, The Insurance Council of Australia (sub. DR62) argues that 'applying the [deferred sales model] to comprehensive motor insurance sold through the motor dealer channel is unnecessary, given these are commonly purchased consumer products and generally well understood'. The Commission concurs with this assessment, and notes that this class of insurance products rates amongst the highest value to consumers as measured by the share of premiums returned in claims (chapter 14; box 14.6) and claims acceptance rates (99.5% in 2016-17, compared with the average rate for retail insurance policies of 95.8%) (General Insurance Code Governance Committee 2018). ASIC also excluded comprehensive motor insurance (and compulsory third party insurance) from its consultation on the car dealership deferred sales model.

Moreover, a one-size-fits-all approach would not be optimal. Some add-on products demand a more flexible sales process, while for others consumer protections objectives might be pursued at little cost (box 15.8). For example, were a deferral mechanism to be linked to the sale of add-on travel insurance, it would need to allow consumers purchasing flights shortly prior to departure to be able to purchase add-on travel insurance if they genuinely desired it.[116]

---

115 The Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre commented further that 'It is not clear that a deferred sales model would resolve the widespread problems of add-on insurance mis-selling in every case. In many instances, withdrawal of this product from sale would be the preferable approach' (sub. DR130, p. 14). The Commission agrees, but notes that ASIC's powers under the design and distribution obligations and product intervention power legislation should assist on this front.

116 While a 2016 survey found that (on average and amongst all travel insurance policies whether sold as add-ons or not) travel insurance was arranged 88 days before departure — 22 days after booking flights (Quantum Market Research 2016), around 20% of people purchase travel insurance in the week prior to departure (Pedersen-McKinnon 2017a).

The Commission considers that the Australian Government should establish a Treasury-led working group to take this objective forward. The working group should establish:

- which add-on insurance markets should (in the first instance) be subject to a deferred sales model and the basis on which ASIC should grant exemptions going forward — at a minimum, we consider that a deferred sales model should apply to CCI sold alongside home loans;
- policy settings for each market in line with the considerations set out in box 15.8 (having regard to a minimum deferral period of seven days from the point at which the consumer applies for or purchases the product);
- a process for monitoring and evaluating the policy.

Box 15.8 **Considerations for the design of a deferred sales model**

Considerations for the design of a deferred sales model for add-on products include:

- *trigger event* — the trigger can relate to the sale of the primary product, the provision of information (by the product retailer) about the add-on product, delivery of the primary product to the consumer or a combination of these measures
- *length of deferral period* — too short and the policy is of little consequence; too long and consumers that would genuinely benefit from purchasing add-on products, as well as intermediaries, are unjustifiably inconvenienced and temporarily uninsured. Other things equal, the more complex and financially significant the primary and add-on products, the longer the deferral period should be; but a minimum across all classes on insurance is essential
- *bridging insurance* — whether intermediaries are permitted to explicitly offer short-term insurance products to cover the deferral period or provide implicit bridging insurance by pre-committing to allow the insurance policy (purchased after the completion of the deferral period) to be backdated to the time of sale of the primary product. However, the importance of this issue should not be overstated when the add-on in question does not typically offer immediate term benefits. For example, the United Kingdom Financial Conduct Authority found that the potential for financial loss from lack of access to GAP insurance in the first seven days after the sale of a car was ‘very small’ (FCA 2014, p. 14)
- *opt-out provisions* — a provision for consumers to voluntarily opt-out of the deferral period and purchase the add-on product prior to its completion. While this can benefit savvy consumers, it may be prone to abuse by intermediaries.

The working group should also draw on the experience in the United Kingdom once the Financial Conduct Authority’s evaluation of its deferred sales model for GAP insurance is released.

RECOMMENDATION 15.1 DEFERRED SALES MODEL FOR ADD-ON INSURANCE

ASIC should proceed as soon as possible with its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships.

The deferral period should be a minimum of 7 days from when the consumer applies for or purchases the primary product.

Following implementation, the Australian Government should establish a Treasury-led working group with the objective of comprehensively extending the deferred sales model to all other add-on insurance products, with the model set in legislation and ASIC empowered to offer exceptions on a case-by-case basis.

Point of sale exemptions for retailers from the National Consumer Credit Protection Act

The passing of the *National Consumer Credit Protection Act 2009* (Cth) (NCCP Act) introduced a requirement for credit providers to hold an Australian credit licence and meet the obligations it imposed — including responsible lending obligations.

However, retailers that provide credit are currently exempt from these requirements, meaning that their customers do not benefit from the protections of the NCCP Act. This exemption operates through the regulations attached to the legislation.

At the time of the introduction of the NCCP Act in 2009, the Government announced that it would review the exemption applying to retailers (such as car dealerships and retail outlets) within 12 months (Bowen 2009).

In 2013, the Treasury announced a review of the exemptions for retailers, released a discussion paper and received submissions (The Treasury 2013). The discussion paper put forward three options:

- maintain the exemption
- apply the NCCP Act to retailers
- apply obligations to retailers that differ according to the functions they perform.

This review was not completed (Treasury, pers. comm. May 2018).

The Commercial and Asset Finance Brokers Association of Australia (CAFBA) (sub. DR92), noted that its members, in arranging consumer finance, were bound by the legislation whereas retailers acting as POS vendors were not subject to the legislation. This could provide the opportunity for high risk consumer finance to be provided to the detriment of consumers and with limited options for redress. It said:

> The exemption, therefore, does not provide any means of adequately regulating or controlling the activities of POS vendor introducers who may cause loss or damage to consumers, despite their linked credit providers/lessors being responsible for their conduct. (sub. DR92, p. 7)

It is now nine years since the exemption was introduced. The Government should direct that the review commenced by Treasury five years ago be completed and published. While we have not been able to examine the issue in detail in this Inquiry, there would appear little justification for continuing to withhold consumer protection under the NCCP Act for consumers who take up finance from retailers.

RECOMMENDATION 15.2 REVIEW OF NCCP ACT EXEMPTIONS

The Treasury should complete its 2013 review into the current exemption of retailers from the *National Consumer Credit Protection Act 2009* (Cth), with a view to removing or reforming the exemption. The report should be made publicly available on completion.

16 Provision of finance to SMEs

Key points

- Debt finance — term loans, overdrafts, lines of credit and business credit cards — is one of the main focuses of small and medium enterprise (SME) interactions with the banking system.
- In Australia, SMEs that are successful in raising loans generally do so by mortgaging real estate (usually a house).
  - Nearly 90% of SMEs that decided to apply for debt finance were successful.
- But with home ownership in the key entrepreneurial period of life (ages 25-34) down by a third over the past 25 years, the continued emphasis on home ownership in Australia's risk weighting system will increasingly inhibit SME lending.
- The risk weights applied to SME lending by Australia's regulators are in many cases higher than those in other countries, where the risk weights more closely reflect the Basel II arrangements. Canadian and European approaches to risk weightings for SME lending not secured by home ownership would appear to make holding such debt less costly for many of their local banks.
- As SME lending (unless secured by property) is relatively less profitable than lending for residential property due to both the higher risks and the local capital holding requirements, many smaller banks have less appetite for this lending.
- New businesses, which are typically small, do find it more difficult than established businesses to access debt finance, so the risk weighting of SME lending is not the whole story. These difficulties reflect the lack of financial and trading information lenders have to assess the credit worthiness of the business, including the business and management skills of the owner(s).
- Credit availability could be improved by moving to a more granular approach to risk weightings for SME lending that better reflects the different types of lending products provided, the risk profiles of different SMEs, alternative forms of security and the loan to value ratios of this security and improvements in data access.
- New entrants and innovative lenders are also entering SME credit markets using online platforms to connect with customers, improving competition at the margin.
  - The information available to lenders via Comprehensive Credit Reporting, a process now moving into mandatory provision of information, will improve credit flows by allowing new and incumbent lenders to more accurately assess risk and price credit accordingly.
  - However, where SMEs require the physical presence of a branch or rely on their lender for other products such as point of sale terminals, the large banks will likely retain much of their advantage.
- Further improvements to credit markets are likely to result from the implementation of improved data access under Open Banking and the consumer data right proposed by the Productivity Commission in 2017 *(Data Availability and Use)*. These, and the use of electronic platforms to enable consumers (including SMEs) to share their financial information with prospective lenders, may erode some of the informational advantages of the large banks.

The ability of small and medium sized enterprises (SMEs) to access the necessary finance to establish and grow their business has been an issue for policymakers and previous reviews and inquiries, particularly since the global financial crisis (GFC). Competition plays an important role in ensuring that SMEs are able to access the finance they require at prices that reflect the risk to the investors.

16.1 Finance provided to SMEs

Much of the focus around SME access to finance has been on debt finance as there is relatively limited use of equity finance by SMEs (box 16.1). Most SMEs, outside of seeking equity finance from family and friends, do not have the scale or size to make it viable to secure equity finance on capital markets or are unwilling to give up control and a share of future profits to attract equity capital (PC 2015b). Instead, the vast majority of SMEs have relied on some form of debt financing to establish and or grow their business. Given this, the focus of this discussion is on SMEs access to debt finance.

Box 16.1 **What's a SME? … it depends on who you ask**

The ABS classifies non-agricultural SMEs according to number of employees: micro businesses include non-employing businesses and those with fewer than five employees; other small businesses employ between 5 and 19 people; and medium businesses employ between 20 and 199 people.

Financial system regulators each use different definitions for small businesses, which in some cases are also reflected in their individual Acts. For example:

- APRA, for prudential supervision, defines small businesses as those with revenue below $50 million
- ATO defines small businesses as those with revenue less than $2 million
- RBA, in analysing financial conditions, defines small businesses as those with loans below $2 million
- Lenders have their own definitions, which at times also vary between different parts of the lending institution (PJC CFS 2011). The Australian Banking Association has recently stated that its members see a small business as one with 20 or fewer employees (under 100 employees for a manufacturing business) and annual turnover of under $5 million; small business loans are those under $3 million in value.

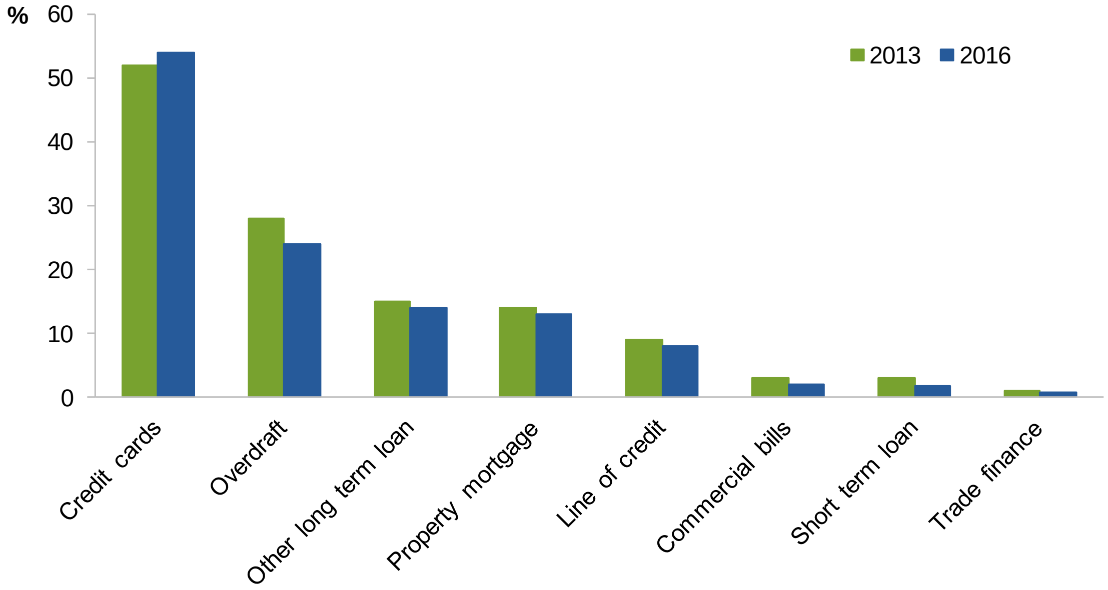
Source: RBA (sub. 29), ABA (2017a)

The most commonly used form of debt finance by small business are credit cards, followed by overdrafts, long term loans and property mortgages (figure 16.1).

However, by value, small business lending is dominated by term loans. These loans account for over 80% of the lending (with the remainder consisting of credit cards, and overdrafts/lines of credits) by authorised deposit-taking institutions (ADIs) (figure 16.2).

Figure 16.1 **Small businesses with lending products**

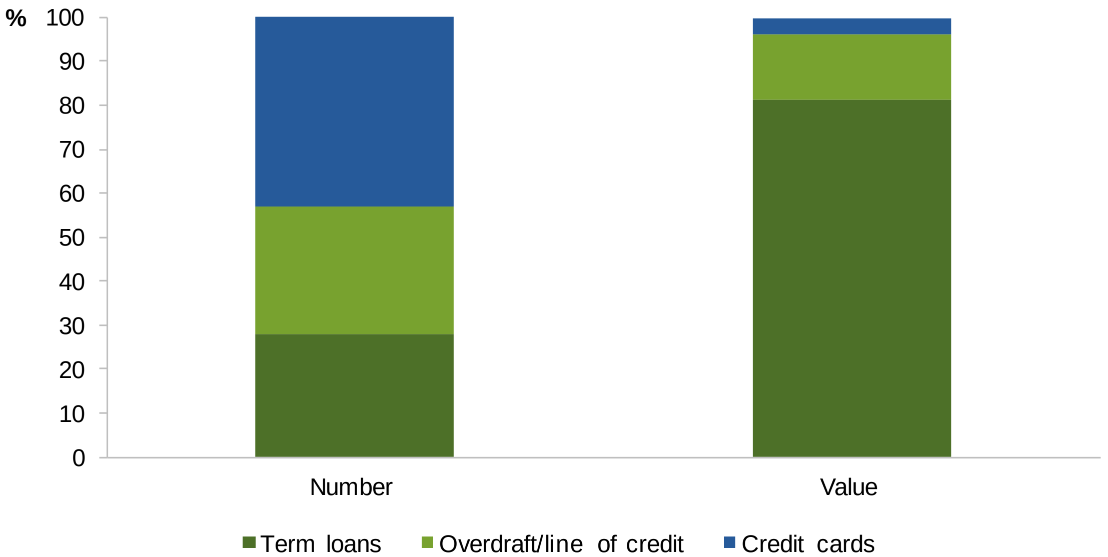
Share of small businesses (by number) using particular lending productions, 2013 and 2016



Source: ABA (2016)

Figure 16.2 **Small business lending by selected debt finance products provided by ADIs**

Share by number and value, June 2017[a]



[a] One ADI's data is based on September 2017.

Source: Unpublished data provided by ADIs, representing 84% of the market for SME lending

16.2 Is there a problem in accessing finance?

Access to finance does not appear to be a problem

Access to debt finance is not a problem for most small businesses that apply for it. Nearly 90% of SMEs that applied for debt finance in 2015-16 were successful (figure 16.3). Since 2006-07 approval rates have been well over 80% (Murray et al. 2014a). A survey of small business for the Australian Banking Association (ABA) and the Council of Small Business Organisations of Australia (COSBOA) found that access to debt finance was an issue for 11% of small businesses and of these 7% already had a loan and 4% did not (ABA and COSBOA 2013).

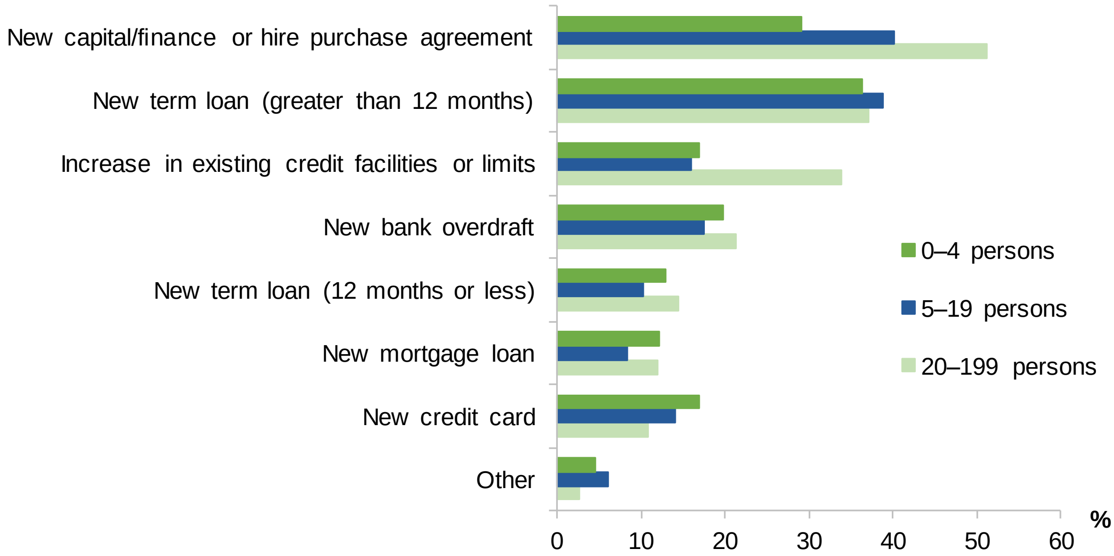
Figure 16.3 **Share of business that successfully obtained debt finance, by employee numbers**

Source: ABS (*Selected characteristics of Australian business* Cat. no. 8167.0, 2017)

The most common form of new or additional debt finance sought by SMEs were term loans and capital/finance or hire purchase agreements. Short term loans (terms less than 12 months), mortgage loans and credit cards were the least sought after type of new or additional finance (figure 16.4). Most SMEs approached either banks (around 75%) and/or finance companies (around 28%) for debt finance (ABS 2017d).

Figure 16.4 **Types of new or additional debt finance sought by SMEs**

By employment size, 2015-16



Source: ABS (*Selected characteristics of Australian business* Cat. no. 8167.0, 2017)

That not every SME applicant is successful in accessing debt finance does not necessarily indicate fundamental problems with the financial system. Rather, the below 100% success rate suggests that lenders are engaging in a rational consideration of the risks, costs and benefits involved with financing each business. If all businesses were successful in obtaining debt finance all the time, this would indicate that financial institutions and their investors were not taking into account the risks and uncertainties of financing SMEs. A major bank suggested:

> Declined applications are a natural result of the combination of responsible lending principles and sound risk management, and are not an inefficient feature of the financial system. (Westpac sub. 28, p. 48)

New businesses find it more difficult

New businesses do find it more difficult than established businesses to access debt finance. New businesses are usually small. What is often termed as the 'small business access to finance' issue, may be more accurately described as the 'new business finance' issue, in light of the figure above. Lenders have insufficient information on new businesses to adequately assess the risk as they are often established by owners with limited business experience, with limited assets and without a proven business model or track record for that business (PC 2015b) (box 16.2). The caution displayed by lenders is not surprising given that the smaller the business (based on either employment or turnover), the lower the survival rate. For example, of all businesses entering the market in 2013-14, non-employing businesses had the lowest survival rate (51%) whereas businesses with over 200 employees had the highest survival rates (79%) as at June 2017. By turnover, businesses with less than $50 000 had the lowest survival rate (51%) while businesses with more than $10 million in turnover had the highest survival rate (76%) over the same period (ABS 2018c).

Due to their lack of financial history, new businesses are often faced with having to use a residence as collateral, in the absence of other collateral, or being offered unsecured finance (usually credit cards). Because of this, there is a gap in the market between the interest rates charged for residentially secured mortgages and the much higher rates charged for unsecured finance such as credit cards (PC 2015b). At March 2018, the interest rate gap between residentially secured small business term loans and low rate credit cards was over 6 percentage points and over 13 percentage points for standard rate credit cards (figure 16.5).

Any gaps in lending to new businesses appear to be the result of a lack of adequate information on which lenders can make an informed assessment of the risk. Being new, these businesses do not have the ability to demonstrate their 'credit worthiness'. New businesses are difficult for lenders to assess — until a business is at least 2 years old there is inadequate trading and financial information to assess the ability of the business to service the loan. If meeting this gap were profitable and there were no regulatory impediments, it would be expected that existing lenders and new players (such as fintechs) would develop the products to do so (PC 2015b). Indeed, the recent arrival of 'challenger banks' with a focus on SME lending may now induce others to attempt to fill this gap.

The GFC had an impact on provision of finance to SMEs

During the GFC, obtaining finance was more difficult for SMEs. Lenders became more risk averse, the price of credit increased due to defaults and business failures and many SMEs became less credit worthy due to weaker sales (ACFS 2014). New business lending for loans under $2 million by Australian banks declined between June 2008 and 2009 by 17% and did not return to June 2008 levels (in nominal terms) until June 2011 (RBA 2017i). The share of SMEs able to obtain debt finance declined in 2008-09 and has taken some time to return to pre-GFC levels (figure 16.3).

This is reflected in business surveys that indicate that access to finance between 2009 and 2011 was considered to be a significant barrier to business competitiveness whereas by 2016-17 it was considered the least significant barrier to business competitiveness (WEF 2017b). As the Australian Industry Group said:

> It [access to finance] scored highly as a problematic factor in 2009-10 and 2010-11 in the aftermath of the GFC, but even then, it was not the first or even the second highest ranked problem. Since then, access to finance has receded as a problem for Australian business, relative to other issues. (sub. DR127, p. 6)

Box 16.2 **What's important to a lender in assessing a loan application from a small business**

In assessing a small business loan application lenders are typically drawn to the three 'Cs', character, capacity and collateral.

In assessing *character*, the lender's focus is on the character and reputation of the business owner to repay the loan by looking for evidence of paying back previous loans, credit history, evidence of management or business experience and business plan. For many lenders, character is a key determinant of the borrower's probability of defaulting on the loan.

The *capacity* of the borrower to generate adequate income to service the debt is critical to the decision of the lender. To determine this, lenders examine the financial records of the business, its actual and projected cash flows along with the personal financial history of the borrower where required. It can be difficult for lenders to adequately assess the financial position of some businesses where the statements of the business may have been prepared with the objective to minimise tax rather than indicate their financial position to a prospective borrower. Lenders, where possible, prefer to be able to access a history of the borrower's transactions to assess their capacity and this becomes easier when the prospective borrower is an existing customer with a well-established transactions history.

There is some divergence on the importance of *collateral*, particularly residential housing (Connolly, La Cava and Read 2015). Some lenders have downplayed the importance of collateral, arguing that it was just a 'backstop' that could reduce the loss for the lender in the event of default, without affecting the probability of a default occurring. In addition, some emphasised how costly and 'undesirable' it was to take possession of a business owner's home upon default.

Other lenders viewed housing collateral as essential, particularly when making larger loans. These lenders highlighted that the provision of housing collateral was an indicator of the borrower's character; it provided the small business borrower with strong incentives to repay, with the borrower clearly having 'skin in the game'. In this way, housing collateral was seen as not just reducing the loss for the lender in the event of default, but also the probability of default. In addition, some lenders viewed home ownership as a positive signal of the borrower's ability to accumulate wealth and as an indicator of the entrepreneur's capacity to repay debt.

Nevertheless, lenders are able to offer larger loans and on considerably better terms and conditions where collateral is available.

Westpac (sub. 28) commented that SME loan applications are declined mainly due to failure to demonstrate the ability to service the debt, poor credit behaviour and/or insufficient security or equity.

Source: Connolly, La Cava and Reid (2015)

Credit renewal

The renewal of finance has been an issue for some SMEs, particularly the amount of notice provided to these businesses when loans were not being rolled over. Previous reviews, including the Joint Parliamentary inquiry into the impairment of customer loans (PJC CFS 2016), the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) inquiry into small business loans (ASBFEO 2016) and the Independent Review of the Code of Banking Practice (Khoury 2017) highlighted that small businesses not in default were often given little notice that their loan facility would not be renewed. This places considerable pressure on these businesses to seek alternative finance on suitable terms and conditions in a constrained time frame. In response to these concerns, the ABA supported changing the banking Code of Practice to require banks to provide a 90 day notification period where a bank has decided not to extend a loan for a further term for customers with aggregated credit facilities below $3 million (ABA 2017b).

Good practice in this area would strongly suggest compliance with the new Code should be reviewed by the ABA after 12 months of operation.

But there are some issues concerning the financing of SMEs

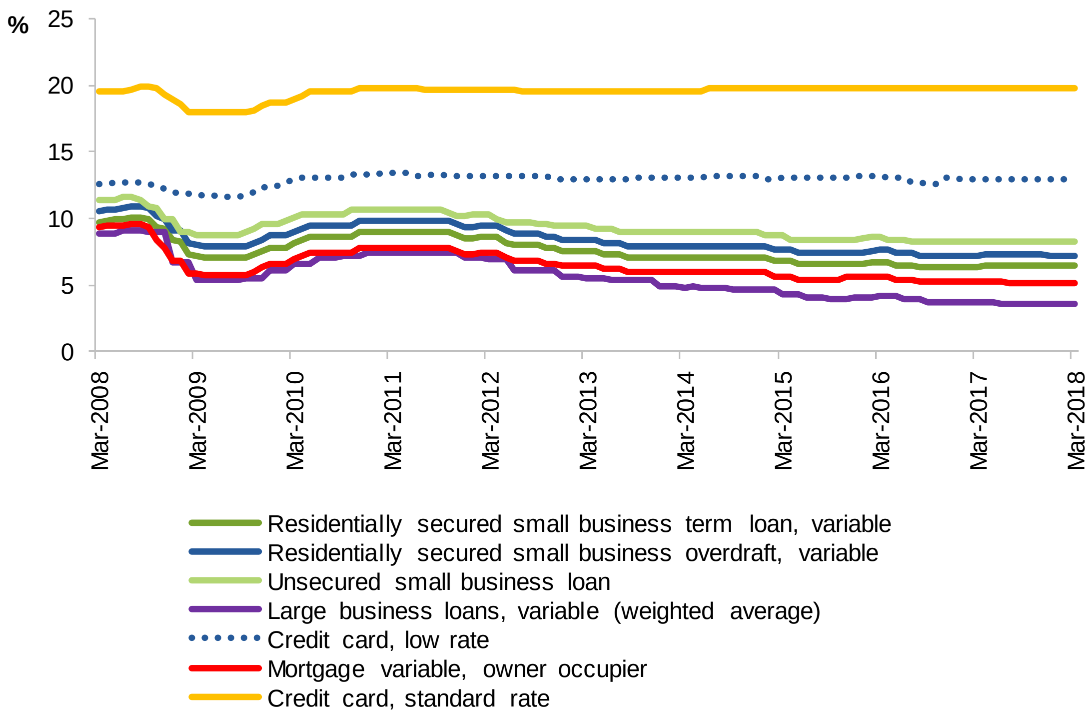
Despite most small businesses being able to access debt finance, there are some issues and concerns around the financing of SMEs.

- *SMEs pay relatively more for their finance*. Interest rates for small business loans and overdrafts secured by residential property are around one to four percentage points higher than the interest rates applying to residential housing and overdrafts for large businesses. The higher interest rates for small business loans secured by residential property than for owner occupied residential housing loans reflects the slightly higher risk associated with this lending. However, small business loans secured by residential property typically have lower interest rates than loans secured by other collateral or overdrafts (figure 16.5). The higher price of unsecured SME finance is due to the higher risk lenders place on lending without security and the higher capital provisions required of lenders by the Australian Prudential Regulation Authority (APRA) (Murray et al. 2014a).
- *The reliance on real estate as collateral*. A significant amount of lending to SMEs is secured by real estate, often a residence. Around a third of all small business lending by value by the major banks is secured by residential property (figure 16.6). For the smaller Australian owned banks, the share of small business lending secured by residential property appears to be higher (3 of the 4 smaller Australian owned banks providing unpublished data to the Commission reported that around 47% of their small business lending by value was secured by residential property with the other bank reporting just over 20%). The APRA capital requirements (discussed below) create an incentive for lenders to seek a residence as collateral (where available) and for SME borrowers to offer a residence as collateral to access the lowest price finance.[117] Also, the business may have limited equity or assets other than the owner's house. The possibly limited knowledge of the lender in regard to the performance of the business — due to less detailed financial reporting requirements than large businesses and lack of expertise across the range of industries in which SMEs operate — makes it difficult (and costly) for lenders to differentiate the actual risk of lending to a SME without a residence as collateral. Those small businesses without collateral, particularly new businesses, must then rely on more expensive unsecured finance.

[117] In some cases, this will require a second mortgage or a mortgage with a higher LVR.

- *The focus of bank lending has shifted.* Lending by Australian banks has shifted towards residential property and away from business lending as lending for residential property is relatively more profitable and general economic conditions have seen a strong and sustained growth in demand for housing credit while demand for business lending has remained soft (RBA 2017x).
- *The large banks dominate SME lending*. Most business finance, particularly for small business, is obtained through the four major banks. The four major banks accounted for over 80% of loans less than $2 million in 2017 and in excess of their share of large business loans and housing loans (figure 16.7, figure 16.13). However, the market share held by the major banks does not necessarily indicate a lack of competition, as providers appear to be competing on product features such as timeliness in the approval process and ease of access to lending products (if not price) and there are emerging innovative lenders entering the SME lending market (as discussed further below).
- *The terms and conditions placed on SME loans*. There have been concerns as to the adequacy of the protections and practices around lending to small business that have resulted in complex one-sided contracts that have enabled lenders to make unilateral changes to the terms and conditions of the loans, including credit renewal, as discussed above (ASBFEO, sub. 30).

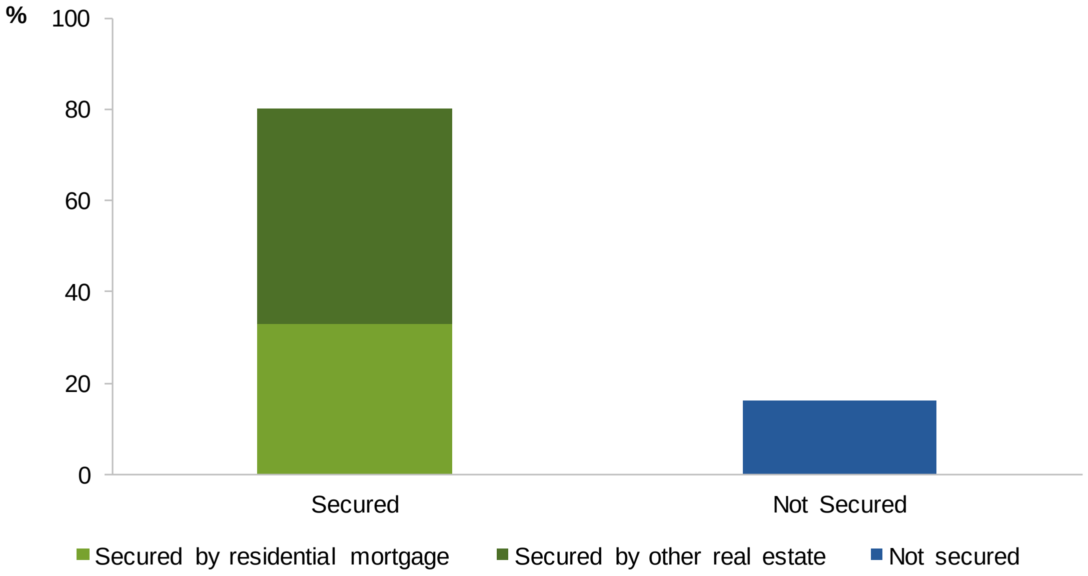
Figure 16.5 **Selected lending rates**



Source: RBA (2018f)

Figure 16.6 **Small business lending by the major banks on term loans secured by real estate[a]**

Share of all small business lending on term loans by value, June 2017

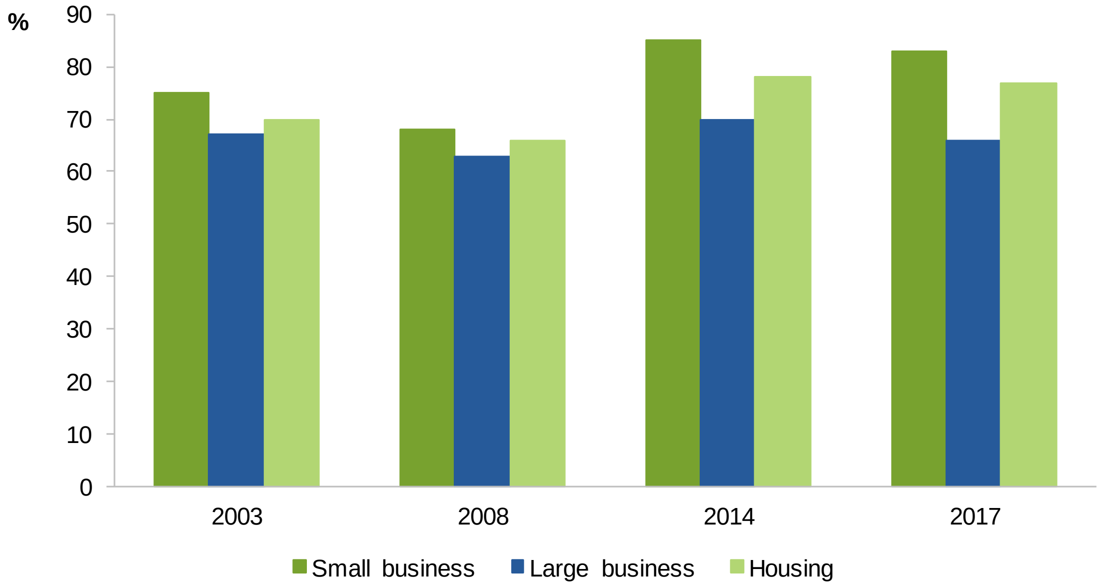


[a] Major banks are the CBA, Westpac, NAB and ANZ. The data for ANZ bank is as at September 2017. The classification of a small business loan is determined by each bank.

Source: Unpublished data provided by ADIs

Figure 16.7 **Concentration in lending products**

Share of major banks, annual average[a,b]



[a] Major banks are the CBA, Westpac, NAB and ANZ. [b] Small business loans are defined as loans of less than $2 million to business.

Source: RBA (sub. 29)

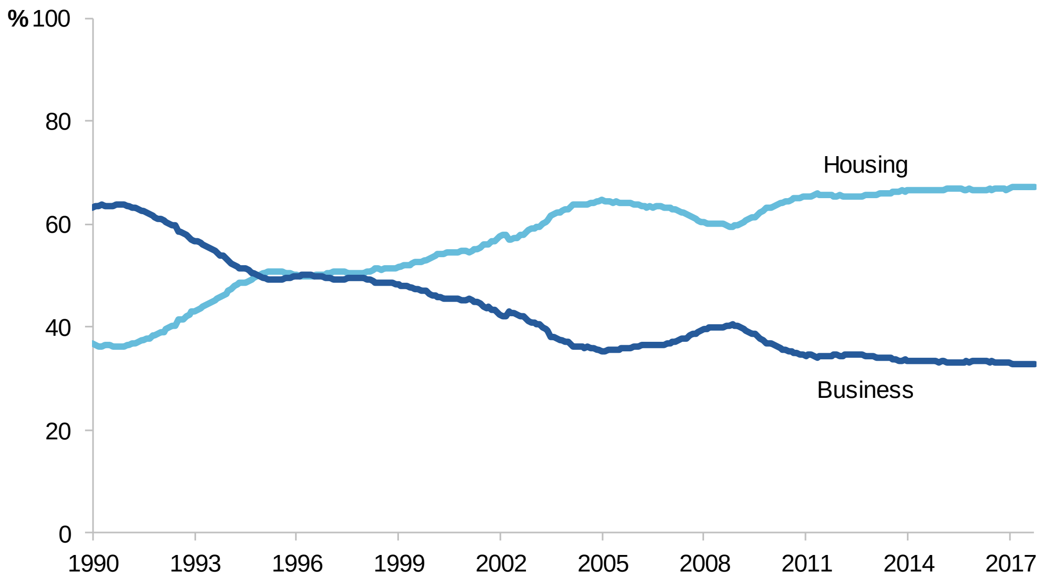
And SME lending is less profitable to ADIs than other lending

SME lending (debt finance provided through term loans, overdrafts, lines of credit and business credit cards) is not as profitable for ADIs compared to lending for residential property or personal lending. This has resulted in more capital being allocated to lending in those areas with higher returns.

For example, of the two major banks that provided data to this Inquiry, the average return of equity (ROE) over the past 5 years for residential mortgage lending was 7% higher than for SME lending for one bank and 4% higher for the other (ADI data).

Judo Capital (sub. 12) commented that, to maximise ROE, banks have shifted capital to residential mortgage lending to take advantage of the lower capital requirements (due to the lower risk rating) for this type of lending. This higher profitability may have been a contributing factor to the long-term decline in business lending relative to lending for residential property. In 1990, all business lending accounted for nearly two-thirds of total lending, but declined to a third by 2017. In contrast, lending for housing increased from 37% to 67% in the same period (figure 16.8).

Figure 16.8 **Business and housing lending, as a share of total lending**



Source: RBA (2017b)

This experience is not unique to Australia. The long term decline in business lending as a share of total lending is reflected in other OECD countries where the share of mortgage lending has been growing steadily since the end of World War II and by the mid-1990s had overtaken business lending. This is considered likely to be due to rising rates of home ownership since 1945 across the OECD in response to government interventions to boost private home ownership and the harmonisation of banking regulation through the Basel Accord from the late 1980s that allowed banks to hold lower amounts of capital against home lending enabling them to use this leverage to expand their mortgage business (Jorda, Moritz and Taylor 2016). From the Australian perspective, a further contributing factor was the financial deregulation of the 1980s and the end of quantitative restrictions on home lending.

This shift in lending focus to housing has seen most ADI groups have relatively less exposure to SMEs than to residential mortgages. The foreign banks operating in Australia are the exception to this, as the only group of ADIs that have relatively larger exposure to SMEs than to residential mortgages (figure 16.9) (although their share of total SME lending is small (figure 16.13). This is because the branches of foreign banks operating in Australia are unable to take retail deposits and have little involvement in retail mortgage lending. They are also less active in small business lending as they are unable to offer a broad banking relationship to many small businesses due to these restrictions on retail deposits — foreign bank branches are unable to accept deposits below $250 000 from non-incorporated businesses (chapter 4). These branches of foreign banks are also not subject to local capital requirements and operate under the capital requirements in their home country, including the risk weightings for SME lending. However, the foreign bank subsidiaries lending (based on their share of interest income from residential property lending and other term loans) more closely resembles the Australian ADIs (APRA 2018p). The market shares of foreign bank subsidiaries compared to foreign bank branches are discussed in chapter 4.

Figure 16.9 **Share of ADIs with exposure to SMEs and residential mortgages[a]**

[a] Foreign banks include both local subsidiary operations of foreign owned banks and local branches of foreign owned banks. Other ADIs includes credit unions, building societies and other classes of ADIs that do not fall into the other categories.

Source: APRA (sub. 22)

The shift of focus by the ADIs into lending for housing does not appear to be the result of increased competition from non-ADIs in business lending. Rather, it has been driven by the relatively higher returns available to ADIs from lending for residential property due to the lower capital holdings required and the general economic conditions that have subdued demand for business credit compared to the prolonged and strong demand for housing credit (RBA 2017x). The non-ADIs share of all lending (including SME lending) has declined since the GFC and remains a small component of all SME lending (RBA 2017p).

Lending for housing is relatively more profitable than SME lending for all ADIs. SME lending is more resource intensive than lending for housing — determining the risk attached to a SME loan is often not straight forward. Lending for housing to a large extent involves a formulaic approach based on the income and credit history of the borrower relative to the value of the property. In contrast, SME lending typically involves an examination of the financial records of the business, an understanding of the market in which the business operates and an assessment of the character, skills and business experience of the business owner/s and often requires the skills and expertise of experienced loans officers.

There is little doubt that ADIs active in the home mortgage market appear to find lending for residential property a highly preferred source of income. Default rates are exceptionally low and profit margins (net interest margins) typically higher. The commercial reality is that SME lending is a harder ask. The opportunity to improve the flow of credit to SMEs appears instead to be in better risk assessment — making a higher margin loan less risky than its cohort through better use of data — or more nuanced regulatory standards meaning less bank capital is needed to be retained against the loan, or both. The source of such changes lies with better data access for both banks and regulators.

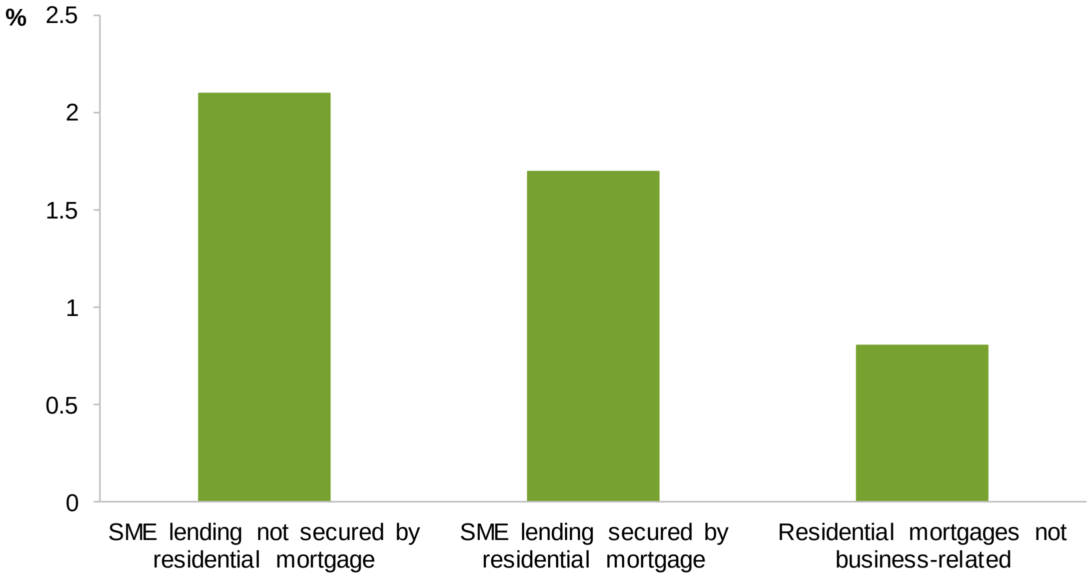
16.3 Can the provision of finance to SMEs be improved?

Does the house have to be on the line?

There are strong incentives for both lenders and SME borrowers to secure a business loan against a residential property. For the borrower, taking a mortgage out over their house provides access to lower interest rates; for very small and new businesses it is likely to be the most significant asset of the owner or owners. For lenders, a residence provides an easily liquidated asset in the event of default. Commercial property is not as easily liquidated as it is often tailored to the needs of the particular business and there is not the same market depth as there is for housing.

SME lending that is secured by residential property is considered by the regulator to be a lower risk than SME lending not secured by residential property — but not as low risk as residential mortgages. This is highlighted by the relative difference in default rates between these types of lending (figure 16.10).

Figure 16.10 **Average default rate by type of lending**[a]



[a] SME lending is based on APRA's SME retail lending asset class that includes loans to SMEs of up $1 million and used by those ADIs operating under the IRB approach to risk weights.

Source: APRA (2014b)

As the RBA has observed:

> … if small business borrowers are able to provide housing as collateral, it significantly reduces the cost and increases the availability of debt finance. (Kent 2017)

Given the importance of residential property as collateral in lending to SMEs and new businesses in particular, declining levels of home ownership in Australia are likely to impact on the availability and the cost of finance to those small business owners without residential property. This is particularly the case for younger business owners as the declining level of home ownership has been more significant in younger age groups. Overall home ownership rates declined from 73% to 67% between 1988-89 and 2013-14 while for those aged between 25 and 34, home ownership declined from 60% to just under 40% over the same period (AIHW 2017).

The application of risk weighting to SME loans by the regulator not only plays a role in encouraging both borrowers and lenders to use residential property as security, it also disadvantages particular banks (depending on how they are regulated in regard to applying risk weights) and impacts on the efficient flow of credit for SMEs.

The Commercial and Asset Finance Brokers Association of Australia noted the incentives that these risk weightings provided to lenders to use residential property as security:

> Due to the low-risk weightings on home loans and high-risk weighting on commercial loans, it is more economic for banks to focus on using the family home as security for finance in preference to SME loans or commercial equipment finance (sub. DR92, p. 4)

The risk weighting attached to SME lending

There have been concerns that the standardised risk weights applied under the Basel II arrangements to improve overall financial stability have imposed costs on SMEs by requiring banks to hold higher minimum levels of risk weighted capital that in turn could reduce their lending capacity (broader prudential regulations are discussed in chapter 6). Under agreed Basel II arrangements, standardised risk weightings where SME lending is below €1 million is covered as retail lending and a risk weighting of 75% applies. Lending to SMEs secured by residential property receives a lower risk weighting (table 16.1). In Australia, the risk weights applied to SME lending are in many cases higher than those applied in other countries, where the risk weights more closely reflect the Basel II standards (see below).

- *Europe*: Small businesses and individuals are ascribed the retail risk rating of 75% for lending not secured by residential property provided the bank's retail portfolio is diverse and no loan exceeds €1 million. SME loans that do not meet the conditions to be ascribed a retail risk rating are assigned a risk weight of 100%. In comparison, a large (AA or AAA rated) company is assigned a risk weight of 20%. This means for a €100 000 loan made to a large company, the bank would only be required to offset the loan with €1400 in capital. This compares with €5250 in capital for SMEs with a 75% risk weighting and €7000 in capital for SMEs with a 100% risk weighting (based on the bank holding 7% of the loan amount as capital, or a capital ratio of 7%) (Padgett 2013).
- *United Kingdom and Canada:* In Canada and the United Kingdom, SME lending not secured by residential property is assigned the retail risk weighting of 75% provided the lender's portfolio is diverse and no loan exceeds CAD $1.25 million or the equivalent of €1 million in the United Kingdom. SME loans not meeting these conditions are assigned a 100% risk weighting (FCA 2017c; OSFI 2017).
- *Australia:* The standardised risk weights used in Australia reflect APRA's implementation of Basel II, which differs from Basel II in some areas. Specifically, APRA's requirements provide for a single risk weighting of 100% for any SME lending that is not secured by a residential mortgage.[118]

Australia's risk weights are higher than required under Basel II

In contrast to Basel II arrangements, Australia has no delineation in standardised risk weights for SME lending by size of borrowing, by the form of borrowing (term loan, line of credit or overdraft) or by the risk profile of the SME borrowing the funds.

APRA's standardised approach does apply a lower risk weighting for SME loans secured by a residence, but potentially remains above the risk weights for residence-secured loans under Basel II and III — the Basel III arrangements for standardised risk weighting, although

118 The approach in Australia is to determine risk weights either through the standardised approach that reflects the general risks of different asset classes or through the Internal Risk Based (IRB) approach that enables accredited ADIs to establish their own weightings.

finalised, have not yet been fully implemented (table 16.1). For example, under APRA's current approach, a risk weighting of between 35% and up to 75% applies for standard loans secured by a residential mortgage (the exact risk weighting applied under the standardised approach depends on the loan to valuation ratio (LVR) and whether the loan is standard or non-standard and/or is covered by mortgage insurance). These are generally above both the Basel II and the Basel III standardised risk weights (table 16.1).

This means that currently, for a $100 000 loan made to a SME under the standardised approach, an ADI would be required to offset the loan, if unsecured, with $7000 in capital (given the 100% risk weighting and based on the bank holding 7% of the loan amount as capital)[119] compared to $2450 to $5250 in capital, if secured by a residence. In contrast, if the Basel II standard risk weights were applied to the same loan, the ADI would only have to offset the loan with $5250 in capital if unsecured (75% risk weighting) and $2450 if secured by a residential property (35% risk weighting) (table 16.1).

The use of a single flat risk weighting for all SME lending not secured by a residential mortgage provides simplicity for standardised banks, but at the expense of reduced SME lending. Specifically, a single flat weighting that is set at the 'upper end' of the Basel weightings, and does not differentiate between the different risk profiles of each SME borrower and the type of lending, will result in less efficient provision of lending to SMEs.

This provides Australia's larger banks with an advantage in SME lending

In contrast to the standardised approach, the IRB approach to regulatory capital holdings (used by only the very largest banks in Australia and discussed further in chapter 6) allows banks to take into account various indicators and a range of pledged security, including residential mortgages, in calculating the risk weights applying to SME lending. As a result, those ADIs using the IRB approach are able to apply risk weightings to more fully reflect the risk of the loan than under the standardised approach.

The average risk weighting used by ADIs under the IRB approach was around 48% for loans below $1 million (which can be considered as retail exposure) and 55% for loans of more than $1 million compared to 100% under the standardised approach for SME lending not secured by a residential mortgage (APRA, pers. comm., 13 October 2017).[120] As with residential mortgages, the difference between weightings used through the more refined IRB approach and the standardised approach for SME lending provide an advantage in funding costs to those banks using the IRB method rather than the standardised weightings. Of course, this advantage reflects the substantial investment the relevant banks have made in

---

119 A risk weight of 50% on a $100 000 loan equates to a risk adjusted exposure of $50 000, requiring a bank to allocate $3500 in capital to achieve a capital ratio of 7% of risk-weighted assets ($50 000 x 0.07 = $3500). (RBA 2015e, p. 52). Most ADIs under the standardised approach have capital ratios well in excess of the current minimum capital ratio (common equity tier 1) (APRA 2017v).

120 To be considered as retail exposure, strict criteria must be met; including, that total exposure to the counterparty is less than $1 million and that the exposure is originated and managed in a retail-like manner (APRA, pers. comm., 12 January 2018)

their internal risk management systems. In contrast, the banks using standardised weights have chosen not to make this investment.

Table 16.1 **Standardised credit risk weightings**

Type of lending	*Basel II Standard risk weightings*	*APRA Prudential standard 112*	*Basel III Standard risk weightings*	*APRA Discussion paper (in response to Basel III)*
	%	%	%	%
SME lending covered under retail lending	75[a]	100[b]	75[a]	85[c]
SME corporate lending (lending not covered under retail)	100	100	85[c]	85[c]
Lending for/secured by commercial real estate	100[d]	**	Between 80 and 130 (depending on LTV)[e]	
Lending for land acquisition, development and constructions			150	
Residential property	35	Between 35[f] and 75[g] (depending on LVR and mortgage insurance)	Between 25[h] and 55[i] (depending on LTV)	Between 30 and 85 (depending on LVR)[j]

** Under Prudential Standard 112 risk weights are derived from the counter-party and not the collateral, except for business loans secured by residential mortgages. The Bank for International Settlements uses the term loan to value (LTV) to express the loan to value ratio (LVR).

[a] To be covered under retail lending, the lending to the one party cannot exceed €1 million. [b] Applies to all SME lending that is not secured by a residential property. [c] The weighting applies on lending to SMEs defined as corporate exposures where the reported sales for consolidated group of which the firm is a part is less than €50 million(or $50 million as proposed by APRA). [d] Lending on office or multi-purpose/ multi-tenanted commercial premises can receive a risk rating of 50% where the value of the loan does not exceed 60% of the mortgage value of the property [e] The 80% risk weight applies for LTC <60%; a 100% risk weight applies for LTV from 60-80%; 130% risk weight applies for LTV > 80% and where repayment is materially dependent on the cash flows generated by the property. [f] Standard mortgage with LVR ≤ 60% and no mortgage insurance. [g] Standard mortgage with LVR between 90% and 100 % and no mortgage insurance. [h] LTV of 40% or less. [i] LTV between 90% and 100 %. [j] The 30% risk weight applies for LVRs ≤ 50% and the 85% risk weight for LVRs > 100%. These apply to interest only residential lending, loans for investment property and loans to SMEs secured by residential property.

Source: APRA Prudential Standard 112; Bank for International Settlements (2015); APRA (2018r)

APRA’s proposals to change the risk weights

Lower the single rate?

APRA, in its discussion paper in response to the Basel III framework, has proposed that SME lending under the standardised approach, when not secured by residential property, be subject to a risk weighting of 85% — this would apply to lending to SMEs with total annual sales equal to or less than $50 million. This reflects the Basel III risk weighting for SME corporate lending. APRA also proposed that SME lending secured by residential property would be subject to the same risk weighting as lending for residential property for investment purposes and interest only loans (APRA 2018r) (table 16.1).

In its proposal, APRA commented that reducing the 100% risk weighting applied under current prudential standards to 85% would provide recognition to different types of security offered by SMEs, other than residential property. It stated that it would not include the 75% risk weighting for retail SME lending arrangements as there was insufficient evidence in Australia that SME retail lending compared to SME corporate lending (as defined by Basel III) exhibited a lower rate of default or loss (APRA 2018r).

Greater granularity through a portfolio approach?

Since the release of its discussion paper, APRA, in its response to the Commission's Draft Report, has indicated that it is open to considering a more granular approach to risk weights for SME lending not secured by residential property. It suggested that the proposed 85% risk weight could represent the average risk weight across the SME lending portfolio of an ADI. This would allow for some of this lending to attract a higher risk weight and other lending a lower risk weight (taking into account different types of security other than residential property). It said:

> If a more granular approach was implemented, for example taking into account additional types of security, APRA would still seek to achieve broadly the same risk weight for the SME portfolio as a whole. This would mean that, while some exposures may benefit from lower risk weights, others (particularly unsecured exposures) would have higher risk weights. (sub. DR116, p. 21)

This proposal, while maintaining a single risk weighting for the overall SME portfolio, would provide a more nuanced approach to risk weighting and reduce the 'cross subsidy' within the portfolio resulting from lower risk SME loans being accorded the same risk weight as higher risk SME loans. ADIs would be able to hold less capital against lower risk SME loans making lending to these SMEs more affordable while higher risk SME loans would face the opposite effects. This in turn should increase overall lending to lower risk SMEs and improve the stability of ADI's SME lending portfolio.

However, the details as to how this proposal would work in practice are yet to be worked through, such as the criteria that APRA would apply to a loan to allow it to be risk weighted above or below the 85% and by what margin. Further development of this proposal should be accompanied by an analysis of its potential impacts on SME lending.

Other developments will give impetus to further refinement of risk weights

Further refinement to the risk weights used is becoming increasingly desirable as the rapid increase in the amount of data on business activities is accompanied by increasing visibility of business activity by lenders. Technology driven changes, such as cloud based accounting that can capture real time transactions, and increased data sharing under Open Banking and the Consumer Data Right are two such developments. The introduction of Comprehensive Credit Reporting will provide further information. In an era of all-encompassing data collection by the private sector, it would be a mistake to presume that APRA would necessarily remain uniquely placed to assess the risk of different activities.

Rather, consideration should be given to allowing lenders to use data from their own portfolio, such as the performance of different loans, to enable APRA to consider proposals to vary from the standard risk weighting for SME lending where such variations do not pose any material risk to financial stability.

Any measures that enable lenders (including non-ADI lenders) to better determine the risk associated with SME lending will place pressure for greater refinement of the risk weighting used for SME lending. Increased refinement of the risk weights attached to SME lending not secured by residential property will become more important to SMEs and those lending to SMEs as a result of the decline in rates of home ownership for those in younger and more entrepreneurial age groups (ages 25-34). In addition to declining rates of home ownership, is the increasing number of service based small businesses, with few 'hard assets'.

As a first step, APRA should remove the single risk weighting applied to SME lending not secured by residential property and set a broader schedule of risk weights to reflect the different types of lending to SMEs and the more diverse risk profiles of SMEs (such as the value of the loan made to an individual SME, alternative forms of security and the loan to valuation ratios of this security). This would improve the allocation of credit and be beneficial to both SMEs and those lending to SMEs.

A significant number of participants in the Inquiry supported introducing a broader range of risk weights for SME lending not secured by residential property to improve the flow of lending to SMEs (Ai Group, sub. DR127; Australian Small Business and Family Enterprise Ombudsman, sub. DR101; National Australia Bank, sub. DR94; Commercial & Asset Finance Brokers Association of Australia, sub. DR92; P&N Bank, sub. DR88; Reserve Bank of Australia sub. DR82; Commonwealth Bank of Australia sub. DR79; Customer Owned Banking Association, sub. DR72).

RECOMMENDATION 16.1 STANDARDISED RISK WEIGHTINGS FOR SMALL BUSINESS LENDING

Instead of applying a single risk weight to all small and medium business lending not secured by a residence, APRA should provide for a broader schedule of risk weights in its Australian Prudential Standard (APS 112).

It should take into account the different risk profile and the type of lending (such as the value of the loans made to an individual business and alternative forms of loan security including commercial property and differing loan to value ratios on this security) to better reflect the Basel Committee's standardised risk weightings.

In light of apparent major improvements in the collection and use of data (including via the New Payments Platform), APRA should also consider proposals by authorised deposit-taking institutions (ADIs) for variations from the standardised risk assessment for small and medium enterprise lending, based on the ADI improving its data and risk management systems. International best practice should be closely considered as APRA reviews proposals from ADIs.

Changes in the IRB approach to the risk weighting of SME lending

There have also been calls to change APS 113 (the prudential standard that deals with ADIs using the IRB approach to credit risk) to improve credit flows to SMEs (Commercial Asset Finance Brokers Association of Australia, sub. DR92). At present, SME exposures that are under $1 million may be classified as retail. This means that such lending is subject to a lower level of monitoring and capital requirements than non-retail lending.

The $1 million cap to be classified as retail lending was implemented by APRA to reflect the Basel II arrangements which sets out a €1 million cap. The Commercial Asset and Finance Brokers Association (sub. DR92) noted that the $1 million threshold is not indexed and has been in place since 2008.[121] Consequently, it would appear that the threshold to consider SME lending as retail lending has become more restrictive over time.

APRA has proposed that under the IRB approach to the risk weighting of SME lending, SME retail lending and SME corporate lending would be merged into a single asset class — making the monetary threshold for SME lending to be classified as a retail exposure redundant. APRA considered that having a single asset class for SME lending would provide the IRB lenders with more flexibility to tailor their approach in dealing with their SME customers and be consistent with the direction of the IRB banks modelling and validation methods that are moving to a customer level basis for SME exposures (APRA 2018r).

Shifting away from the use of a monetary threshold would remove a sharp dividing line applying to the risk weighting of SME lending and provide the flexibility for the IRB ADI lenders to take a more nuanced approach to aligning regulatory capital with the different risks associated with SME lending.

121 If the cap has been implemented at the then AUD equivalent in mid-2008, the threshold would have been around $1.65 million.

Can credit guarantee schemes help?

There have been suggestions that credit guarantee schemes similar to those used overseas, such as through the state owned British Business Bank, would increase competition in small business lending (ASBFEO, sub. DR101). These schemes are based on the government paying the lenders all or part of a defaulted loan and receiving part of the return on a performing loan.

The Commission looked at these schemes in some detail in a previous inquiry (PC 2015b). It found that such schemes were distortive and inefficient. They transferred risks from private parties to taxpayers and could dissuade lenders from undertaking sufficient monitoring and vetting when making loans, increasing adverse selection and moral hazard problems. While such a guarantee could reduce a lender's loss in the event of a default, it did not reduce the probability of default and could increase the risk of default if lenders were discouraged from undertaking the necessary due diligence by the existence of a taxpayer guarantee.

It found little conclusive evidence that such schemes materially increased the number of loans made to new and small businesses over what would have otherwise occurred. Moreover, the costs of establishing and operating such schemes were high and represented a significant contingent liability on the public budget that could become very large, very quickly if there was an upwards trend in loan defaults (as could be the case in a recession) (PC 2015a).

Improving the terms and conditions of loan contracts

The terms and conditions placed on loans to small business have been an ongoing concern and were examined by ASBFEO in 2016.

It highlighted the asymmetry of power in the relationships between lenders and small business borrowers that had manifested itself in one-sided contracts that provided the lenders with maximum power to make unilateral changes to the lending arrangements and time frames of loan contracts that left borrowers vulnerable. There was also a lack of transparency and potential conflict of interest for the lenders in dealing with third parties, such as valuers, involved in impaired loan processes (ASBFEO 2016).

To address these type of issues, the Murray Financial System Inquiry (FSI) (Murray et al. 2014a) recommended that the unfair contract provisions under the *Australian Securities and Investments Commission Act 2001* (Cth), which apply to consumers, be extended to small business loans. In late 2015, the unfair contract provisions were extended to cover small business loans of up to $1 million. Following further work and consultations by ASIC and the ASBFEO throughout 2017, the four major banks agreed to specific changes to eliminate unfair terms from their small business loan contracts for loans of up to $3 million. ASIC and ASBFEO will undertake further monitoring of the terms and conditions of the banks' loan contracts (ASIC 2017j). In addition to monitoring the lending contracts of the four major banks, ASIC announced in 2018 that it would also examine other lenders loan contracts to ensure they did not breach unfair contracts provisions (ASIC 2018g).

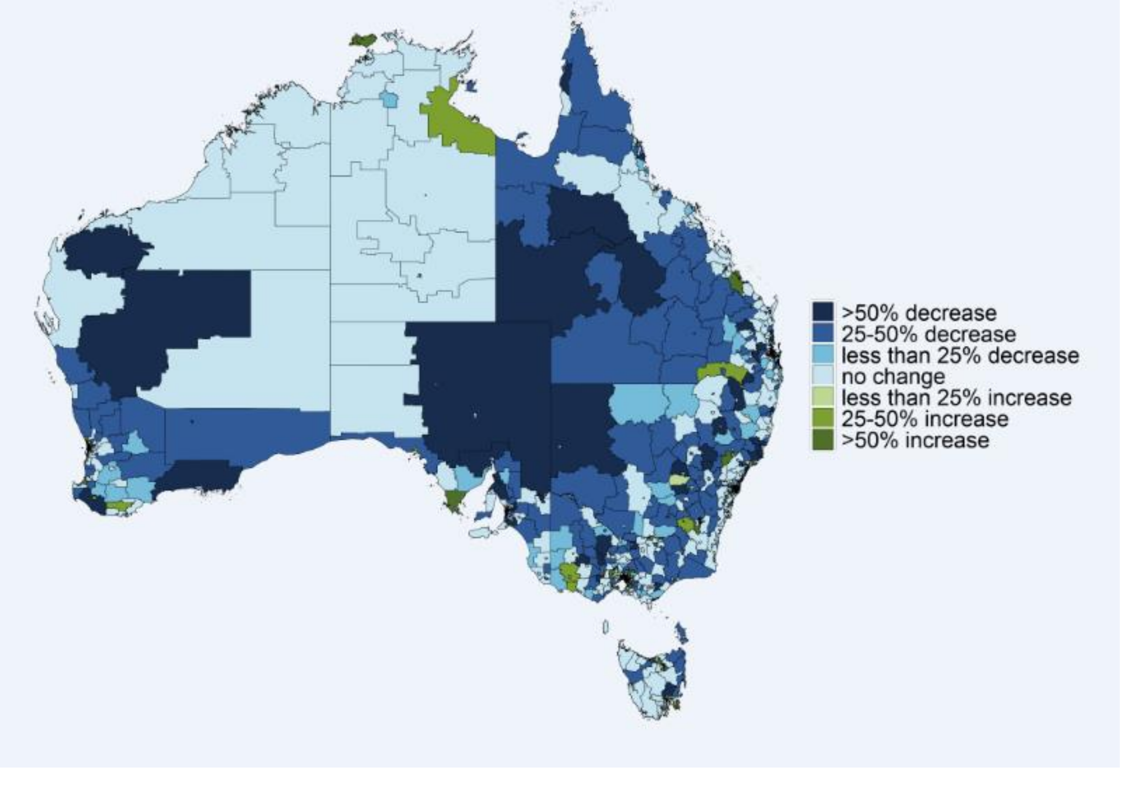
Will the large banks continue to dominate SME lending?

In Australia, the dominance of the large banks has resulted from their large branch network which has been used to maintain relationships with their customers, including SMEs, for a range of banking products and through their systems and expertise in assessing business risk.

As new entrants develop their systems and expertise to assess the risks involved in SME lending, the advantages of the large banks in some areas may be eroded. Other new entrants have taken a focus on a particular segment of business lending, such as Rabobank in agribusinesses. However, in other areas, particularly where the business requires the physical presence of the bank branch to deposit takings or where the SME uses the bank for other products such as a residential mortgage or payment terminals (the payment system and merchant fees are discussed in chapter 17), the large banks may retain their advantage.

Not all small businesses need ready access to a bank branch. As the number of bank branches declines (figure 16.11) due to lower demand for physical banking services, this advantage will be eroded.

Figure 16.11 **Changes in bank branches**
% change between 2008 and 2016



Source: Unpublished APRA points of presence data

The increasing use of online financial transactions (including banking, making payments and invoicing) by SMEs reflects the decline in the demand for physical banking services. In

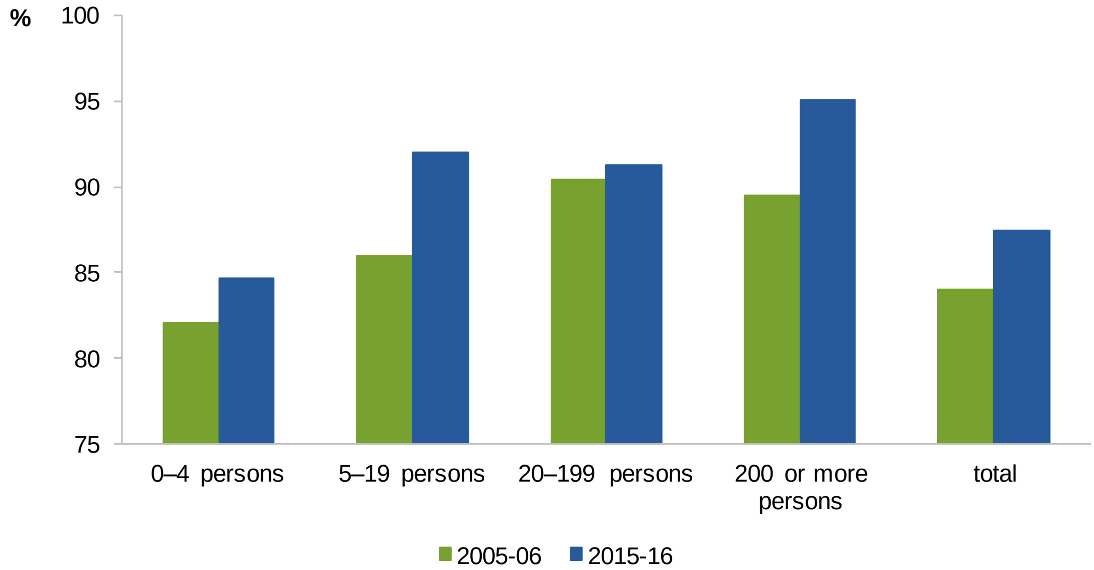
2015-16, between 85 and 95% of SMEs were using the internet to perform financial transactions (figure 16.12). This would suggest that SMEs are becoming less reliant on a physical banking presence, which may raise the scope for the entry of more online lenders and service providers.

The extent to which major bank lenders adapt to the declining levels of home ownership and the growth in small businesses that have more intangible assets (such as intellectual property) and few physical assets that can be used as collateral will increasingly influence their overall importance in SME lending.

One major bank stated that they are taking a larger focus on cash flow in credit assessment in recognition that in the future many smaller businesses will have fewer physical assets (Westpac, sub. 28). In efforts to embrace technology and innovation, the major banks have worked with innovative technology providers to adapt to the growing demand for digital services. For example, NAB has joined with Xero to enable NAB customers to use the software company's accounting platform to make payments and access credit (Eyers 2018b).

Figure 16.12 **Share of businesses undertaking online financial transactions[a]**

By employment size, 2005-06 and 2015-16



[a] Financial transactions include online banking, making payments and invoicing.

Source: ABS (*Business use of IT*, ABS, Cat. no. 8129.0, 2017)

The expansion in activity by foreign banks in Australia — being primarily focused on lending to large, highly rated Australian companies rather than for small business lending — has failed to diminish the dominance of the major Australian banks in SME lending (Connolly and Jackman 2017) (figure 16.13).

As to competition between the major banks, the distinction between the major banks in market share is more apparent in SME lending than it is in the home loan market. Australia's largest lender of small business loans (based on the share of business loans under $2 million in 2017) has a considerably larger market share than its nearest rivals (APRA 2017e). But as in the home loan market, there appears to be greater competition in product features — such as the ease of access and availability (in part driven by smaller innovative lenders operating off new online platforms) — than on the price of the loan, which remains strongly linked to the security offered against the loan.

Figure 16.13 **Share of business loans under $2 million provided by ADIs[a]**
September 2017

[a] Fixed and variable interest rates business loans provided by ADIs to business.

Source: APRA (2017e)

Where will competitive pressures on the major lenders come from?

Contestability in SME lending is increasing with the arrival of non-bank lenders (such as Judo Capital a 'challenger bank' with a focus on SME lending) and fintechs into this market in recent years and the expansion of specialised foreign banks such as Rabobank in services to medium (and large) agribusinesses. APRA has advised the Commission that under its new restricted banking licensing regime (that allows new entrants to commence operating before progressing to a full licence), several of the potential applicants have a strong SME focus (APRA, pers. comm., 12 December 2017).

The registered financial corporations — that are outside the prudential regulations applying to ADIs — also lend to SMEs. The size of the non-ADI lending sector is relatively small and has yet to fully recover to its pre GFC size, accounting for about 6% of financial system assets in 2016, compared to 10% in 2007 (RBA 2017p).

The use of new technology to increase competition

APRA (sub. 22) considered that the provision of finance to SMEs would benefit from an expansion in innovative financiers, including greater use of existing technology such as online platforms to connect with customers.

New lending models are emerging

The use of technology to establish new lending models for SMEs and the operation of fintechs is seen as adding to competitive pressures. Peer-to-peer (P2P) lending although relatively small at present, is considered likely to grow in the near future (PC 2015a). In 2015, P2P lending balances in Australia were estimated to be less than $25 million, but some predict that P2P lending will be worth $22 billion by 2020, reflecting the strong growth of P2P lending in the United States and the United Kingdom (Morgan Stanley 2015).

Other new lending platforms, such as online consumer sales platforms, have the potential to provide additional competitive pressures on traditional debt finance offered by banks. For example, PayPal provides loans to merchants — based on their cash flow and lending up to 30% of their PayPal sales. Between commencing in 2014 and 2016 PayPal Working capital provided $85 million in loans to 3000 small businesses in Australia (Bennet 2016). However, in aggregate this remains a very small component of the market, where over $86 billion of new loans under $2 million were provided in 2016 (RBA 2017i).

Invoice or debtor finance (a longstanding source of funding for SMEs) has also used online platforms to enable borrowers to locate lenders to provide funds against their outstanding invoices. Debtor financing provided to all businesses in Australia has grown by around 16% in nominal terms in the five years to 2017, with turnover that year of about $39 billion (Australian Finance Industry Association, pers. comm., 27 October 2017).

E-commerce companies are entering into SME lending

E-commerce companies have also entered into the small business lending market. Amazon lending commenced in 2011 and is operating in the United States, United Kingdom and Japan. It specialises in loans of between US$1000 and US$750 000 and has plans to expand to other countries where it operates market places (Arora 2017). Alipay Financial was established by the Chinese e-commerce platform Alibaba to offer loans to its existing small business customers and operates in China. The Japanese Rakuten Group established a loan facility for merchants operating on its platform in 2013 and offers lending for mainly business expansion and working capital for loans ranging between US$8000 to US$80 000 (WEF 2015).

Telcos have also entered this space. The Mexico based Telmex offers loans to its small business customers and has targeted small businesses that have been unable to access loans from traditional sources because of a lack of credit data and bases a significant part of its credit risk assessment on its customers' phone records (WEF 2015).

As in other jurisdictions, the expansion of e-commerce platforms in Australia will provide additional sources of SME financing.

Although the fintechs will have a major impact on how finance is provided to SMEs, they may not be able to establish themselves as dominant players in the provision of SME finance. The World Economic Forum (2017) commented that while fintechs have materially changed the basis of competition in financial services and how services are structured, provisioned and consumed, they have not yet materially changed the competitive landscape. It noted that although they play a critical role in defining the pace and direction of innovation across the sector, they have not yet been able to overcome the scale advantages of large financial institutions (although the large e-commerce firms may not face these difficulties).

Better information helps borrowers and lenders

Credit markets function most efficiently when lenders are able to access reliable information on borrowers. The more information that is available to the lender on the business seeking finance, the more accurately the lender is able to assess the risk and set the loan price and terms accordingly. Low risk borrowers would be offered lower interest rates and/or more finance, which stimulates the overall demand for loans by that group, and fewer high risk borrowers would be declined finance, as lenders possessing reliable information may be able to better set terms for the finance to accommodate the risk. It also assists lenders as additional information better enables them to identify high risk borrowers.

These information asymmetries were highlighted by the Murray FSI and were noted as the most significant structural factor contributing to the lower availability and higher cost of finance for SMEs. These asymmetries could also impede competition in SME lending as limited or little access to information for potential entrants to SME lending would increase the cost of establishing SME lending facilities (Murray et al. 2014a).

The RBA, in recognising the information problems facing SME lenders, noted that initiatives to improve information flows had the potential to increase competition in SME lending (sub. 29).

Improving access to information

Most OECD countries have some form of credit reporting system in place. However, Australia's credit reporting system has been limited to sharing negative events, such as defaults, rather than a broader range of credit data including positive events, such as loan repayment and other financial history. The more comprehensive a credit reporting system, the greater the public benefit (box 16.3).

Equifax reported that voluntary participation by credit providers in the comprehensive credit reporting (CCR — see box 16.3) regime has resulted in just under 30% of all customer records being loaded, not all of which have yet been made viewable for other institutions (sub. 38).

Box 16.3 **What is comprehensive credit reporting?**

Comprehensive Credit Reporting (CCR) enables credit reporting agencies to provide lenders with a more complete snapshot of a credit applicant's borrowing history. Previously, the *Privacy Act 1988* (Cth) stipulated that an individual's credit information file could only include records of:

- inquiries — credit providers seeking credit information in connection with an application for credit and the amount of credit sought
- current credit providers — a list of current creditors to the individual
- negative information — including information about certain loan defaults, dishonoured cheques, and court judgments or bankruptcy orders made against the individual.

In March 2014, amendments to the Privacy Act meant credit reports could now include 'positive' information about the individual. This includes information about:

- a two-year repayment history — including whether repayments were made in full or on time
- the consumer's history of credit liabilities — including the type of credit account, credit limits, information about the credit provider and the date accounts are opened and closed.

These changes will benefit people demonstrating 'good' credit behaviour, especially if they have limited credit histories and even if they have 'bad' credit behaviour on file.

Source: ALRC (2008), Canstar (2017b)

Consistent with the Productivity Commission's Inquiry *Data Availability and Use* (PC 2017c) — which recommended that the scheme be mandated if a minimum target of 40% of all active credit accounts was not reached voluntarily by June 2017 (as at November 2017 the figure was less than 1%) — legislation will come into effect by July 2018 to impose mandatory participation in comprehensive credit reporting (including the reporting of repayment history) by the four major banks (Morrison 2017d, 2018c).

As at May 2018, 65% of potential CCR data was with credit reporting agencies, either live or being tested prior to going live (Australia Retail Credit Association, pers. comm. 15 May 2018).

The new mandatory arrangements for CCR do not extend to SME credit accounts, only those of individuals. The view of the Murray FSI (Murray et al. 2014a) was that while the additional reporting would place costs on credit providers, the additional data was unlikely to improve information imbalances given the credit health of a business owner(s) as an individual remained the primary information source for credit decisions rather than information about the SME itself.

The Australian Finance Industry Association noted the importance of understanding the credit health of business owners in making lending decisions to SMEs. It also highlighted that CCR — by removing the impediments to accessing repayment history information — would generate direct benefits to SMEs both in terms of cost and access to finance (sub. DR110).

While the use of comprehensive credit reporting is likely to increase the overall level of lending and enable some SMEs to access finance who were previously unable to do so, it is not clear if it will have a significant impact on the market share of existing lenders, given the experience in other countries (box 16.4).

Box 16.4 What has been the impact on finance availability from the introduction of more comprehensive credit reporting in other countries?

Comprehensive credit reporting is associated with increase credit availability. Research across a range of countries as to the impact of introducing more comprehensive credit reporting indicates increased overall levels of lending following its introduction (Djankov, McLiesh and Shliefer 2007; Turner et al. 2014).

However, the introduction of a more comprehensive credit reporting regime overseas has not been associated with meaningful declines in bank concentration or market share. The regime would primarily be expected to improve market efficiency rather than alter market structures. It would be expected that following the introduction of improved credit reporting: lenders would adapt to the new environment and maintain their customer base — improved credit reporting does not enable lenders to screen competitor’s databases to poach customers. As efficiencies in lending expand, lenders will focus on the unmet credit demand instead of reallocating the existing customer base. It has been suggested that these markets may be more profitable than securing another lender’s existing clients (Turner et al. 2014).

In New Zealand, the introduction of comprehensive credit reporting identified a significant number of individuals as a high-credit risk that were previously invisible to lenders under the negative reporting credit environment. Reducing exposure to these customers was estimated to save New Zealand lenders around NZ $100 million annually. The same analysis estimated that lending to eligible consumers could increase by NZ $1 billion annually (Dun and Bradstreet 2016).

However, some consumer groups have concerns that the additional data may exclude vulnerable people from accessing credit from the banks and force them into using higher priced short-term credit products (CALC 2017).

Technology driven improvements in information sharing

There is scope to improve information flows through the use of technology. For example, cloud based accountancy service providers, such as Xero, provide SMEs with access to lenders on the platform and SMEs seeking finance can provide lenders with access to their business data and real-time transaction data.

Having access to wide ranging historical and real-time transaction data provides improved information for lenders to better determine a borrower's level of risk. The Commission was told that invoice lending and lending against cash flow can be provided to borrowers at lower rates where lenders have access to such information. For the SME, access to real-time transaction data will also assist them in managing their business.

Similarly, open banking systems, where properly designed, can improve information flows. The report of an independent review to establish an open banking regime recommended that banking customers, including SMEs, be allowed to direct that they, or third parties chosen by them, be provided with pre-determined parts of their banking data in a secure environment and in a prescribed way, so that it can be used to increase competition and offer them new or better services (Farrell 2017).

For a SME, this will enable them to provide financial data to lenders (who then have access to more detailed information) when seeking finance. This reflects the Commission's Inquiry *Data Availability and Use* (PC 2017c) that recommended consumers (individuals and SMEs) be given the right to direct data holders (such as financial institutions) to transfer their data in a machine-readable form to the consumer or their nominated third party. The Government, in responding to the review into open banking, announced that Open Banking would be implemented as part of the Consumer Data Right as recommended by the Commission's 2017 Inquiry, *Data Availability and Use* (Morrison 2018d; PC 2017c). The open banking regime is to be phased in from July 2019 commencing with the major banks then followed by all other banks (The Treasury 2018a).

To provide for improved data access, the proposed open banking system should be implemented to ensure that small business have the full suite of rights, as consumers, to access and use digital data as set out in the Commission's Inquiry report, *Data Availability and Use* (see recommendation 5.1).

17 The payments system

Key points

- Card payments and bank transfers have grown in Australia and are dominated by the major banks, Visa and MasterCard. The use of cash and cheques is in decline and while eftpos is often the most price-competitive debit card scheme, it is rapidly losing market share. Innovations, such as digital wallets, are changing the way people access their money and may shape future trends.
- Consumers do not usually face the direct cost of card payments. Thus, instead of competing on lower costs to consumers, most financial institutions focus on attracting customer loyalty through rewards, often on credit cards, which tend to be a relatively high-cost payment method.
- Merchants bear the bulk of the costs associated with card payments. But most merchants do not surcharge customers for fear of losing business to competitors. This creates significant scope for price exploitation by card issuers (often banks) and schemes with market power.
- The Payments System Board (PSB) regulates the price of interchange fees paid on card transactions by a merchant's financial institution to the customer's institution. The PSB should ban all interchange fees to increase transparency and lower overall costs. If institutions decide to recoup these costs directly from cardholders, this would mean an average increase of less than $8 per card per year. In addition, the ACCC should evaluate whether interchange fee regulation significantly favours unregulated card schemes, and if so, investigate further intervention to prevent this (such as regulating merchant service fees).
- Contactless transactions using dual-network cards are mainly processed through the Visa or MasterCard networks by default, rather than through eftpos. The PSB should give merchants the ability to choose the default network so they can choose the lower-cost option.
- Consumers can find it difficult to understand and compare costs associated with making overseas payments — foreign transaction fees and exchange rate markups. The ACCC should review these arrangements and propose ways to make them more transparent.
- Stored value payment methods have the potential to be a significant source of competition to traditional methods, but face a complex set of regulations that may limit their incentive to grow. The Council of Financial Regulators should review the competition implications of these regulations.
- The ePayments Code is a voluntary set of basic rules for electronic payment providers. ASIC should mandate the code for all organisations that send or receive electronic payments and amend it to clearly allocate liability for unauthorised transactions involving third-party providers.
- The New Payments Platform (NPP) offers near instant payments, 24/7. The NPP is a significant piece of national infrastructure and should be subject to an access regime imposed by the PSB.
  - Specialist payment providers that are not authorised deposit-taking institutions but hold an Exchange Settlement Account with the RBA should be able to apply to access the NPP.
  - The NPP's transaction fees should be reviewed by the PSB to make sure they are competitive.
  - Shareholding participants that use an overlay service should be required to share de-identified transaction-level data with the overlay service provider.
- The NPP offers customers simple banking aliases. But these have limited functionality. The ACCC should investigate ways to improve this (and other) functionality of the NPP to foster competition.

Australians make millions of payments collectively worth billions of dollars every day. The payments system is essential to the financial system and economy more broadly. It gives people, businesses and governments a means of efficiently exchanging value. Poorly structured incentives and hidden costs on transactions can skew consumer behaviour and lower efficiency across the economy.

The payments system comprises wholesale and retail components. The wholesale component involves high-value payments typically made between financial institutions, such as interbank settlements or foreign currency exchange. In contrast, the retail component directly touches the lives of all Australians. It includes payments between people, businesses and governments to make purchases or transfer funds.

We have focused our assessment of competition on the retail payments system for two key reasons. First, the retail payments system accounts for the overwhelming majority of payments — about 99% of the number of payments (APCA 2015b). This means that even small improvements to competition can lead to significant benefits for consumers. Second, the system involves many complex relationships between parties in the supply chain and prices that are not always transparent. Addressing these distortions can improve outcomes for consumers.

17.1 Competition in the retail payments system

There are many ways that people and businesses can pay each other (figure 17.1). These payment methods include cash, cheque, card, direct entry (bank transfers) and purchased payment facilities (such as PayPal).[122]

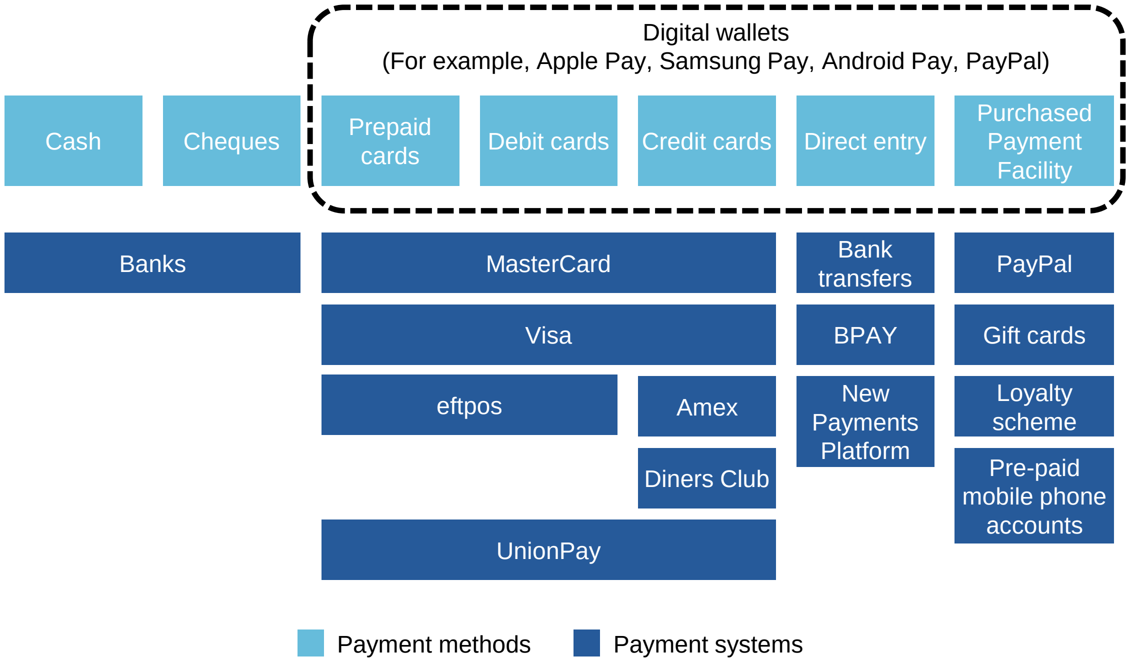
There is scope for providers to compete *within* and *between* these payment methods. For example, card schemes compete with each other for a customer's card transactions. But they also compete to move a customer's non-card payments to their network instead, such as using card instead of cash at the supermarket.

Banks and other authorised deposit-taking institutions (ADIs) are the main institutions involved in the systems underlying each payment method. They disburse cash through the country's ATMs, provide cheque facilities, operate bank transfers between each other and are major participants in the card market. Other financial and non-financial institutions, such as card schemes and platform providers, also have important roles in payment systems.

For people and businesses to make and accept payments at least cost and with greatest efficiency, they must be able to recognise when a cost is being imposed and have both a choice of alternative payment instruments and the incentive to use them.

122 Purchased payment facilities provide a store of value for deposits, such as gift cards.

Figure 17.1 **Overview of payment methods and systems in Australia**

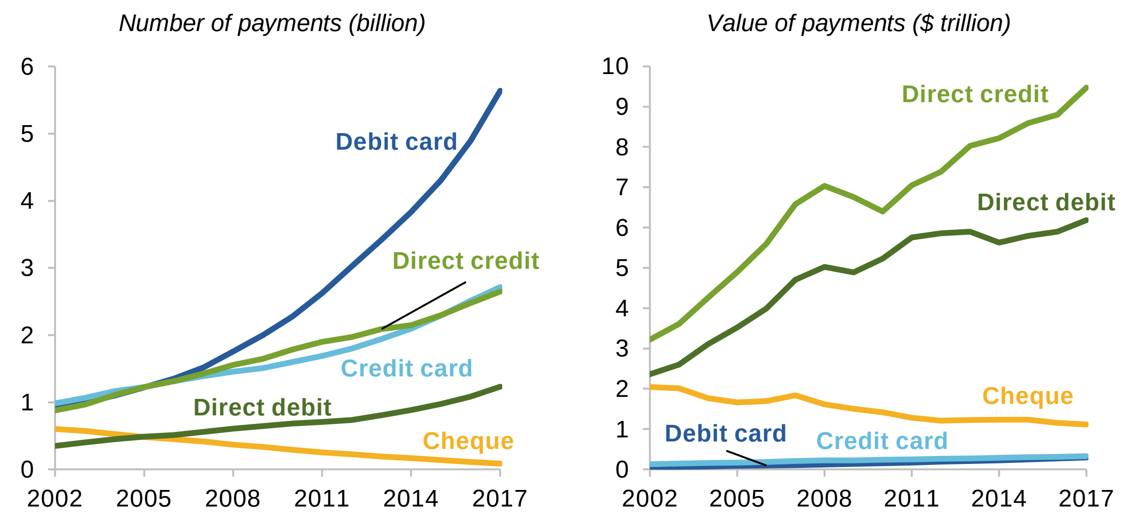


Australians are strongly embracing electronic payments, with the majority of retail payments now made through non-cash methods (Doyle et al. 2017). Australia has the fourth highest number of non-cash payments per person and the highest level of contactless card use in the world (ASIC 2016e). Most of the growth in the *number* of non-cash payments came from cards and growth in the *value* came from bank transfers (figure 17.2). This suggests that people use cards to make many low-value transactions and bank transfers to make relatively fewer high-value transactions. In contrast, the number and value of ATM cash withdrawals has declined from its peak in 2009 (RBA 2017g), and the use of cheques has declined.

As consumer preferences change, providers of payment systems are also adapting. Payment systems are undergoing a wave of innovation driven by technology and the growing use of data. Incumbents are investing in innovation and there are growing opportunities for fintechs to provide complementary services to existing payment systems or compete against incumbents in their own right (chapter 4). New ways of authorising payments, such as blockchain, may reduce costs and improve efficiency of payment systems (Hanson, Reeson and Staples 2017). And new platforms, such as digital wallets, are changing the way people pay and the market dynamics of the retail payments system.

The Payments System Board (PSB) within the Reserve Bank of Australia (RBA) is the main regulator of the payments system in Australia (appendix B). The PSB is responsible for controlling risk in the financial system as well as promoting competition and efficiency in the payments system. The PSB distinguishes between systems where stability is very important (high-value payments) and those where competition and efficiency are important due to the large number of transactions (retail payments). Accordingly, the PSB operates Australia's only high-value settlement system, but takes a relatively hands-off approach in the retail payments system.

Figure 17.2 **Number and value of non-cash transactions[a]**



[a] Direct credit and direct debit are both types of bank transfers. Direct credit is a 'push' payment where a payer initiates a bank transfer. Direct debit is a 'pull' payment where a recipient initiates a bank transfer.

Source: RBA (2017k, 2017m, 2017n)

Debit and credit card providers have substantial market power

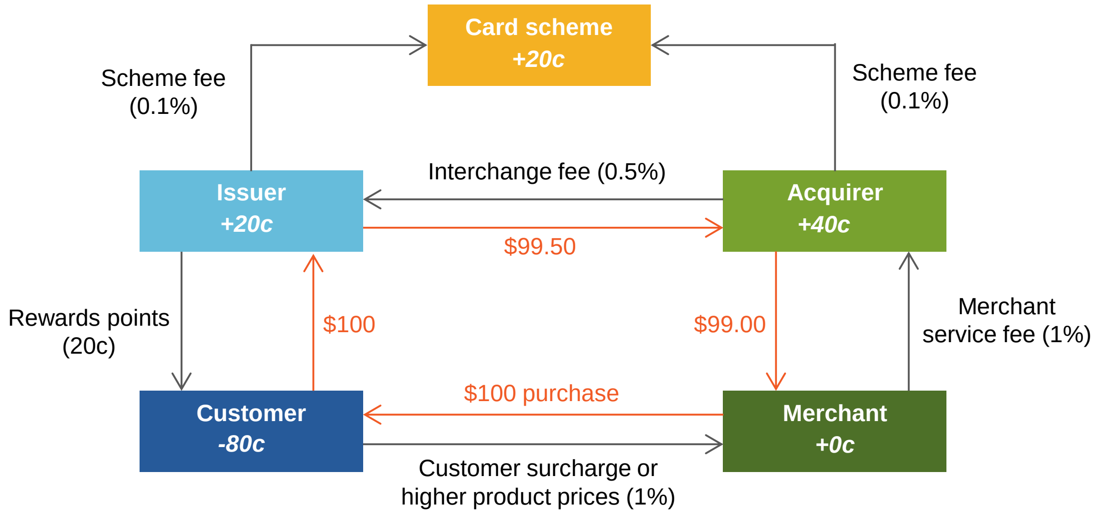
Apart from the cardholder and merchant, there are generally three different entities involved in processing a card payment (figure 17.3):

- issuer — the customer's financial institution that issues the card
- acquirer — the merchant's financial institution that accepts the payment
- card scheme — the network that routes payment messages between issuer and acquirer.

Each card transaction triggers a flow of payment and fees between these entities (figure 17.3). When a customer makes a purchase, their card issuer (often a bank) pays the acquirer (again, often the merchant's bank) who then pays the merchant. The card scheme (such as MasterCard or Visa) operates the link between the issuer and acquirer.

For each transaction, the issuer charges an interchange fee to the acquirer. Interchange fees are generally charged as a percentage of the transaction value (for credit cards) or a flat rate (for debit cards) per transaction and are set by the card scheme. The acquirer recoups the cost of interchange fees, as well as other (fixed) costs such as payment terminals, by charging a merchant service fee to the merchant. The merchant can choose to recoup this cost by imposing a direct surcharge on the cardholder or charging higher prices for its products or services.

Figure 17.3 **An illustrative example of payment flows for a card transaction**[a]



[a] All numbers are for illustrative purposes only. The numbers in boxes are the net result of transaction fees.

There are three distinct arrangements for card-based payments.

- Four-party system: the merchant, cardholder, issuer and acquirer. This arrangement applies for eftpos, MasterCard and Visa. The four-party system is open for other institutions (such as banks) to enter and compete by issuing their own cards or providing services to merchants.
- Companion card system: the merchant, cardholder, issuer and acquirer/card scheme. This arrangement provides two different credit cards on the one account, such as an American Express card issued with a Visa or MasterCard.
- Three-party system: the merchant, cardholder, and the issuer/acquirer (in this case, not a bank). In Australia, this applies primarily for cards issued by American Express and Diners Club. These schemes have no competition within the brand, only competition with other brands. In the figure above, the issuer, acquirer and card scheme are one and the same in a three-party system (RBA 2015h).

Debit and credit cards are bank-dominated and heavily concentrated

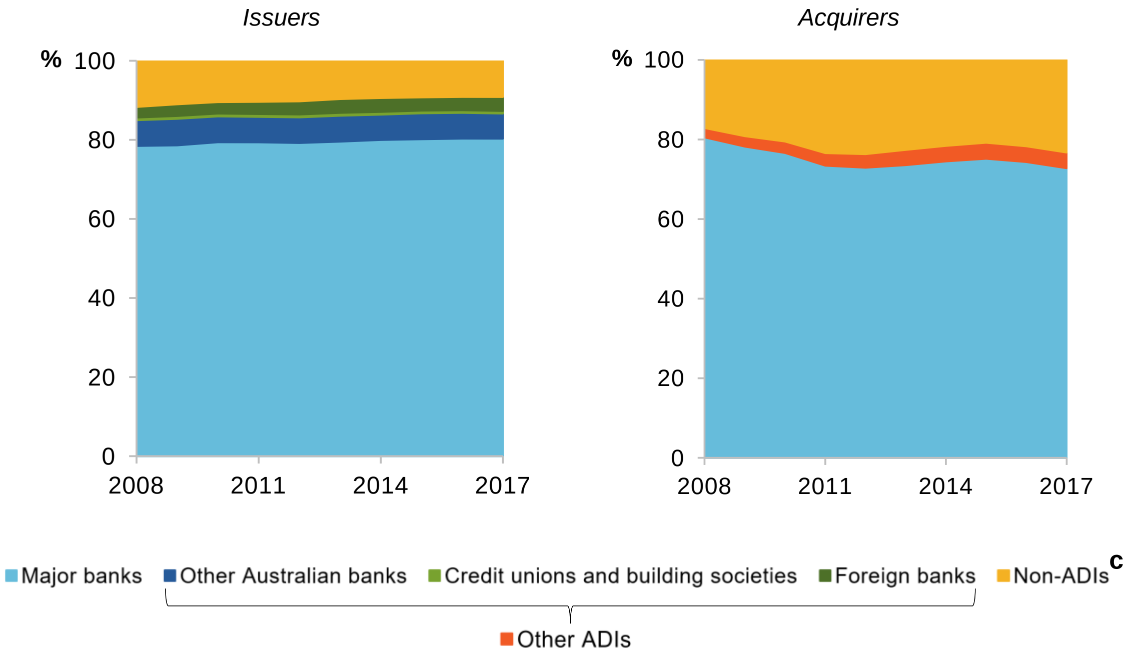
In Australia, the major banks (CBA, Westpac, NAB and ANZ) are the main card issuers. In 2017, they provided over 70% of all debit and credit cards on issue in Australia and made up about 80% of the value of payments (RBA, pers. comm., 3 October 2017; figure 17.4).

Many of the larger banks offer acquiring services to merchants, usually bundled with card acceptance facilities. The acquiring market is slightly less concentrated than the market for issuers and concentration has declined over the past decade (figure 17.4). There has been growth in acquiring services by specialist payments providers and banks, such as Cuscal, Tyro and Indue, as well as new acquirers to the Australian market, such as Square, Adyen, First Data and

Pin Payments. Some of the decline in concentration is also attributed to growth in the market share of American Express (Amex) cards which are directly acquired by Amex (RBA, sub. 29).

Figure 17.4 **Market shares of issuers and acquirers**

By value of payments[a,b]



[a] Includes all debit and credit card transactions, ATM withdrawals, cash-out purchases, prepaid debit cards and cash advances. [b] Year end June. [c] Includes some ADIs whose main business is payments.

Source: RBA (pers. comm., 3 October 2017)

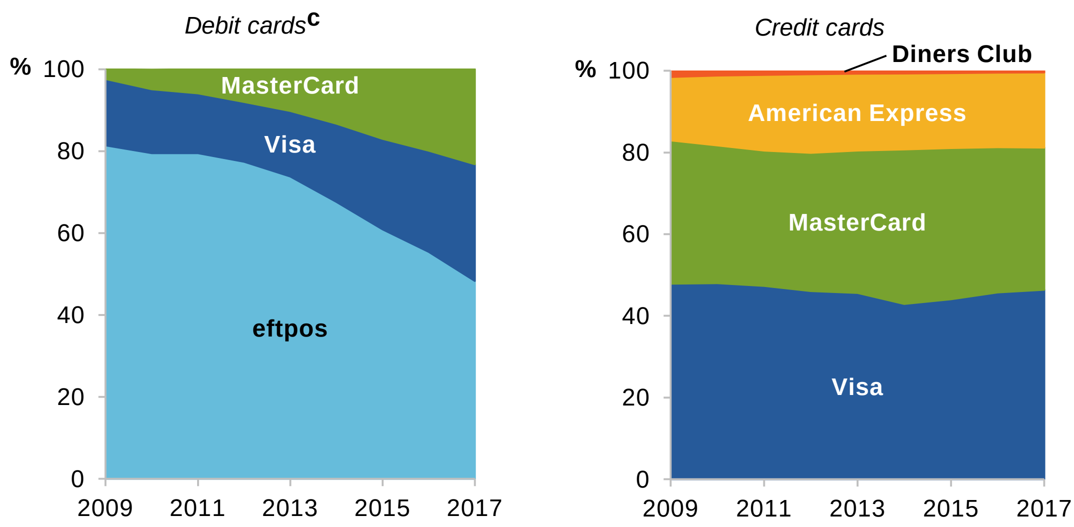
Australia's debit card schemes are also heavily concentrated: MasterCard, Visa and eftpos are the only debit card schemes. The use of MasterCard and Visa debit cards has grown at a much faster rate than eftpos over the last decade — their combined market share now makes up over half of the debit card market (figure 17.5). This is partly a result of strong uptake in contactless and online payments offered by MasterCard and Visa (RBA, sub. 29).

The decline in market share of eftpos is concerning because eftpos is considered highly price-competitive (Stewart et al. 2014). This suggests that competition is stymied by other forces, such as distortions in who pays the costs of card payments (section 17.2).

The market for credit card schemes is also dominated by MasterCard and Visa, which make up over 80% of credit card payments (figure 17.5). Concentration in a few card schemes is characteristic of many card markets because they have strong network effects, giving established schemes substantial market power.

Figure 17.5 **Market shares of card schemes**

By value of payments[a,b]



[a] Year end June. [b] Does not include UnionPay. [c] Includes prepaid debit cards and excludes ATM withdrawals.

Source: RBA (pers. comm., 1 February 2018 and 13 March 2018)

Many barriers to entry are inherent, but some are regulatory

There are structural barriers for new card schemes. It can take considerable time and resources to grow a card network, making it difficult for a new card scheme to achieve the critical mass necessary for merchants and cardholders to adopt their systems. Merchants have little incentive to switch to, or adopt additional, card schemes with relatively less customer reach.

> Cardholders value credit or debit cards only to the extent that these are accepted by the merchants they patronize; affiliated merchants benefit from a widespread diffusion of cards among consumers. (Rochet and Tirole 2003, p. 1)

New card schemes also face strategic barriers to entry. Financial institutions often bundle cards with other products, such as debit cards bundled with transaction accounts or credit cards bundled with home loans (chapter 9). Many of these institutions have exclusivity arrangements with either Visa or MasterCard, making it difficult for new card schemes to grow their network. That said, entry is possible. Chinese card scheme, UnionPay, is one of the largest worldwide and is gradually building merchant acceptance in Australia (RBA, sub. 29).

Financial institutions face regulatory barriers to entry. Debit card issuers face the strictest barriers because they are linked to a customer's transaction account and must therefore be an ADI. Credit card issuers are not required to be ADIs, but are subject to responsible lending obligations under the *National Consumer Credit Protection Act 2009* (Cth). If a new card scheme grows large enough, it can expect to be regulated by the PSB, but there is no trigger for regulation.

All new issuers and acquirers must also comply with each card scheme's rules and standards for operating and participation (APCA 2015a). Visa, MasterCard, Amex and Diners Club administer their own rules for participation. The PSB (2017w) imposed an access regime on Visa and MasterCard to prevent these schemes from unduly restricting participation. eftpos is responsible for all decisions in relation to its membership, participation, compliance, processing and fees. It has chosen to use the Australian Payments Network's (AusPayNet) rules and standards (such as the security of PIN handling) to determine which terminals and devices are approved to use eftpos. AusPayNet develops industry policies and rules for regulation of various payment systems, including cheques, cash, bank transfers and cards (appendix B).

In some cases, rules differ between the schemes. For example, merchant acquirer Square relies on 'PIN on glass' technology to accept customer transactions through smartphones rather than a physical keypad. This method of capturing PINs has not been approved under any security standard in the world (AusPayNet, sub. DR75). Nonetheless, since its global release in 2014, Square (2015) has been operating in Australia and is capable of accepting cards from Visa, MasterCard and Amex by relying on waivers of their current rules while new international standards are being developed. Square (2018) remains unable to accept eftpos transactions.

This suggests that Square may be slow to adapt its approach to satisfy security requirements. Or that AusPayNet and/or eftpos have not adapted their policies to developments in technology and new business models (compared to the international card schemes), or otherwise have an incentive to deter entry in the name of security. More generally, incumbents including the major banks, Visa and MasterCard can act as gatekeepers for cards-based innovations.

The major banks dominate bank transfers

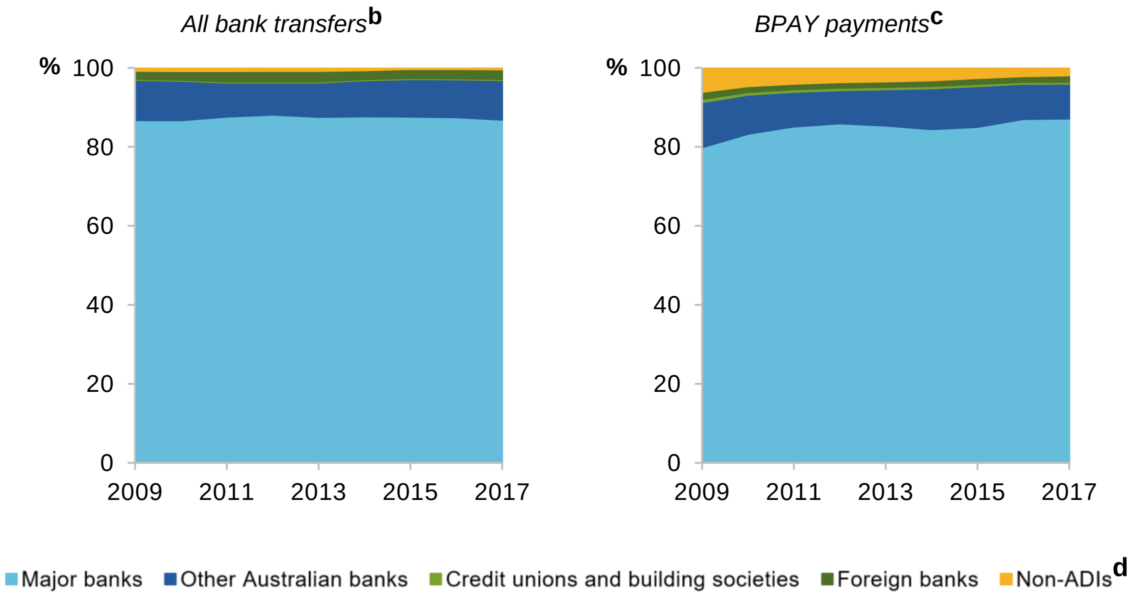
The market for bank transfers is heavily concentrated. This reflects the market shares of personal deposits given bank transfers are made between deposit accounts (chapter 3). Over the past decade, the major banks accounted for almost 90% of the value of bank transfers (figure 17.6). Competition in bank transfers might be expected to come from other smaller Australian banks and foreign bank subsidiaries, but market shares have remained static. Further, the total market share of specialist payments entities has not increased.

There are regulatory barriers to entry in bank transfers. A provider generally must be an ADI and settle payments using an Exchange Settlement Account (ESA) held with the RBA, or through an agent, such as Cuscal (Fraser and Gatty 2014; RBA 2012a).

Over the past decade, about 10% of the number and about 3% of the value of bank transfers were made through BPAY (RBA pers. comm., 3 October 2017). Over 150 financial institutions are members of BPAY, covering 95% of the consumer banking market (BPAY 2017a). However, the major banks — who jointly own BPAY's operator (BPAY Pty Ltd) — facilitated the vast majority of BPAY payments (figure 17.6). For new members to join BPAY, they must comply with its rules and operating procedures (2017b). There is no access regime that prevents BPAY from unduly restricting new members, but we are not aware of anyone that has been refused membership.

Figure 17.6 **Market shares of bank transfers and BPAY payments**

By value of payments[a]



[a] Year end June. [b] Made up of direct debit and direct credit transfers, including BPAY transactions. [c] Includes internet and telephone initiated BPAY payments. [d] Includes some ADIs whose main business is payments.

Source: RBA (pers. comm., 3 October 2017)

Innovations are changing the way people access their money

Consumers are embracing payments innovation around the world (box 17.1). Innovation is a major driver of the migration towards electronic payments (WEF 2017a). Many innovations have focused on integrating payments into products or services.

- Some e-commerce platforms partner with payment providers to integrate payments. For example, in 2017, Gumtree partnered with Assembly Payments, which holds payments and releases them once the service is satisfactorily completed (Smith 2017).
- Services such as Uber provide a seamless payment experience for customers. Customers link an existing payment method (such as credit card) to the service, and once completed, payment is automatically processed.
- Wearable accessories, such as smart watches are incorporating payments into their capabilities. For example, in 2017, Fitbit and Apple introduced new smart watches that are able to make contactless payments. Other accessories, such as rings, can also be used to make payments. In 2016, Optus (2016) introduced a coffee cup (SmartCup) which can be used to make payments anywhere that accepts contactless Visa card transactions.
- Other fintechs, such as Afterpay and zipMoney, offer customers access to credit upon payment at the checkout, giving customers the ability to buy now and pay later.

- Social media platforms, such as Facebook, are integrating payments into their services.
- Innovations are also improving the business experience with payments. For example, while Tyro (2017a) is itself a bank, it offers the ability for a business to use Tyro's payment acceptance facilities while banking with a separate financial institution.

In recent years, digital wallets have burst onto the payments landscape. These digital platforms (such as apps on a mobile phone) can provide some of the same functions as a physical wallet. This includes storing details of people's various payment methods so they can readily access them — typically credit, debit and prepaid cards. Digital wallets complement payment methods, such as card payments, by providing another way to access them, and have been a major driver of online and mobile payments globally (box 17.1). Australians are rapidly adopting online and mobile payments. The value of online payments rose from 13% of all retail payments in 2007 to 39% in 2016. And in 2016, about 20% of online payments were made using a mobile phone, up from 6% in 2013 (Doyle et al. 2017).

Many digital wallets have been created by technology companies (rather than traditional financial institutions), such as Apple Pay, Samsung Pay, Android Pay, Google Wallet and Amazon Pay. These are not all available in Australia. These companies use their established user base to compete in the payments system. For example, Facebook introduced the ability for its users in the United States, Britain and France to make free payments between each other, using a linked Visa or MasterCard debit card (Mason 2017). And in 2017, Apple gave its users in the United States the ability to make payments using value stored as Apple Pay Cash (Cipriani 2017).

Incumbent financial institutions are also innovating. For example, incumbents can use the New Payments Platform to offer customers instant bank transfers (section 17.4). And in June 2018 CBA, NAB and Westpac launched a new app, 'beem it', that lets users pay each other using the card networks. Users register with a MasterCard or Visa debit card which is used to send payments, and the eftpos system is used to put funds into recipients' accounts (Eyers 2018a).

Innovation can also improve the customer experience with existing payment methods. Australia has experienced a rapid rise in the use of contactless payments for in-person transactions. About 66% of in-person card payments were contactless in 2016, up from about 23% in 2013 (RBA 2013d, 2016e). However, the vast majority of contactless payments were made using a physical debit or credit card at the point of sale.

In contrast, very few people use mobile phones to make contactless payments. This is despite over 80% of Australians owning a smartphone (Deloitte 2016b). Many people prefer not to use their mobile phone to make contactless payments because of security concerns or they are satisfied with their current method of payment. The number of mobile phone payments is expected to rise in the coming years as people grow more comfortable with the technology.

Many people do not yet have the necessary devices, apps or internet connectivity to make contactless mobile phone payments. For example, Apple Pay is a mobile digital wallet that uses Near-Field Communication (NFC) hardware on Apple devices to make mobile payments. However, not all Apple users can take advantage of Apple Pay to make payments.

Box 17.1 Innovation in select payment systems overseas

China

In China, estimates suggest digital payments have grown from about 4% of retail transactions in 2010, to about 17% in 2015, largely led by Alipay and WeChat (BTCA 2017).

Alipay launched in 2004 as a payment system for the Chinese e-commerce platform, Alibaba. Its primary product, Alipay Wallet, is a digital wallet that can make payments using credit cards, bank accounts or stored value. In 2009, Alipay developed a mobile app and now people can make payments online, or in person using a QR code which allows merchants to accept payment without investing in payment terminals (ACCC sub. 17). In 2014, Alipay rebranded as Ant Financial (2017) and began offering other financial products, such as consumer credit.

One of China's major social media apps, Weixin (WeChat), also developed a digital wallet, WeChat Wallet. The growth in WeChat as a social network has led to growth in payments made through WeChat Wallet. WeChat has grown from about 200 million users in 2012 to over 800 million in 2016 (BTCA 2017). Over the same period, the value of WeChat payments increased from US$12 billion to US$1.2 trillion. However, users must have a Chinese bank account to use either WeChat Wallet or Alipay Wallet (Wang, Mullin and Penafuerte 2017).

Sweden

Launched in 2012 as a collaboration between six of Sweden's largest banks, Swish is a mobile payment service that lets people pay each other and businesses from their bank account (Swish 2017). Transfers are instant, free of charge and only require the recipient's phone number to transfer money to them. Swish is used by more than half of the Swedish population and is likely to be contributing to the reduction in cash circulating in Sweden (Ahlfort 2015; Brunet 2017).

Kenya

In 2007, Kenya's largest telco operator, Safaricom, launched the mobile payment service, M-PESA (The Economist 2015). M-PESA lets people make payments using stored value from their mobile phone account. People can transfer money to other M-PESA users or anyone else with a phone number (Safaricom 2017). People can deposit or withdraw cash at one of Safaricom's 40 000 agents throughout Kenya. M-PESA has also begun to offer loans and savings products, and moved into other countries including Tanzania, Afghanistan and India (ACCC, sub. 17)

India

In 2015, the Reserve Bank of India gave in-principle approval for 11 entities to create payments banks (RBI 2015). Payments banks are a stripped-down type of bank which are subject to a differentiated banking licence. These banks aim to encourage India's low-income households and small businesses to move away from cash-based transactions to formal banking (The Hindu 2015). They are expected to reach customers mainly through their mobile phones, rather than traditional branches. Payments banks can process mobile payments and issue debit cards, but they cannot offer loans.

Paytm is India's largest e-commerce platform. Similar to Alipay, Paytm offers a digital wallet which can be topped up using bank transfers, debit and credit cards or depositing cash at select institutions. Paytm's digital wallet has over 200 million users (The Economic Times 2017). In 2017, Paytm launched its own payments bank that has about 10 million users.

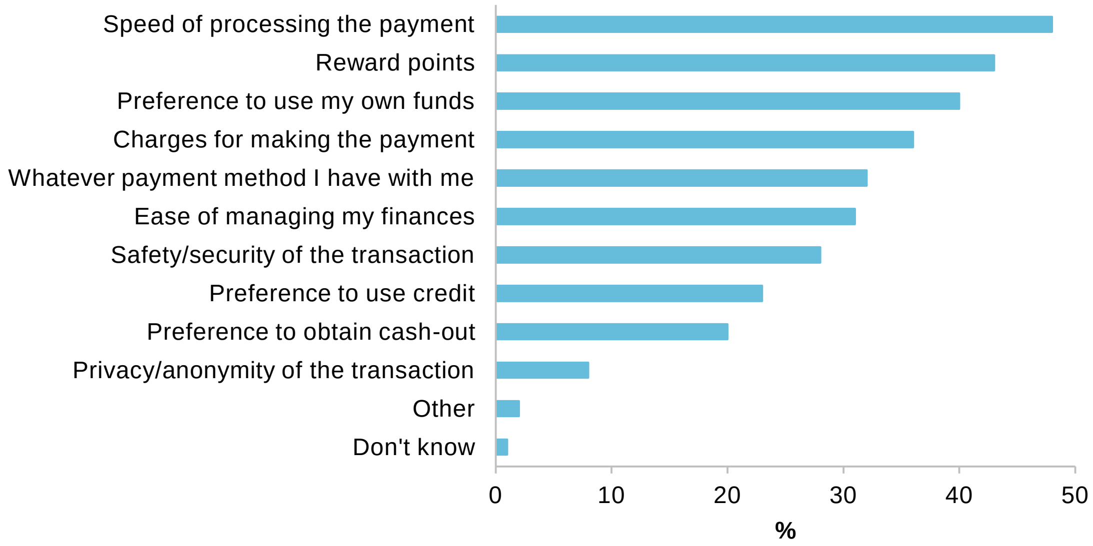
In 2016, Bendigo and Adelaide Bank, CBA, NAB and Westpac applied to the Australian Competition and Consumer Commission (ACCC) (2017a) for authorisation to collectively negotiate access to the NFC controller in Apple iPhone devices in order to provide their own digital wallets. The ACCC denied authorisation due to concern that the conduct would reduce competition between card issuers and act as a barrier to customer switching, among other things. Many financial institutions, such as ANZ, Cuscal and Amex, have negotiated deals with Apple and now offer customers the ability to use Apple Pay (Gizmodo 2017).

17.2 Addressing distortions in the payments system

Consumers choose how to pay given the costs and benefits they face

Consumers' and merchants' use of different payment methods evolve over time as their preferences change and technology develops. Each payment method offers different costs and benefits, including availability, convenience, security, cost and rewards. For example, credit cards can be convenient, but may come at a higher cost (annual fees or interest). When paying in person, consumers prefer payment methods that offer them speed, rewards and low cost (figure 17.7). Similarly, merchants choose their acquiring institution based on dependability, speed, security, pricing and customer service (McKinsey 2013).

Figure 17.7 **Factors influencing consumers' choice of payment method[a]**



[a] Payment in person at the point of sale. Excludes payments over $9999, transfers to family and friends and automatic payments. Respondents could choose more than one factor.

Source: RBA (2016e)

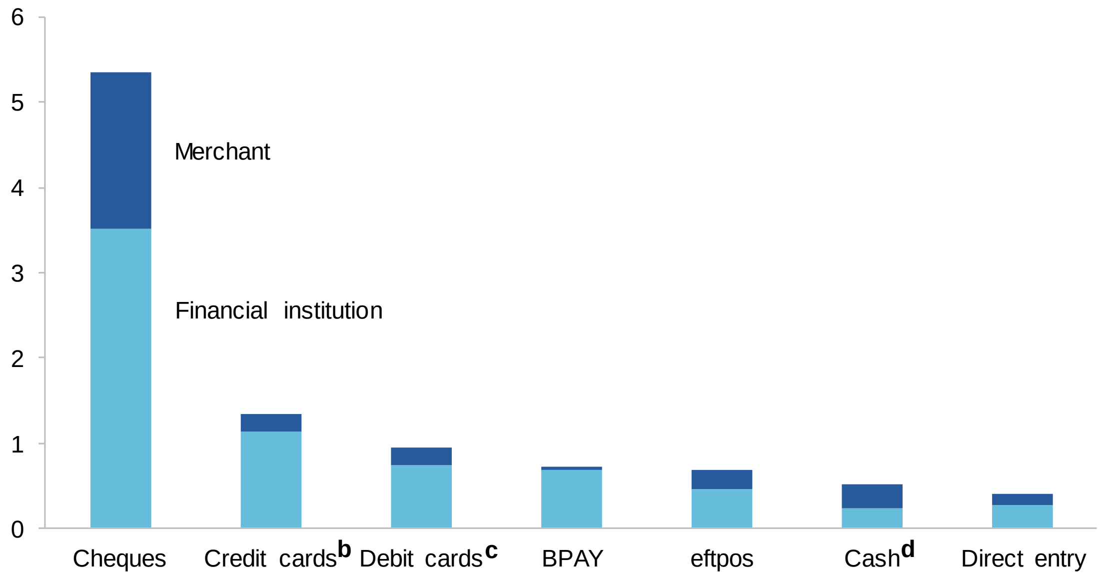
Cost is one of the most important factors driving consumers' choice of payment method. When people face the full cost of payment, they have an incentive to substitute from high-cost to lower-cost payment methods. When consumers are confronted with surcharges for different payment methods, many either choose a lower-cost payment method or switch to a non-surcharging competitor (box 17.2). If enough consumers were motivated to switch, this would put pressure on payment providers to compete by lowering the cost of payments. The RBA (2016d, p. 30) considered surcharges an important price signal for customers.

> It allows merchants to signal the costs of different payment choices and to pass on these costs to users, aligning end users' private costs more closely to social costs and thereby contributing to a more efficient payments system.

In 2014, the RBA estimated the underlying resource cost for each payment method (figure 17.8). This includes direct costs and overheads, such as the cost of infrastructure. There is a vast difference in the costs of each payment method. The RBA (2014) also estimated that the *per transaction* cost of all payment methods, except cash, fell between 2006 and 2013. However, the reduction in overall system costs was limited because people substituted payments away from cash (less expensive) to cards (more expensive).

Figure 17.8 **Underlying resource cost for each payment method**[a]

$ per average-sized transaction, 2013



[a] Made up of the direct costs to merchants and both direct and overhead costs to financial institutions (issuers and acquirers). [b] Does not include the costs of the credit function and rewards. [c] MasterCard and Visa debit cards only. [d] Direct costs to financial institutions include costs incurred by the public sector.

Source: Stewart et al (2014)

Box 17.2 The impact of cost on people's payment choices

If they face the cost of payment, consumers are likely to choose lower-cost payment methods.

In 2015, the Reserve Bank of Australia (RBA) estimated the willingness to pay surcharges to use debit and credit cards, rather than cash. Using data from its 2013 consumer payments survey, the study estimated that about 60% of consumers are unwilling to pay a 0.1% surcharge. The study also found that on average, consumers have a higher willingness to pay to use credit cards than debit cards, likely because there is additional value placed on associated rewards and interest-free periods.

> Our findings suggest that cost-based surcharging leads to some consumers switching to less costly payment methods, resulting in greater efficiency of the payment system and an increase in consumer surplus of 13 basis points per transaction. (Lam and Ossolinski 2015, p. i)

In 2013, a survey found that about half of respondents confronted with a significant credit card surcharge or transaction fee chose to use an alternative fee-free payment method (Commonwealth Consumer Affairs Advisory Council 2013). If there were no fee-free alternatives, about one quarter of respondents chose to cancel the purchase or find another supplier.

In 2010, a study of price incentives on consumer payments found that participation in a loyalty program and access to an interest-free period tend to increase credit card use.

> While interest-free periods induce substitution to credit cards from debit cards, loyalty programs induce substitution from cash. We find that for a base case consumer, with average characteristics, loyalty programs increase the probability of credit card use by 23 percentage points and reduce the probability of cash use by 14 percentage points. (Simon, Smith and West 2010, p. 1771)

In 2009, industry (with pressure from the RBA) reformed ATM fees to make them more transparent. Prior to the reforms, customers who withdrew cash from another bank's ATM only saw the fee on their subsequent monthly statement. The customer's bank would pay an interchange fee to the ATM owner. The new reforms require ATM owners who wish to charge customers for withdrawals to do so with a direct charge disclosed clearly at the time and the customer given an opportunity to cancel the transaction at no charge. RBA analysis suggested that this transparency led to a significant drop in the number of ATM withdrawals.

> First, the increased transparency of ATM fees following the 2009 reforms led to a marked change in cardholder behaviour. Cardholders reduced their overall use of ATMs, with the number of withdrawals falling by 7% in the first year. They also began making greater use of their own banks' ATMs in preference to ATMs where they would pay a direct charge. (Flood and Mitchell 2016, p. 33)

In 2008, a study of customers and merchants in the Netherlands found that if faced with a surcharge for debit cards, many customers would opt to use cash instead.

> Based on consumer and retailer survey data, our analysis shows that surcharging steers consumers away from using debit cards towards cash. Half of the observed difference in debit card payment shares across retailers can be explained by this surcharge effect. (Bolt, Jonker and Van Renselaar 2008, p. i)

But people rarely directly face the full costs of their card payments …

While cost could be an important factor in driving people's choice of payment method, it is unlikely to impact on people's choices unless they are faced with paying it. The cost per transaction is greater in the card system (particularly for credit cards) than for bank transfers. Yet, consumers choose to use cards more often than any other payment method and their use continues to grow (figure 17.2). That consumers get the benefits of using cards but do not see the costs significantly distorts their choice of cards for payment relative to other methods.

Where customers do face the costs of processing card payments, this may be direct or indirect. Surcharging is a direct way of passing the cost onto the cardholder, but in most cases, customers pay the cost indirectly — either through charges from the issuing institution, such as annual fees, or higher product prices charged by the merchant. But these costs are not obvious, diluting consumers' incentives to choose the lowest-cost payment method for each transaction.

> As has been outlined by the [RBA] in previous regulatory work, the rewards and services offered on credit cards imply more favourable pricing of credit card transactions to consumers at the point of sale, this is likely to raise the share of payments made using credit cards relative to other methods. (Stewart et al. 2014, p. 35)

… leaving merchants to bear the costs of consumer payment choices

Like cardholders, merchants benefit from participating in the card market. They attract a broader group of customers (over those merchants who accept cash only) and benefit from the security and convenience of card payments.

However, there is a fundamental difference in the decisions being made by merchants and cardholders. On the one hand, it is the cardholders who make the immediate decision about which payment method to use for each transaction. And they are only limited in choice by the payment methods accepted by the merchant. On the other hand, the merchant must make a long-term decision about which payment methods they are willing to accept across all transactions in the future. This dynamic of payment systems ultimately gives the cardholder the balance of power in this two-sided market.

This likely results in the merchants' demand for a given card scheme being less responsive to changes in price (demand inelastic) compared to cardholders (relatively more elastic) (Börestam and Schmiede 2011; European Commission 2015). Most merchants feel compelled to accept the widely used card schemes (MasterCard and Visa) because if not, they fear losing business to competitors who do (RBA 2016d). This imbalance gives card schemes and card issuers the opportunity and incentive to grow the network by competing on the value to cardholders — such as rewards — rather than the costs to merchants. They can subsidise the benefits of cards to attract more cardholders (who are more responsive to a price decrease) by raising prices to merchants (who are less responsive to a price increase).

This results in an interchange fee embedded in service fees charged to merchants, which usually flows from the merchant to the cardholder, rather than the other way around. Merchant service fees are largely made up of interchange fees, but also include other relatively fixed charges such as equipment fees. Interchange fees vary depending on the benefits associated with cards. A customer who pays with a premium card may cost the merchant a higher fee than a basic card, but the customer may receive more 'rewards points' or other benefits using the premium card. A 2014 study by the RBA estimated that merchants bear the greatest share of the overall transaction cost across credit and debit cards (Stewart et al. 2014).

Given this market dynamic, merchants can choose to recoup the cost of interchange fees by surcharging cardholders directly or charging higher product prices overall.

If all merchants decided to surcharge, the net effect of the interchange fee would likely be neutral (Gans and King 2003). Cardholders would face the cost of their card payments upfront and respond by lowering their card use to the same level as if there were no interchange fee.

However, as noted above, the vast majority of merchants do not surcharge cardholders, primarily due to the risk of losing customers to competitors who do not surcharge (Murray et al. 2014a). The RBA estimated that just 3% of all card payments attracted a surcharge in 2016 (Doyle et al. 2017). This is a reasonable response for most merchants who are subject to intense competition and lack the market power to impose a surcharge without a strong response from customers.

Further, merchants that are small or face strong competition lack the market power to negotiate lower merchant service fees with their financial institution. Negotiating a better deal for merchants is something that industry associations may do on behalf of their members. And the entry of relatively new competitors, such as Tyro, can strengthen merchants' negotiating power. However, given interchange fees are usually set by the card scheme, the merchant's financial institution tends to pass these on directly to the merchant, so even if they switch providers, interchange fees would likely be similar.

Large (and some mid-sized) merchants have more scope to negotiate lower fees with their financial institution (Richards 2017). The result is that not all merchants face the same set of fees. For example, Visa (2017) and MasterCard (2017) impose different interchange fees depending on the volumes of transactions processed, with large supermarket chains paying lower merchant fees. Further, merchants that face limited competition or otherwise have significant market power, such as providers of niche products, oligopolies or monopolies, have more scope to surcharge customers. Prior to recent reforms, the airline industry was able to impose customer surcharges on some fares far in excess of their cost of acceptance (RBA 2015h).

Instead of surcharging, most merchants rely on passing on the interchange fee to customers through higher product prices. This creates an inherent cross-subsidisation from customers who use other (relatively low-cost) payment methods, such as cash or bank transfers, to those who use relatively higher-cost methods, such as credit cards. In addition, there is a cross-subsidy from those with basic credit cards to those with premium cards. Those who do not use credit cards are unambiguously worse off, paying higher product prices, yet receiving none of the benefits to cardholders. This issue of cross-subsidisation has been a constant theme in past efforts to regulate interchange fees (RBA 2015h; Wallis et al. 1997).

It is clear that cardholders impose significant costs to the majority of merchants through interchange fees. Yet, given merchants generally recoup this cost through higher product prices, *all* consumers — not just cardholders — end up indirectly paying for the costs of card transactions.

Regulating interchange fees limits costs and aligns incentives

In its Draft Report, the Commission recommended banning interchange fees as a way to limit costs and better align incentives in the payments system.

There was strong opposition to this reform from many Inquiry participants, including the major card schemes, card issuers and acquirers, special interest groups and others (for example, Airplus, sub. DR63; American Express, sub. DR84; ANZ, sub. DR74; AusPayNet, sub. DR75; Berg, Sinclair and Potts, sub. DR61; CBA, sub. DR79; COBA, sub. DR72; Cuscal, sub. DR98; HSBC, sub. DR102; MasterCard, sub. DR91; NAB, sub. DR94; Visa, sub. DR87; Westpac, sub. DR125; WEX, sub. DR60).

We expected some opposition to the draft recommendation, given this potential reform targets a revenue source for particular entities and attempts to recalibrate a market structure. Some Inquiry participants supported a ban on interchange fees (ALNA, sub. DR114; CHOICE, sub. DR97; CMSPI, sub. DR99; Peter Mair, sub. DR53).

The case for keeping interchange fees is not strong

Interchange fees are *variable* fees on a card network, charged on each transaction. Interchange fees for debit transactions are typically fixed per transaction, whereas those for credit transactions are typically charged as a percentage of the transaction value — a volume-based variable charge (RBA 2016d).

Many submissions asserted that the rationale for interchange fees is to balance incentives and share costs between cardholders, merchants and their financial institutions. This involves the merchant's bank (or other financial institution) compensating the cardholder's bank for the costs incurred in issuing cards and the benefits the merchant receives (over and above those reflected in other merchant fees).

> Interchange fees reflect the value merchants receive from accepting electronic payment products and play a key role in balancing the costs consumers and merchants incur. (MasterCard, sub. DR91, p. 5)
>
> Its primary role is to create the right balance of incentives and costs between the issuer, which promote and issue payment cards to consumers, and the merchants' acquirer, which enrol and process payment transactions for merchants. (Visa, sub. DR87, p. 4)

Many of the costs to card issuers are *fixed* costs that do not vary with the value of transactions, such as issuing cards, security, travel insurance and one-off regulatory costs (table 17.1).

The actual cost to process an additional transaction on an electronic card system is negligible. And the cost of an additional transaction does not depend on the *value* of the transaction. Even though networks might require technology upgrades to cater for an increasing number of transactions, these are generally one-off investments. Indeed, Visa (sub. DR87, p. 6) noted that the cost of processing transactions are recouped elsewhere, not from interchange.

> Merchants pay what is known as a Merchant Service Fee ("MSF"), which is negotiated with their acquirer and may include interchange, the cost of transaction processing, terminal rental and customer service, and the acquirer's or processor's margin, among other costs.

On the other hand, a cardholder's bank pays some costs that are *variable* in relation to the value of transactions. Many submissions pointed out that interchange helps pay for the cost of interest-free periods offered to credit card holders. However, this is a feature of the credit product itself, rather than the payment aspect of a credit card. The cost of this feature is perhaps more closely aligned to the other costs associated with extending credit, such as the cost of funds and credit losses from non-repayment. These costs are generally recouped via comparatively high interest rates and fees from the party that directly benefits from these features — the credit card holder.

This leaves rewards programs as the other main variable cost in card systems. Rewards can be useful to grow card networks in their infancy, by increasing the incentive for consumers to use cards. However, this has come at a cost to merchants and consumers more broadly who are paying higher product prices for a higher-cost payment method to grow. Now that the main card schemes have matured and are ubiquitous in Australia and worldwide, the case for interchange fees to grow the networks through rewards is weak.

> … while there may be a role for interchange fees in emerging payment systems in encouraging the use of a system by one side of the market or the other, the case for such fees is much weaker as the system becomes well established. The latter conditions clearly apply in Australia … (RBA 2015g, p. 24)

Table 17.1 **Costs to banks for participating in card schemes**

Expenses	*Variable*[a]	*Fixed*[b]
Cost of funds	✓	
Interest-free periods	✓	
Credit losses from non-repayment	✓	
Rewards programs[c]	✓	✓
Processing transactions (receiving, verifying, reconciling and settlement)[d]	✓	✓
Other services such as travel insurance		✓
Card issuing costs (such as re-issuing cards)		✓
Security, protection and fraud		✓
One-off regulatory, technological or other commercial costs		✓

a Typically varies with the value of transactions. **b** Typically does not vary with the value of transactions. **c** Involves a fixed component: banks pay a management fee to a provider of a rewards program. Also involves a variable component: banks provision against the number of points accumulated by the customer. **d** These costs are recouped through scheme fees paid by financial institutions to the scheme (such as MasterCard and Visa) to provide the infrastructure, processing and settlement services. The key costs in relation to scheme fees can including a licensing fee, transaction volume fee and currency hedging fee.

Source: ABA (2015); Productivity Commission analysis from submissions

To the extent that cardholders benefit from rewards, a more transparent and efficient payments system would involve the cost of these rewards being faced by the decision-making party directly, rather than indirectly through the use of interchange fees.

Card issuers are entitled to recoup their costs. However, there is little case for interchange fees based on the number of transactions (for debit), let alone the value of each transaction (for credit). That interchange fees flow from the merchant's bank to the cardholder's bank is more likely a reflection that merchants are less able to respond to changes in price than cardholders.

Several submissions commented on the benefits that merchants receive from participating in the card system to justify why they should pay for some of the costs incurred by issuers (for example, MasterCard, sub. DR91; ANZ, sub. DR74). Merchants are not required to take on credit risk, benefiting from guaranteed payment from credit cards in the event of credit default or fraud. Merchants also benefit from faster transaction times, reducing the time spent taking payment and providing a smooth customer experience. Some submissions also suggested that merchants may benefit from increased sales, such as for online commerce. However, with the prevalence of card acceptance, this is unlikely to be a significant point of difference that increases sales.

Yet, as noted above, merchants already pay to participate in card networks — the non-interchange fee component of their merchants service fees covers costs such as transaction processing, terminal rental and customer service, as well as the acquirer's or processor's margin.

While card schemes do not earn revenue from interchange fees directly (MasterCard, sub. DR91), interchange contributes to the growth of card schemes indirectly. As noted by Visa (sub. DR87), interchange fees can be a useful way for card schemes to *maximise* the number and value of transactions made through their network. This is because schemes can subsidise cardholders to use cards at merchants' expense. Maximising transactions increases the market power of the card scheme and the revenue it earns through scheme fees charged to participating institutions. Further, maximising the volume of transactions increases the interchange fee revenue earned by card issuers.

While this is an understandable commercial motive, the objective of the payments system is not to maximise the volume of card transactions, but to optimise the use of all payment methods based on their relative costs and value to consumers and merchants. The PSB noted the perverse incentives associated with interchange fees.

> Historically, interchange fees had been set collectively by the members of the scheme. Competition between the schemes had, if anything, created upward – not downward – pressure on these fees. The higher the interchange fee paid to card issuers, the greater their incentive to issue the cards of a scheme and the larger the subsidies that can be paid to cardholders to encourage use of those cards. (RBA 2015h, pp. 4–5)

Given the perverse incentives, the PSB has introduced regulations to limit costs and better align incentives in the card system (box 17.3).

> The Bank's reforms starting in 2003 have served to bring the average interchange fees of the different card systems closer together (and closer to zero), meaning that decisions about the choice of payment method are more likely to be based on the relative attributes of the different systems themselves, rather than being driven by price signals underpinned by centrally set interchange fees. (RBA 2015h, p. 29)

In other jurisdictions where interchange fees are unregulated, they are often significantly higher. For example, in the United States, credit cards are not subject to interchange regulation and the fees can reach 3.25% plus 10 cents per transaction (CBA, sub. DR79).

Box 17.3 Regulation of interchange fees in Australia

Since the early 2000s, the Payments System Board (PSB) has introduced regulations to limit costs and better align incentives in the card system.

Interchange fees

The PSB has regulated interchange fees since 2003 (RBA 2015h). In 2003, the PSB set a benchmark for BankCard, MasterCard and Visa credit cards based on the average costs of the issuers of each scheme (RBA 2003). Since 2006, this changed to a common cost-based benchmark for average interchange fees of 0.5% for MasterCard and Visa credit cards and 12 cents for debit cards (RBA 2006). The PSB updated its benchmarks in 2017, maintaining a 0.5% benchmark for credit cards, but reducing the benchmark for debit cards from 12 to 8 cents per transaction (RBA 2016d). Further, the PSB set a ceiling on individual interchange rates at 0.8% of the transaction value for credit cards and 15 cents (or 0.2%) for debit cards.

Surcharging standards

From 2003, the PSB required card schemes to remove restrictions on merchants that prevented surcharges on credit card payments (2016d). Following the 2014 Murray Financial System Inquiry, the PSB imposed a standard to limit excessive surcharges levied on customers with the Australian Competition and Consumer Commission responsible for enforcing the standard.

Capturing companion cards

One aspect of the PSB's recent interchange fee regulation involved capturing the companion-card system (where a card scheme is also the merchant's financial institution), which previously circumvented interchange fee regulation. Since 2016, the PSB has regulated issuer fees on companion cards (such as American Express cards issued by a separate institution) in the same way as four-party credit card systems (MasterCard and Visa). Consequently, all four of the major banks have scrapped (or plan to scrap) their American Express (Amex) companion cards by the end of 2018 (McMullen 2018b). This has the potential to reduce Amex's market share, and in turn, increase the dominance of Visa and MasterCard. That said, in 2017, Amex reduced its merchant service fees for small business in an attempt to grow its market share (Yeates 2017a).

Amex has since formed a new partnership with Westpac whereby Westpac's customers are offered Amex-issued credit cards which let customers earn rewards within either Amex or Westpac's rewards programs (McMullen 2018a). This essentially bypasses the PSB's 2017 interchange fee regulation because the cards are issued by Amex, which does not face interchange fee regulation as it is both the card issuer and acquiring institution.

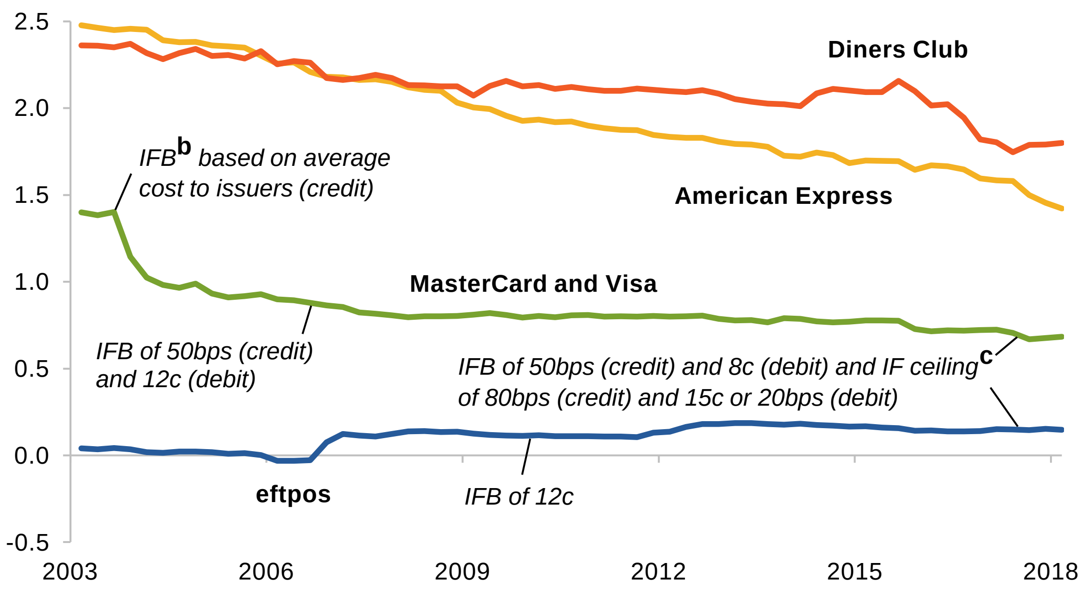
Setting interchange fees to zero has several benefits

One way to limit costs and better align incentives in the card system is to set interchange fees to zero — essentially a ban on interchange fees. There are several benefits to doing so.

First, merchant service fees would likely fall. This is because the bulk of these fees are driven by interchange fees. The RBA (pers. comm., 3 October 2017) estimated the average interchange fee is about 70% of the average merchant service fee for Visa and MasterCard credit cards, and about 45% for Visa, MasterCard and eftpos debit cards. Data shows that the PSB's caps on interchange fees have coincided with, and likely contributed to, the reduction in merchant service fees over time (figure 17.9). Further, in competitive markets lower merchant service fees would likely flow through to lower product prices for consumers. That said, we are aware that removing interchange fees may cause financial institutions to increase other fees to recoup some of the lost revenue.

Figure 17.9 **Average merchant service fees[a]**

% of transaction values acquired



a Does not include other (relatively small) merchant fees such as annual or monthly fees and terminal rental. **b** IFB is interchange fee benchmark. **c** IF ceiling is a cap on the individual interchange rates.

Source: RBA (2006, 2015h, 2016d, pers. comm., 3 October 2017)

Second, the cost and complexity of interchange fee regulation would fall. The PSB would no longer need to estimate costs to inform its weighted-average benchmark, reducing the cost of its consultations, monitoring and updates to regulation. In 2017, the PSB increased the frequency of its compliance monitoring for the interchange fee benchmark from a three-yearly cycle to quarterly reviews. The international card schemes noted 'that more frequent resets of fee schedules would be costly' (RBA 2016d, p. 14). Further, removal of a transaction fee may remove the need for some merchants to surcharge for card transactions, reducing the need for surcharging regulations and a potential pain point for consumers.

Third, removing interchange fees would increase transparency and efficiency of the payments system. Card issuers could choose to recoup the costs of processing transactions through variable fees (such as per transaction fees) or fixed fees (such as annual fees) to cardholders. In the event that a card issuer chooses to charge cardholders directly, cardholders would now face a price signal for using their card (previously imposed on merchants), giving them an incentive to respond to the cost of the card transaction.

Fourth, transparency would likely reduce the costs of the payments system overall if cardholders move some of their card payments to other, lower-cost payment methods, such as cash or bank transfers. Visa (sub. DR87) noted that when the United States began regulating interchange fees for debit cards, consumers responded to increased fees by shifting some of their payment usage to other payment methods.

This would impose an important discipline on card issuers and schemes to focus on the cost of their transactions, putting downward pressure on the costs of card payments. This would likely reduce the focus of card issuers on rewards and other incentives used to subsidise card payments. Indeed, recent changes and limits to interchange fee regulation have likely reduced the value of credit card rewards (Emmerton 2017; RBA 2017a). This is mainly because rewards can make up to one quarter of the overall costs of issuing credit cards (ABA 2015), which are in turn funded from interchange fees.

Finally, to the extent that merchants pass on the cost of interchange fees as higher prices for all consumers, setting interchange fees to zero would reduce this cross subsidisation from the prices all consumers pay to the benefits received by cardholders. This means the people who receive no benefit from card payments do not have to pay for the benefits to others.

Addressing concerns on the costs of banning interchange fees

Some Inquiry participants were concerned about the potential consequences of banning interchange fees.

One of the main concerns was that a ban on interchange fees meant that card issuers would be likely to recoup the revenue lost by raising costs to cardholders or reducing their benefits.

> If interchange were banned, system costs do not simply disappear. The system would still need to fund these costs and the evidence from here and overseas shows consumers being worse off in the form of higher fees, higher interest rates, shorter interest-free periods and a curtailment of rewards offerings. (MasterCard, sub. DR91, p. 9)

While some card issuers may choose to recover part of the costs from cardholders or reduce their associated benefits, it is important to reiterate that these costs are already being paid by all consumers through higher product prices. That cardholders might see the costs of using their cards means that the cost is now signalled to the party who makes the payment decision. Further, to the extent that interchange fees may be used as pure rent-seeking by card issuers, overall costs will likely fall as transparent signalling shines a light on this behaviour.

Some submissions suggested there is no evidence merchants will pass savings through to lower product prices for consumers (for example, MasterCard, sub. DR91). However, as noted by the PSB:

> It is impossible – given the imprecision in any econometric model of consumer price inflation – to measure exactly how these reductions in merchant service fees have flowed through into prices for consumers. However, just as with reductions in any other business costs – such as wages, taxes, the cost of energy, etc – that influence the prices charged by business in any industry, it

seems reasonable to assume that they have mostly flowed through to lower retail prices for consumers, just as it is reasonable to assume that increases in merchant costs are similarly passed on to consumers over time. (RBA 2015h, p. 23)

Some submissions suggested that interchange fees help participating financial institutions fund investment in card payments innovations and that removing this revenue source would likely lead to lower levels of innovation (for example, AusPayNet, sub. DR75; Cuscal, sub. DR98; MasterCard, sub. DR91; Visa, sub. DR87; Westpac, sub. DR125). However, innovation in card payments is unlikely to rely on the level of interchange fees. Indeed, CBA noted that:

Australia has one of the most innovative and secure payments systems in the world, as well as one of the lowest interchange fee regimes in the world. (CBA, sub. DR79, p. 48)

Further, participants would face a strong incentive to continue innovating in order to create value for cardholders (who may now see the costs of innovation) and also to increase efficiency in order to offset lost revenue. In addition, there is nothing to stop participants recouping the costs of innovation elsewhere as they do for other financial products. The PSB has also gone so far as to say it sees no merits in such arguments given evidence of strong card innovation over the past decade despite the introduction of interchange fee regulation (RBA 2016d). Finally, banning interchange fees may increase the prospects for new payment methods to emerge and compete on costs to consumers.

COBA (sub. DR72), Cuscal (sub. DR98) and P&N Bank (sub. DR88) expressed concern that banning interchange fees would disproportionately affect small issuers. This is because small issuers would become less competitive compared to the major banks which would balance the lost revenue from the issuing side of their business by not having to pay interchange fees on the merchant acquiring side. This situation is a strong reflection of the subsidised use of cards funded by interchange fees and we recognise that small card issuers will take time to adjust or transition to new revenue streams. At the same time, this reform would likely benefit merchant acquirers, including small merchant acquirers that do not issue cards.

Some issuers of corporate cards (WEX, sub. DR60 and Airplus, sub. DR63) were concerned that removing interchange fees would make Australia less commercially viable for their business. They argued that corporate cards are different to consumer cards because they are limited to business use and suggested that any ban on interchange fees should not apply to these cards.

However, we do not consider that corporate cards should be treated differently. Like people, businesses are consumers in the card payments system. Indeed, the arguments presented by issuers of corporate cards in favour of interchange fees tend to mirror those of consumer-oriented card issuers: that the card issuer incurs many different costs which should be paid by the merchants who also benefit. As noted by the card issuers themselves, their commercial card solutions are highly innovative and offer significant benefits to their business customers. In this case, businesses would either pay for the benefits they receive or accept fewer benefits, such as reduced interest free periods. Indeed, in its recent review of payments regulation, the PSB decided against providing special treatment for commercial cards.

> But with the benefits of corporate card programs falling mostly to the cardholding side, it should be expected that much of the cost of these programs should fall on that side. (RBA 2016d, p. 18)

Further, if commercial cards were exempt from interchange fee regulation, it could potentially create a loophole for consumers with access to a business card able to route their personal transactions through a business card, rather than a consumer card.

Several submissions (for example, American Express, sub. DR84; ANZ, sub. DR74; CBA, sub. DR79) suggested that given the PSB reviewed and implemented its latest round of interchange fee regulation in 2017, any further reforms should wait until sufficient time has passed for the latest change to flow through and be reviewed. We appreciate that constant regulatory change can be inconvenient and difficult for some participants to manage. But further delaying reforms is costing both consumers and merchants more broadly.

Continuing down the bold path of regulation

The case for interchange fees is not strong. Australia is at the forefront of interchange fee regulation. It was the first jurisdiction to regulate interchange fees (RBA, sub. DR82) and has lowered and tightened its interchange fee benchmarks over time.

Other than the card system, most payment methods in Australia do not rely on interchange fees to operate. Interchange fees for eftpos transactions were likely minimal in the early 2000s, leading to merchant service fees that were close to zero or even negative (figure 17.9). And where the ATM system used to operate with interchange fees when a customer used another bank's ATM, the PSB reformed these fees in 2009 in favour of charging cardholders directly (box 17.2). In 2017, many financial institutions removed these ATM fees altogether — removing an estimated revenue of $500 million (Coorey 2017). Further, there are several examples of card systems operating without any interchange fees at all. In other countries, such as Canada and New Zealand, domestic debit card schemes have set interchange fees to zero (FRB of Kansas City 2017).

In 2014, the Murray FSI considered banning interchange fees altogether, but considered there could be high transitional costs to doing so (Murray et al. 2014a). But, the PSB has since reduced interchange fee benchmarks further, and set a ceiling on individual interchange rates.

Productivity Commission analysis of data received from nine ADIs (which capture the vast majority of the market) shows that they made a net gain of about $530 million from interchange fees in 2016-17 and confirms that the vast majority of interchange fees pass back and forth between the major banks as either issuers or acquirers. This is to be expected as the major banks processed about 80% of the value of card transactions as card issuers and over 70% as card acquirers in 2016-17 (figure 17.4). The net effect of interchange fees for most other banks appears relatively small or even negative.

If financial institutions made the decision to recoup *all* of these costs from the 69 million cards on issue (RBA, pers. comm., 3 October 2017), this would mean an average increase of less than $8 per card per year. And it is possible that card issuers may choose not to recoup these fees directly.

However, we are aware of the potential for some unintended consequences from setting interchange fees to zero, and indeed, from regulating interchange fees more generally. In its submission, the RBA noted that in its recent review of interchange fee regulation, it ultimately decided against reducing benchmarks below 0.5% for credit and 8 cents for debit transactions after considering two main factors.

> These factors include the risks of significant effects on the competitive balance between three- and four-party credit card schemes or of a significant increase in circumvention efforts. (RBA, sub. DR82, p. 8)

We are aware that card schemes and participants are likely to consider new ways in which they can circumvent interchange fee regulation in the same way companion cards were used (box 17.3). The PSB would likely need to monitor scheme fees paid to and received from card schemes to determine whether interchange fees are merely re-routed through the scheme.

However, participants can be expected to try and circumvent regulation whether interchange fees are banned or not. For example, a new partnership between Westpac and Amex may already be bypassing interchange fee regulation (box 17.3).

We accept that there is a risk of changing the competitive balance between three- and four-party credit card schemes. This comes about because four-party schemes would be regulated and lose the ability to use interchange fees to encourage card use by subsidising benefits to cardholders, whereas three-party schemes do not. This may lead three-party schemes (such as Amex) to grow at a faster rate, despite being more costly. This concern led the Australian Retailers Association (ARA, sub. DR113) to recommend that the RBA regulate three-party schemes. However, it is generally not practicable to regulate the internal price of a business.

However, we would note two further points:

- The risk of changing the competitive balance exists under current interchange regulation and is not an argument to avoid tightening this regulation by banning interchange fees.
- The extent of the risk and, if it is large, the potential to reduce or eliminate it, have not been evaluated.

The risk may not be large. The four-party schemes would compete vigorously to retain market share if they considered their profits were under threat from the three-party schemes. In this situation, any rebalancing may be small or nonexistent.

Even if the risk is non-negligible, it may be removed by modifying the current approach to regulation. For example, the three-party schemes may not have traditional interchange fees, but they do levy merchant service fees. If competitive balance was a regulatory risk, then banning interchange fees while directly regulating the merchant service fees (paid by a merchant to their financial institution) of the three-party schemes would eliminate this risk.

The direct regulation of merchant service fees has received far less attention than interchange fee regulation around the world. In 2015, the European Commission (2013) briefly considered the option to regulate the merchant service fee *instead* of the interchange fee, but considered it may be costly to regulate and may reduce competition in the merchant acquiring market. As far as we are aware, the potential for regulating the merchant services fees of three-party schemes as an *adjunct* to interchange fee regulation was not considered. More research should be done on the potential benefits (and costs) of this reform.

Therefore, even if there is a risk that interchange fee regulation in general may artificially favour three-party schemes if they can avoid regulation, this is not an argument against tightening current interchange fee regulation. As such, the Commission considers that interchange fees for card systems should be banned as soon as feasible, preferably by end-2019.

However, we consider that an evaluation of the potential of interchange fees and their regulation to distort market outcomes, together with analysis and recommendations including (but not limited to) merchant service fee regulation, is well overdue. This evaluation and assessment should not delay the banning of interchange fees. Rather it is complementary to any interchange fee regulation, including current regulations. The ACCC as competition champion in the financial system and a regulator with strong experience dealing with merchants — with input from the PSB — should carry out this evaluation and assessment.

RECOMMENDATION 17.1 BAN CARD INTERCHANGE FEES

The Payments System Board should introduce a ban on card payment interchange fees by the end of 2019. Any other fees should be made transparent and published.

RECOMMENDATION 17.2 ANALYSIS AND ASSESSMENT OF THREE-PARTY SCHEMES

The ACCC, with input from the Payments System Board, should investigate:

- whether current or recommended interchange fee regulation favours three-party card schemes and, if such a distortion exists, whether it is significant enough to require further regulatory intervention; and
- if further regulatory intervention is desirable, the nature of such intervention, including, but not limited to, the possibility of regulating merchant service fees as an adjunct to the interchange fee ban.

This investigation should be completed by no later than mid-2019.

Giving merchants a choice of the default route for transactions

Many financial institutions issue dual-network debit cards, which provide point of sale functionality from two card schemes — eftpos and either MasterCard or Visa. In 2015, about two-thirds of the 32 million debit-only cards on issue were dual-network cards (RBA 2016b).

Merchants are likely to prefer that their financial institution route dual-network debit card payments to the lowest-cost option by default. But in many cases, merchants are unable to decide which network is used to process payments by default. Giving merchants the ability to make this choice is termed merchant choice routing. Variations of merchant choice routing are commonly available overseas (box 17.4).

Box 17.4 How card payments are routed in other countries

Europe — From June 2016, consumers and retailers can choose the payment type when paying with co-badged cards. Retailers can install a default application choice in their payment terminals but must inform customers who have the last say and can override with their own preference.

Canada — The domestic network has preference for domestic point-of-sale debit card payments. Merchants can choose which payment options they will accept. Consumers have unrestricted control over payment default settings on mobile devices and wallets and can select the payment applet used for contactless payments.

United States — All debit cards must be enabled on at least two unaffiliated networks. Some acquirers, such as First Data, offer merchants dynamic routing that instantly calculates the least-cost route for each transaction.

New Zealand — If a mobile device has more than one application, the customer must be able to determine the priority between applications and cannot be overridden.

Malaysia — Merchants have first priority in deciding which payment card network a transaction is to be processed by. Cardholders have second priority.

Source: APCA (2017b); Bank Negara Malaysia (2014); First Data (2011); Groenfeldt (2017)

If a customer makes a 'contact' transaction (by inserting the card and inputting a PIN) using a dual-network card, the customer decides whether the transaction is routed through eftpos (if they select CHQ or SAV) or one of either MasterCard or Visa (if they select CR).

However, if a customer makes a 'contactless' transaction (tap and go), either through a physical card or mobile digital wallet, they are not asked to decide which network to use. This is a convenience measure for the customer that has arisen because until recently international card schemes were the only networks that offered contactless transactions. Thus, all contactless debit transactions were automatically routed through their networks.

In 2015, eftpos (2016) introduced contactless functionality on most of its debit cards and terminals. However, merchants have been prevented from routing debit transactions through the eftpos network. A consequence is that the rapid rise in contactless transactions has led to an increase in the number of debit card payments that are automatically routed through the relatively more expensive Visa or MasterCard schemes. This can end up costing the merchant an average of about 0.55% of the transaction value compared to just 0.14% if the same contactless payment was routed through the eftpos system instead (Richards 2016). The ARA (2017) estimated that this can increase overall costs to the economy by $290 million per year.

While some large merchants have managed to find workarounds, the acquirers (again, mostly banks) appear unable or unwilling to make changes.

> Following on from the lead of Woolworths, who via owning their own switch simply turned off the ability for a customer to use the credit button when a scheme debit card was presented, a number of merchants have informed the ARA that they had been advised by their merchant acquirer that the acquirer is unable or unwilling to program the terminal to turn off the credit button so that the transaction is routed via the eftpos network. (ARA 2014, p. 6)

With contactless transactions, the debit card issuer determines which network is given priority (RBA, sub. 29). In 2013, the RBA (2013a) received voluntary undertakings from the eftpos, Visa and MasterCard schemes agreeing not to prevent merchants from choosing contactless transaction routing defaults for dual-network cards. However, Tyro claimed that the Visa and MasterCard schemes instead influence the issuers to block merchant choice.

> … the Visa and MasterCard schemes have mandated to the issuers that their own network has to be the first priority in network selection. … The consequence is that for the high volume of contactless transactions, any choice for the merchant or the consumer is de facto removed. The technical specifications are written in a way that makes it impossible for the acquirer to offer its merchants a possibility to overwrite the mandated network priority. (Tyro 2017b, pp. 1–2)

Such decisions appear to demonstrate substantial market power on the part of the card schemes and financial institutions. This behaviour could be expected when the card schemes and card issuers receive higher revenue per transaction if they are processed through Visa and MasterCard, rather than eftpos. For example, a financial institution that is both a card issuer and merchant acquirer may prevent its acquiring arm from offering merchant choice routing if there is an overall gain to the institution from using the higher-cost network.

Merchant choice routing does not necessarily mean that *all* transactions must be routed through the eftpos network by default. Indeed, this may not be a merchant's best option. For very small transactions, the merchant service fee paid on eftpos (fixed fee) may not be lower than Visa or MasterCard (variable fee) (Richards 2017). In this case, merchant choice routing could mean that merchants choose to minimise the total cost of fees using dynamic routing technology, where *each individual transaction* is routed through the lowest-cost network. This technology is already available in other countries (box 17.4).

A number of Inquiry participants supported merchant choice routing (for example, Ai Group, sub. DR127; ARA, sub. DR113; AusPayNet, sub. DR75; Westpac, sub. DR125). Others expressed concerns about the potential impacts of merchant choice routing if it is not well implemented.

NAB (sub. DR94) and Visa (sub. DR87) stated that consumers may lose some valuable benefits — such as security — if their transactions were routed through eftpos, rather than the international card schemes. That said, we understand that many of a card's benefits, such as travel insurance, are associated with the card itself, rather than which network a transaction is routed through. Further, transactions through the eftpos network are subject to the ePayments Code and its associated consumer rights in the event of unauthorised transactions.

Visa (sub. DR87, p. 8) considered that competition on merchant costs alone can negatively impact value-added services for merchants and consumers.

> Merchant choice as opposed to 'least cost' routing is an important distinction to consider as merchants may see the benefits in choosing certain payments acceptance solutions that are higher cost, but that provide greater value both to their businesses and to their customers.

We agree that merchant choice routing should be the goal, but note that most merchants are likely to prefer the least-cost route for default payments.

Cuscal (sub. DR98) suggested that an unintended consequence of *mandating* this type of reform may be the demise of dual-network debit cards and the convenience they provide. But such an approach was not suggested in our Draft Report. Some Inquiry participants (for example, NAB, sub. DR94; CBA, sub. DR79; Visa, sub. DR87) also believe that implementation of merchant choice routing should not hurt the customer experience, such as time taken to make a transaction, and are keen for the industry to work together on a solution. Finally, many submissions were in favour of giving consumers the final choice of network for their transactions (for example, AusPayNet, sub. DR75; CBA, sub. DR79; CHOICE, sub. DR97; Cuscal, sub. DR98).

We consider that ultimately whichever party faces the cost of making the payment — the consumer or the merchant — should be able to set the *default* network route for contactless transactions using dual-network debit cards. And while there are currently no dual-network *credit* cards, this principle should also apply to these cards in the event this occurs in the future.

If consumers faced the cost of each card transaction from their financial institution, they may also need to be given the ability to vary the default route. For example, the financial institution could show the average cost per transaction through both networks when the card is first issued. Then the consumer could be asked to preselect the default route, with the ability to easily change the default route at will (such as through internet banking).

However, as discussed above, merchants tend to be the party that faces the direct cost of card payments, and therefore should be able to set their preferred default route. Thus, providers of dual-network cards should not be able to prevent merchants (or their acquirers) from setting the default route. This approach has similarities to that currently in place in Europe, the United States and Malaysia (box 17.4). CMSPI (sub. DR99) noted that merchant routing in the United States has put downward pressure on merchant costs.

Some acquirers have already begun or are considering providing merchant choice routing. In March 2018, Tyro (2018) became the first Australian bank to allow merchant choice routing, stating that merchants will save 6% on their merchant service fees on average as a result. Both ANZ and NAB have committed to rolling out least-cost routing in 2018 (Yeates 2018), while Westpac (2018) committed to a 2019 roll out. CBA (sub. DR79) is assessing its implementation of merchant routing, but is yet to comment publicly on its timeline.

The PSB has strongly supported calls for institutions to provide merchant choice routing (RBA 2017u). But at its May 2018 meeting, it decided that in light of industry progress, it will not consult on a regulatory standard requiring merchant choice routing.

Merchant choice routing could lead to a significant reduction in merchant service fees. The Commission considers that rather than taking a wait-and-see approach, the PSB should actively require that merchants be given the ability to choose the default network to route transactions for dual-network cards from 1 January 2019 at the latest. Setting a regulatory standard will speed up and ensure implementation across all providers of merchant services and provide protection to merchants into the future.

This could potentially be implemented by the PSB setting a standard that neither a scheme, nor any of its participants, can prohibit or deter a merchant from setting the default route. Giving merchants the ability to set the default route should not impact on the consumers' ability to override the default by actively selecting the network route. Further, if the PSB finds that merchant choice routing leads to a reduction in the offering of dual-network cards, it can look to the example set in the United States, where all debit cards must be enabled on at least two unaffiliated networks.

RECOMMENDATION 17.3 MERCHANT CHOICE ROUTING FOR DUAL-NETWORK CARDS

The Payments System Board should set a regulatory standard that gives merchants the ability to choose the default network to route transactions for dual-network cards. As the technology is readily available, this reform should be in force by 1 January 2019 at the latest.

More transparency can shed light on fees for foreign transactions

It is not only card payments in Australia that are affected by distortionary and opaque fees. If Australians want to send money or make purchases overseas, they usually need to convert Australian dollars into foreign currency. Many financial institutions provide foreign exchange services to Australians. There are two main ways that these financial institutions charge customers for this service: a foreign transaction fee or an exchange rate markup, or both.

Financial institutions will often charge a foreign transaction fee as either a fixed fee per transaction or percentage fee of the value of each transaction. Financial institutions may also earn a markup on the exchange rate used to convert currency. Most institutions do not provide the mid-market exchange rate — the midpoint between buying and selling rates on the market — such as that published by the RBA. This is because institutions do not actually buy and sell currency at the midpoint, rather they transact at the buy or sell price. However, many institutions leave a gap between the exchange rate they offer to customers and the actual exchange rate they use for conversion — an exchange rate markup.

A study commissioned by TransferWise (sub. DR58) estimated that Australians spent about $2 billion in exchange rate markups and foreign transaction fees on overseas purchases and international money transfers in 2016.

Overseas purchases

Consumers can generally make overseas purchases, either online or in a foreign country, using cards issued by banks (or other card issuers). Many of the cards that people use every day charge a foreign transaction fee on each overseas purchase. On average, credit card foreign transaction fees have increased from about 1% in the early 2000s to almost 3% in recent years (Perry and Maruthiah 2018; RBA 2005). Fees may be used to cover the cost of processing transactions through the international card schemes. However, there is some concern that the fees charged are in excess of what it costs banks to process the transaction (CHOICE 2015b; Creighton 2018) — for example, the RBA (2016d) noted that interchange fees on foreign-issued cards are typically lower at 1.5%–2%. The exchange rate for overseas card purchases are generally set by the international card schemes, such as MasterCard, Visa and American Express.

Alternatively, many banks offer customers specialised pre-paid travel cards that do not necessarily charge foreign transaction fees, but require the customer to load up the card with foreign currency at a specified exchange rate. This gives the customer certainty in the cost of foreign transactions.

Foreign transaction fees can be difficult for consumers to respond to. Consumers generally do not see these fees upfront at the time the transaction takes place, rather they show up on the card statement after they make the purchase.

One option to improve transparency is to more clearly communicate foreign transaction fees to consumers upfront at the time they are searching and applying for a new credit or debit card. Another option could be to communicate foreign transaction fees to consumers at the time an overseas purchase is made. For example, when making an overseas purchase the customer could be told that the transaction will attract a 3% foreign transaction fee, and then accept or decline the transaction — perhaps opting to use an alternative payment method. This latter option reflects the PSB's 2009 reforms to ATM fees (box 17.2).

At face value, overseas merchants may offer customers the ability to use 'dynamic currency conversion' (DCC). DCC lets customers make overseas card payments in Australian dollars at a fixed exchange rate, giving them clarity over how much they will be charged before they make the purchase. However, the DCC exchange rate is usually set by the overseas merchant or financial institution and can include a significant exchange rate markup compared to the international card schemes. On top of that, DCC fees can be as high as 10% of the transaction value (Bradney-George 2016; Ryan and Hurwood 2016). Finally, DCC may not actually avoid the foreign transaction fee charged by the customer's financial institution.

International money transfers

When Australians make international money transfers, they usually pay foreign transaction fees and exchange rate markups. Each financial institution tends to offer customers a different exchange rate that changes throughout the day. This alone makes it difficult for consumers to compare exchange rates. However, it can be even more difficult when customers try to compare exchange rate markups and foreign transaction fees across multiple institutions. Further, people may not realise that they can be charged both types of fees. A survey commissioned by TransferWise (sub. DR58) estimated that only one in five people understand that they may pay an upfront fee and an exchange rate markup on international money transfers.

While financial institutions are free to set their own prices on foreign exchange, it is clear that consumers struggle to understand and compare the different types of prices charged. If consumers do not respond to price signals, it affects competition in foreign transactions.

One option to improve transparency of international money transfers is to give consumers a benchmark exchange rate to compare the rate offered by their financial institution, such as the RBA mid-market exchange rate. Financial institutions could be required to clearly disclose the dollar cost of their exchange rate markup compared to this benchmark rate. A behavioural experiment conducted in the United Kingdom found that if suppliers present information in a standardised way, consumers make significantly better decisions when presented with a benchmark exchange rate and the exchange rate markup is expressed in dollar terms (BIT 2018). In the Philippines, banks are required to disclose all fees for remittance services, including a benchmark exchange rate, and the European Commission is developing similar regulations (BSP 2017; European Commission 2018).

Review transparency of fees on foreign transactions

There is evidence of price-based competition in overseas purchases and international money transfers coming from foreign banks and new entrants. Some institutions, such as ING, Citibank and 28 Degrees, offer specialised prepaid, debit or credit cards that do not charge a foreign transaction fee per transaction (Cabral 2018; Liu 2018). Others, such as TransferWise (sub. DR58), provide international money transfers at (or close to) the mid-market rate and just charge a foreign transaction fee.

The Commission considers that it will be important to monitor the impacts of recent competition in fees for overseas payments. The ACCC, in consultation with the Australian Securities and Investments Commission (ASIC), should investigate the use of a benchmark rate to improve transparency of international money transfers and determine whether additional disclosure methods, including lessons from behavioural economics, could be used to improve consumer understanding and comparison of foreign exchange fees, including those paid on overseas purchases.

RECOMMENDATION 17.4 REVIEW TRANSPARENCY OF FEES ON FOREIGN TRANSACTIONS

By end-2019, the ACCC, in consultation with ASIC, should investigate what additional disclosure methods could be used to improve consumer understanding and comparison of fees for foreign transactions levied by authorised deposit-taking institutions and other payment providers.

This should include determining the feasibility of using benchmark exchange rates to improve transparency of international money transfers, as well as measures to improve transparency for fees on overseas purchases.

17.3 Barriers to innovation can stem from regulation

Innovations can encourage consumers to use lower-cost payment methods if they are more easily substitutable for higher-cost methods. For example, new features made available by the NPP may mean consumers switch some of their card payments to potentially lower-cost bank transfers (section 17.4), and in the future, merchants can use Open Banking to find a better deal on merchant services. However, innovation in payments can also encounter barriers as a result of inconsistent regulation. Examples include the regulation of purchased payment facilities and the ePayments Code.

The rise of purchased payment facilities can threaten incumbents

Some digital wallets, such as PayPal, have developed purchased payment facilities (PPFs) which compete with traditional payment methods, such as cards and bank transfers.

A PPF is similar in functionality to a deposit at a bank. Users can store value in the PPF by loading up funds from an existing bank account and, in some cases, receiving funds from other users of the PPF. Depending on the type of PPF, funds can be used to make payments to other users, withdrawn to an existing bank account, or stored as a gift card which can be used to make purchases from the provider. The main difference between a PPF and traditional deposits is that the PPF is a closed-loop system — users can generally only transfer deposits to other users *within* the system (RBA 2014a).

PPFs have grown rapidly around the world. For example, digital wallets such as Alipay (520 million users) and PayPal (210 million) have grown their user base (Alipay 2017; PayPal 2017). In Australia, PayPal has over 6 million active customer accounts.

There is potential for PPFs to pose a significant threat to other payment methods in Australia. For example, customers may choose to purchase a product online using their PayPal balance as an alternative to using a linked credit card or bank account. And with the introduction of the NPP, it will potentially be faster for people to reload their PPF from a bank account.

More flexible and clear regulation can encourage entry and growth

PPFs face complex and potentially stunting regulation that can deter entry and expansion.

If PPFs are widely available and redeemable upon demand for Australian currency, such as PayPal's stored balance, they are considered a banking business and subject to prudential regulation by the Australian Prudential Regulation Authority (APRA) (*Banking Regulations 2016*). APRA regulates PPFs as limited ADIs: they can take deposits, but cannot pay interest on them. PPFs have strict liquidity requirements compared to traditional ADIs, having to hold high-quality liquid assets of equal value to their stored-value liabilities (Murray et al. 2014a).

At the same time, PPFs must hold a specified level of Tier 1 capital: the greater of a minimum value of start-up capital set by APRA, or 5% of its total outstanding stored liabilities (APRA 2005). For example, the minimum start-up capital for PayPal was set at $5 million (APRA 2006). However, it is unclear how APRA determines this minimum level. If set too high, this minimum could deter entry of new PPFs that wish to become an ADI. Further, PPFs must meet many of the same standards as traditional ADIs, such as governance standards, despite their 100% liquidity requirement, imposing significant compliance costs.

If PPFs are not widely available or not redeemable for Australian currency, they fall under the jurisdiction of the PSB. The PSB can exempt PPFs from regulation (RBA 2015c). Exemptions apply to general loyalty schemes, gift card facilities, electronic road toll devices and pre-paid mobile phone accounts. In addition, any PPF is exempt if its total obligations do not exceed $10 million, it is used by 50 people or fewer, or is guaranteed by an ADI or government authority. As a result of these exemptions, the PSB does not regulate any PPFs. PPFs originating from overseas, such as Alipay and WeChat, where the stored value is held overseas, are generally not regulated in Australia.

The Murray Financial System Inquiry (Murray FSI) suggested that APRA's PPF regime involves significant compliance costs and creates perverse incentives (Murray et al. 2014a). PPFs with a 100% liquidity requirement could find it difficult to compete with other ADIs, creating an incentive to limit their growth to avoid entering APRA's PPF regime. The Murray FSI proposed that APRA replace its current single-tier regime with two tiers.

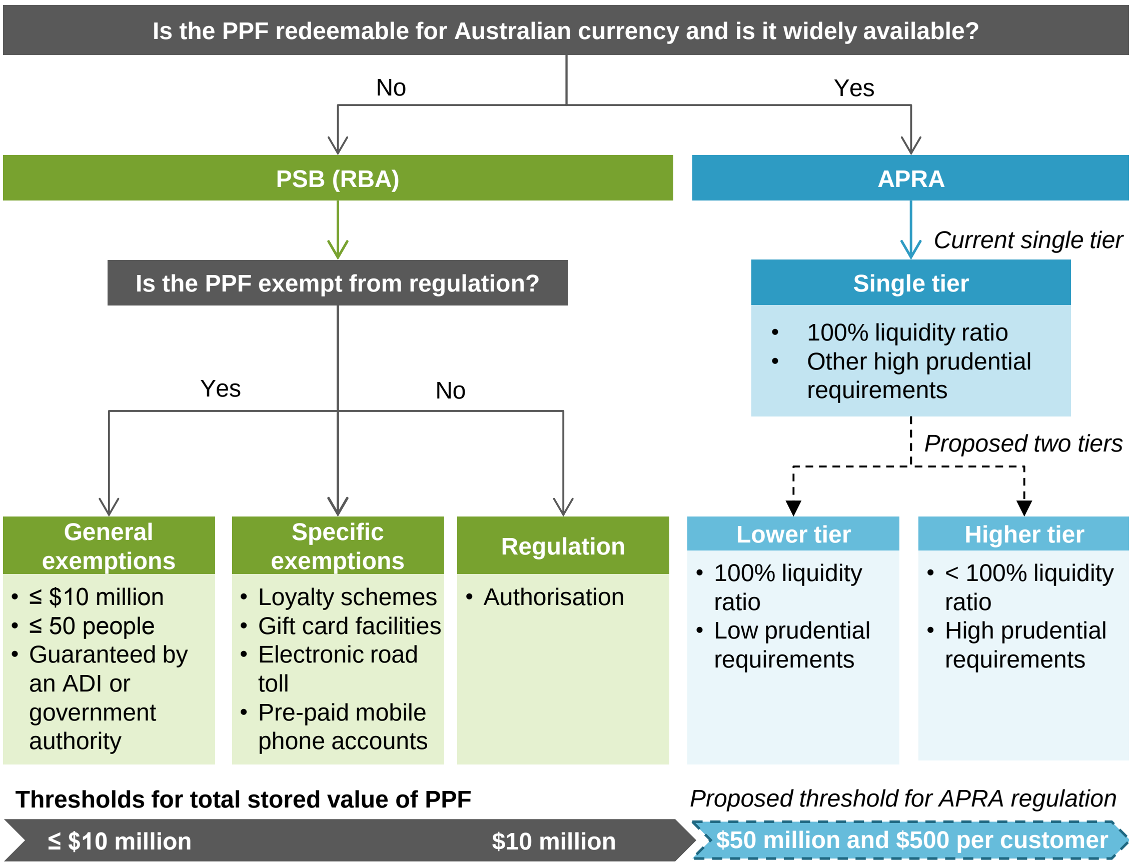
- The lower tier would maintain the current 100% liquidity ratio requirement but reduce other prudential requirements to lower compliance costs.
- The higher tier would reduce liquidity requirements but strengthen other prudential requirements. Lower liquidity requirements would ensure competitive neutrality between PPFs and other ADI service providers. (Murray et al. 2014a, p. 162)

This approach would give PPFs the opportunity to better manage their compliance costs and prudential requirements. In addition, the Murray FSI proposed that APRA should publish clear thresholds, so that it only captures PPFs of sufficient scale — for example, PPFs that hold more than $50 million in stored value and let individual customers hold more than $1000.

We consider there is merit in a review of PPF regulation, including implementation of a tiered regime for prudential regulation of PPFs. This is likely to encourage potential new entrants and reduce barriers for small PPFs to grow. A review could also consider giving PPFs the chance to prove themselves while keeping at-risk funds relatively low. For example, while the Murray FSI recommended freeing-up entities with less than $50 million in stored value and individual customer deposits below $1000, a lower customer threshold (say $500 per customer) would reduce the risks.

Under a revised approach, PPFs with stored value below $10 million would remain exempt from both PSB and APRA regulation (figure 17.10). PPFs with stored value between $10 million to $50 million would be regulated by the PSB or otherwise exempt. And PPFs with stored value above $50 million and individual customer deposits above $500 would fall under APRA's regulation and choose to comply with either the lower or higher tier of prudential regulation.

Figure 17.10 **Reduced regulatory barriers for purchased payment facilities**



In its response to the Murray FSI, the Australian Government (2015) agreed with a clearer graduated regulatory regime in principle and stated that APRA, the RBA and ASIC will review the framework for regulation and develop clear guidance. In 2015, we also broadly supported changes along the lines recommended by the Murray FSI (PC 2015b). And again, the Australian Government committed to a review (The Treasury 2017b). However, there has been little progress to date.

Both APRA (sub. DR116) and the RBA (sub. DR82) noted that they are open to a review of the regulation of PPFs and that they have already held preliminary discussions with each other as well as ASIC and Treasury. However, the RBA suggested that this would require significant consultation with stakeholders and APRA noted that given its current priorities, it is unlikely to feasibly introduce a new regime for PPFs by mid-2019.

In March 2018, the Council of Financial Regulators (CFR) 'endorsed the establishment of a working group to consider regulatory perimeter issues related to stored value payment systems' (RBA 2018d). The CFR should review, consult on and re-design regulation of PPFs to encourage entry and expansion, with regard to necessary safeguards to protect consumer funds. This would involve simplifying and clarifying regulation of PPFs at all stages of their development, including a tiered structure for PPFs, with one tier that does not attract prudential regulation. The review should be completed by end-2018 and implemented by mid-2019.

RECOMMENDATION 17.5 REVIEW REGULATION OF PURCHASED PAYMENT FACILITIES

The Council of Financial Regulators should review the current regulation of Purchased Payment Facilities (PPFs).

The review should develop an approach to simplify the regime, develop clear thresholds for regulatory responsibility and reduce barriers to growth in this sector. The review should consult on and design a tiered regulatory structure for PPFs, including one tier that does not attract prudential regulation.

The review should be completed by end-2018 at the latest and provide a path forward for regulators by mid-2019.

Updating the ePayments Code could promote consumer protection

ASIC (2017n) administers the ePayments Code, which places requirements on financial institutions that make electronic payments in order to provide basic protections for consumers. The code requires subscribers to give consumers certain terms and conditions, sets out the rules for who pays for unauthorised transactions, establishes a regime for recovering mistaken payments and requires internal dispute resolution.

The code is voluntary, though most electronic payment providers subscribe (ASIC 2017n). In 2015, the Australian Government (2015) committed to mandating the code to act as minimum standards for consumer protection. However, there has been no progress to date.

There was broad support from stakeholders for mandating the code (for example, ANZ, sub. DR74; CBA, sub. DR79; CHOICE, sub. DR97; CALC, sub. DR130). ASIC (sub. DR123) supported mandating the code, but noted that it would require the Australian Government to give it the power to do so. Some submissions also suggested that the code should be reviewed regularly and needs to be updated to deal with developments in technology and new business models (ABA, sub. DR119; AusPayNet, sub. DR75; Cuscal, sub. DR98; Fintech Australia, sub. DR111).

We consider that mandating the code for all entities involved in electronic payments may create an unnecessary barrier to entry. A less restrictive method may be to mandate the code for any organisation that *sends or receives* electronic payments. Thus, entities that want to *monitor* electronic payments would not face this barrier. For example, many mobile apps, such as Pocketbook (2017) and MoneySoft (2017), offer expense tracking and budgeting tools that rely on 'read access' to bank account information.

That said, entities that want to monitor accounts currently rely on the same bank account details as those that want to send or receive electronic payments, yet they would not be required to subscribe to the code. Providing clarity in the code around which party is liable for unauthorised transactions can go some way to alleviating concerns that customers of entities that monitor (not initiate) payments may be left without remedies.

Lack of clarity in the code affects fintechs and their customers

Liability for unauthorised transactions remains unclear under the current code. Typically, if a consumer wants to allow a third party, such as an account aggregator, to access their financial data, they can give the third party their bank login details, including their passcode. Many aggregators (or other third parties) use these details to access their customers' banking data using 'screen scraping' technology to pull data from the bank's customer interface.

Presently under the code, unless the consumer's financial institution expressly or implicitly endorses the third party, the consumer may be liable for any losses from unauthorised transactions — the consumer may be at fault for handing their login details to a third party which is not endorsed. ASIC is aware of the issue, but has not changed the code.

> There is uncertainty amongst consumers and industry about how liability provisions of the ePayments Code relating to account aggregators are to be interpreted. While ASIC has not yet formed a view about how the uncertainty regarding liability can or should be resolved, provided security concerns can be addressed, consumers should not be disadvantaged by their use of legitimate account aggregation services. (ASIC 2016i, p. 3)

CHOICE suggested that this uncertainty creates a barrier for third-party providers, such as fintechs, because incumbent financial institutions are unlikely to endorse their competitors.

> Currently, consumers may not receive protections under the ePayments Code if they share their banking details with services that their bank does not endorse. Banks are unlikely to endorse third-party services that introduce greater competition into the credit card or other aspects of the personal banking market. (CHOICE, sub. 42, p. 18)

There may be other reasons why institutions would be unwilling to endorse a third party — primarily security. Banks have indicated that they are unwilling to be liable for losses if they believe the third party is at risk of a data breach. For example, CBA (2016) stated:

> Some websites or smartphone apps may offer services where they ask for your NetBank client ID and password. We always recommend you only enter these into the CommBank website or CommBank app … Commonwealth Bank offers customers a 100% security guarantee against online fraud where our customer is not at fault and has taken steps to protect their client ID and password. We may not be able to provide this guarantee if customers share those details …

It can be difficult to determine whether a bank (or similar institution) has refused to endorse a third party for security or anticompetitive reasons. In some cases it may be both. However, incumbents should not be in a position to create barriers for competitors. There may be several ways to achieve a more competitive outcome.

Can Open Banking solve the problem of safe competition in electronic transfers?

Open Banking reforms now underway could provide a standard method for banks to share a customer's data, at the customer's discretion (chapter 5). This would make the need for customers to share their bank account details redundant, thus eliminating the need for customers to take on liability for unauthorised transactions.

> Over time, the ability to share customers' banking data in a more seamless and secure way through Open Banking should reduce the need for customers to compromise their security and privacy by disclosing their login credentials. (Farrell 2017, p. 52)

Some stakeholders suggested that Open Banking could be relied upon as a more secure way to share data and possibly eliminate the practice of screen scraping, thus making the issue redundant (ABA, sub. DR119; ASBFEO, sub. DR101; AusPayNet, sub. DR75).

However, there are two key problems with relying on the Open Banking regime to improve competition in electronic payments in the near future.

First, Open Banking will (initially at least) be focused on read-only access. The Farrell Review into Open Banking did not consider 'write access' — the ability for third parties to initiate payments on a customer's behalf — within its initial scope. The review considered it premature to implement write access before Open Banking was 'fully bedded down' given the risks involved in giving third parties the ability to make payments (Farrell 2017, p. 109).

Given the security concerns, this is an understandable limitation of Open Banking at this point in time. But this will not persist for too long, lest other work-arounds start to dominate. Lack of write access is likely to delay the benefits of Open Banking for electronic payments competition — particularly as it will not be able to eliminate the current problem of customers handing over their bank details to third parties. For example, customers of the Raiz (2018) app can provide their bank login details to have small amounts of money automatically transferred to an investment portfolio. Write access can create further opportunities for fintechs and other businesses to innovate, for example, the ability for a third party to actively monitor and move a customer's funds between bank accounts that offer superior savings rates. Write access is an important component of the UK's Open Banking reforms and the European Union's Payment Service Directive 2 (PSD2) reforms.

Second, the timeline for implementing Open Banking is long, given the enormity of the undertaking. The Australian Government agreed to the recommendations in the Farrell Review and decided that all major banks will begin phasing in Open Banking from mid-2019 and make available data on all products by mid-2020 (The Treasury 2018a). All other banks are given an extra year to comply. The Farrell Review recommended that this be formally evaluated one year after it begins, including a review of the potential for future write access. Therefore, under an optimistic assumption that it could take another year before write access begins, Open Banking is unlikely to begin to make screen scraping redundant until 2021 at the earliest.

The ePayments Code should be updated

Liability under the ePayments Code needs a stronger solution at present which Open Banking cannot yet supply (but is likely to do so in the future).

For the next few years, as an interim measure a balance in the liability between the code institution and the third party could be established to apply under specific circumstances. For example, if a customer wants to give a third party access to their finances, the code institution would be obliged to give the third party a unique set of details to access the customer's account. This would be similar to a joint bank account. Then, in the case of an unauthorised transaction, the code institution can prove whether the unauthorised transaction — and therefore, liability — is attributable to the customer or the third party. In this case, the customer would no longer need to hand over their personal login details. This type of arrangement was identified by the Farrell Review (2017) as a short-term bridging solution until Open Banking is developed.

This method of sharing liability need not merely be a short-term solution while the industry waits in hope that Open Banking makes screen scraping redundant. The Farrell Review even noted that the persisting threat of screen scraping provides a viable alternative that can impose an important discipline on Open Banking to become a superior service.

> This Review does not make any recommendation that the Government should endorse screenscraping. However, banning it would remove an important market-based check on the design of Open Banking. (Farrell 2017, p. 84)

Thus, the ePayments Code should be amended such that, at the customer's direction, the code institution would be required to give a third party unique access details to the customer's account. And, that the third party would take on the liability of unauthorised transactions that use their unique access details. In this case, if a third party with read-only access is not also a code institution (voluntarily), it would be necessary for that party to accept liability for unauthorised transactions using their unique access details and be subject to a dispute resolution scheme, such as the Australian Financial Complaints Authority. Whereas third parties with write access would be required to subscribe to the code and its associated dispute resolution arrangements. Further, the code institution can provide separate details for third parties that rely on read access or write access permissions. Shared liability for unauthorised transactions is similar to new payment regulations (PSD2) that are being implemented in Europe (Payments UK 2016).

RECOMMENDATION 17.6 UPDATING AND MANDATING THE EPAYMENTS CODE

The Australian Government should give ASIC the power, by end-2018, to make the ePayments Code mandatory for any organisation that sends or receives electronic payments.

ASIC should review the ePayments Code and update it to reflect changes in technology, innovative business models and developments in Open Banking. ASIC should more clearly define the liability provisions for unauthorised transactions when third parties are involved, including participation in financial dispute resolution schemes.

ASIC should update the ePayments Code by end-2019 and commit to 3-yearly reviews.

17.4 The New Payments Platform

In 2018, participants in the payments system began implementing the New Payments Platform (NPP), which is introducing new, innovative functionalities in bank transfers. The origins of the NPP stem from a 2012 review by the PSB which identified a set of desirable features for the payments system, such as real-time settlement of bank transfers (RBA 2012d). In response, the payments industry developed the NPP to deliver some of these features, including:

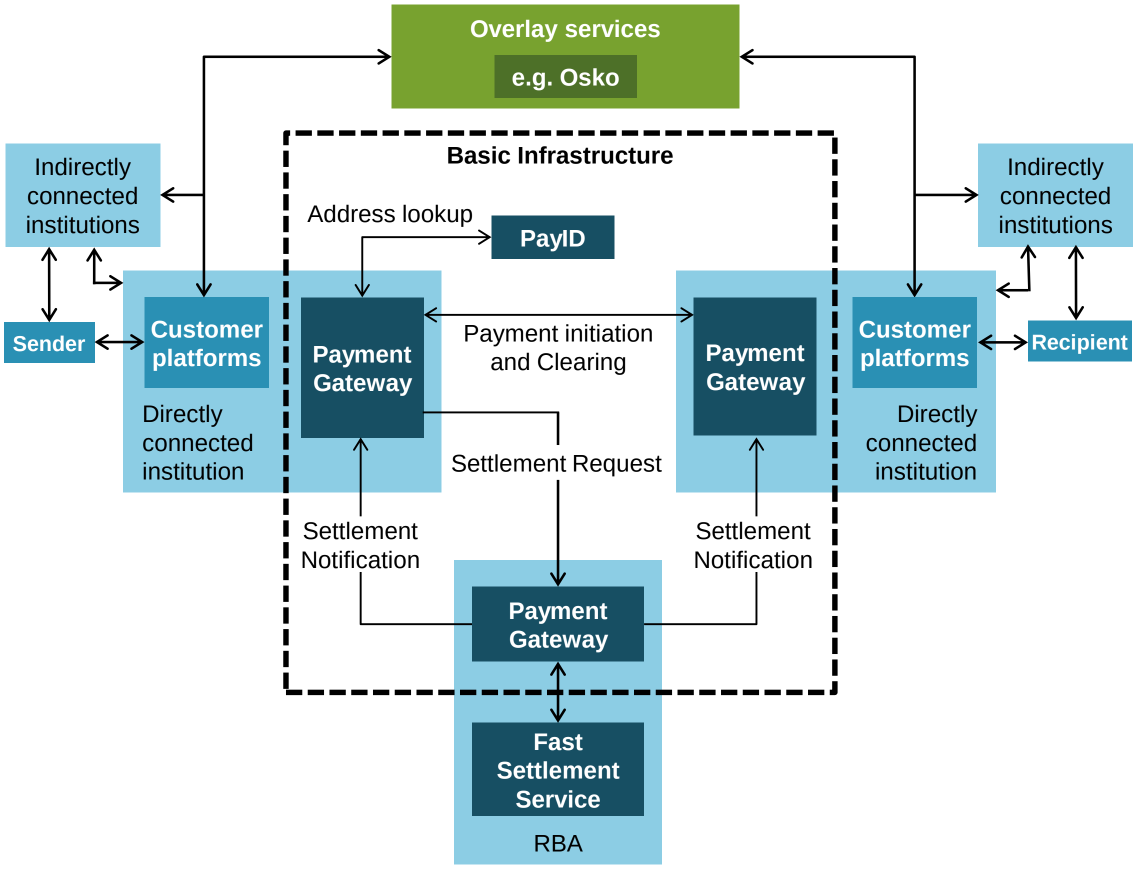
- near real-time settlement, available 24/7
- easy-to-remember banking address for users — the ability to pay someone using a simple alias, such as a phone number or email (called ‘PayID’)
- richer payment information. (NPPA 2017f)

The NPP was set up, and is mutually owned, by 13 initial shareholder participants (including the RBA). The major banks are all common shareholders of the NPP, BPAY and eftpos. NPP Australia Limited (NPPA) is the governing body that operates the NPP. Although the NPP became operational in February 2018, some participants have been slow to roll out NPP services to customers (NPPA, sub. DR122).

The NPP is made up of two components: the basic infrastructure consists of hardware and software protocols; and overlay services that provide the rules and applications for the user experience (figure 17.11).

Making bank transfers using the NPP involves sending payment messages between participating financial institutions and near real-time settlement using the RBA's Fast Settlement Service. Financial institutions can connect directly to the basic infrastructure through an NPP payment gateway, which acts like a node in the network. Other financial institutions can access the NPP indirectly by entering a commercial agreement with a direct participant (table 17.2).

Figure 17.11 **A schema of the New Payments Platform**



Source: Adapted from NPPA (2017c)

Table 17.2 **Different ways institutions can participate in the NPP**

Parties	*Clearing and settlement*	*NPP payment gateway*	*NPPA shareholder*
Direct Participant[a]	direct	own	yes
Indirect Participant[b]	direct	indirect	yes
Identified Institution[c]	indirect	indirect	no
Connected Institution[d]	none	own	no
Overlay Service Provider	none	none	no

[a] Can also act as a 'sponsoring participant' that connects other financial institutions to the NPP. [b] Connects via a Direct Participant using an outsourcing arrangement. [c] Relies on a sponsoring participant to clear and settle payments on their behalf. This is expected to be used by smaller financial institutions that may not find it financially viable to invest in the infrastructure themselves. [d] Connects directly through their own NPP payment gateway to send payment initiation or other non-value messages. May involve organisations that make a large volume of payments or provide an overlay service.

Source: NPPA (2017c, 2017e, pers. comm., 25 July 2017)

Overlay services are customer-facing services that sit on top of the basic infrastructure and provide a tailored or other value-adding service to the NPP. Financial institutions that participate in the NPP can subscribe to overlay services in order to provide these services to customers. Overlay service providers do not have to connect to the basic infrastructure to operate, but may choose to, if for example, it optimises service delivery.

In essence, overlay services are a set of rules for subscribing financial institutions to follow when making payments through the basic infrastructure. They provide a platform for participants and fintechs to innovate. Examples of overlay services include mobile applications that help people budget or switch to new products. BPAY operates the first overlay service provided on the NPP, named Osko. Osko is a platform that is built into most financial institutions' internet banking platforms (BPAY 2017c). People or businesses can use Osko to make payments — like they would BPAY or 'Pay Anyone' payments — using the functionality of the NPP's basic infrastructure, such as near real-time payments using PayID.

The NPP runs alongside the current (delayed settlement) bank transfer system, but is widely expected to replace it eventually as more and more consumers opt to use its benefits. Therefore, the major banks can be expected to retain their dominance in the market for bank transfers. NAB (sub. DR94) stated that in the first three weeks of operation, NAB customers received about 100 000 payments and sent almost 400 000 payments. Further, the NPP facilitates use of, but also competes directly with, card schemes, such as MasterCard, Visa and eftpos. As new and innovative overlay services are developed, customers may prefer to move some of their payments from cards to directly using the NPP instead.

Near real-time settlement is likely to benefit customers. The current batch settlement system can result in significant delays between the day when a payment is initiated by the sender and settlement actually occurs (RBA 2017b). This might result in significant costs to consumers in interest forgone, but even in a low interest environment, it is likely to provide a windfall return to financial institutions while funds are 'in transit' (box 17.5). It reduces liquidity and the efficiency of the economy as funds in transit are not available to either the payer or the recipient for other uses. It also limits the type of transactions that can be carried out using bank transfers, leading customers to choose more costly alternatives, creating a loss for the entire economy.

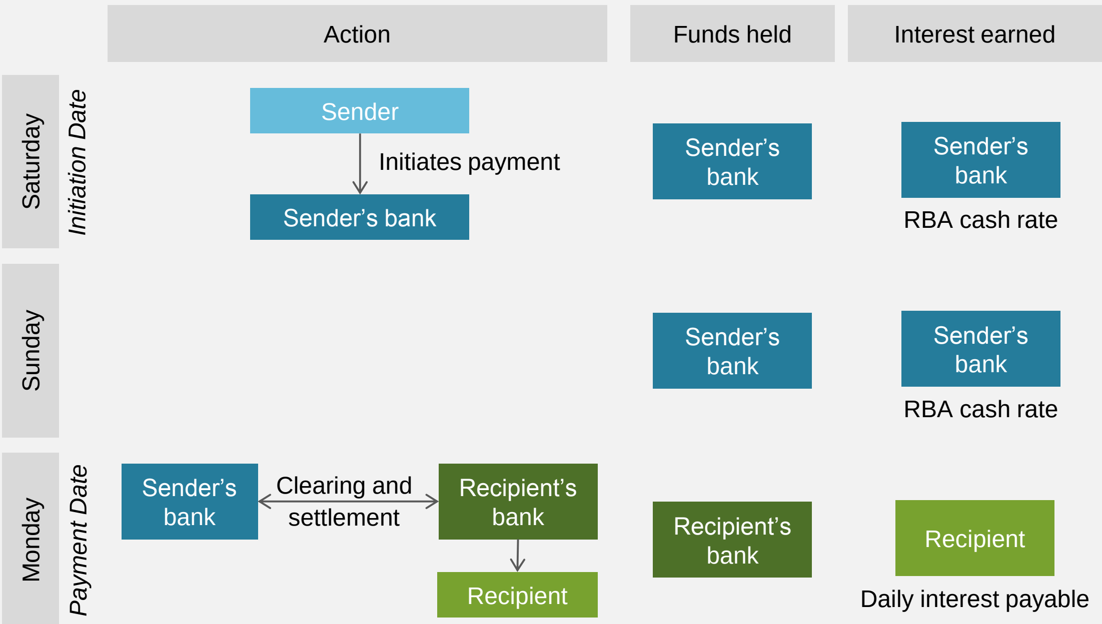
Box 17.5 What happens to bank transfers over the weekend?

Assume you make a bank transfer on Saturday — the 'initiation date'. Most financial institutions tend to calculate daily interest for a customer's account based on the closing account balance at the end of the day. Therefore, you forfeit the daily interest attributable to the transfer amount. Then, the general practice is for financial institutions to lodge the clearing and settlement instructions on the next available business day, being the following Monday — the 'payment date'. Once the payment is settled on Monday, the recipient receives the funds, and daily interest is payable on the transferred amount.

In its submission, AusPayNet (sub. DR75) stated that banks give the payer the benefit of any interest until the agreed payment date and the recipient gets the benefit of interest from that date forward — this position was based on their understanding of the practice of Australian banks (AusPayNet, pers. comm., 20 April 2018).

But there is no regulatory obligation on the sender or recipient's institution to provide interest to the funds sender or recipient from the initiation date. We were advised that this is a matter for the terms and conditions of individual products at each financial institution. This process can end up costing the sender and/or recipient in interest forgone on the transfer and result in a windfall gain for the financial institution — the sender's institution can still earn interest on these funds, for example in short-term money markets at a rate akin to the cash rate. We estimate that while this gain to financial institutions is likely to be small, the loss to some consumers may be significant.

An illustrative example of bank transfers over the weekend



By removing the delay in settlements, customers using the NPP will receive any interest earned on transfers immediately. Further, removing the lag between clearing and settlement eliminates the risk that payments are initially cleared but unable to be settled. It increases the range of transactions that can be paid for using bank transfers and increases the efficiency of the payments system. It will reduce banks' revenue from the interest on funds in transit. It is unclear how or whether financial institutions may recoup this source of revenue. Accordingly, we consider there may be a case to monitor fees charged under the NPP. The removal of any past earnings from inefficiency and delay does not create a case to restore profit margins.

New entrants should not be unduly restricted from access to the NPP

The NPP is expected to reduce technical barriers for new institutions to enter the payments system. New entrants can join the network using one single connection, rather than establishing bilateral links with all of the existing participants (Richards 2014). Institutions can also choose to join the network using an outsourcing arrangement to a participant who is already connected.

The NPP Regulations govern the rules of access and participation in the NPP. New entrants must meet eligibility and technical requirements to participate. They must also pay fees for accessing the infrastructure, including application fees, upfront fees and transaction fees.

In our Draft Report, we expressed concern that participants of the NPP may be subject to conflicts of interest that could create barriers for new entrants to access the NPP. It is ultimately up to the Board of the NPPA, largely made up of directors representing incumbent participants, to determine whether or not to accept a new applicant (NPPA 2017e). At launch, the NPPA Board was made up of 11 voting members, the majority of which are incumbent banks.[123]

A model that requires new competitors to be accepted by incumbents can reasonably be expected to involve conflicts of interest: incumbent banks have an incentive to unduly restrict new entrants from access to the NPP. Yet, at launch, the NPP is not subject to a formal access regime imposed by the PSB or an access undertaking accepted by the ACCC.

An access regime (or undertaking) can facilitate third party access to services provided by significant infrastructure facilities with natural monopoly characteristics. Access regimes are rarely used, but where they are, it is generally for a good reason: they are enforceable by the regulator and the asset involved is of national economic significance. Variations of access regimes currently apply in a range of industries such as rail, wheat export, telecommunications and energy (ACCC 2013c). The PSB has also imposed access regimes on MasterCard and Visa schemes in the payments system (appendix B).

In 2017, the ACCC authorised potentially anticompetitive provisions in the NPP Regulations — the suspension and termination provisions of the NPP regulations for 5 years and the eligibility criteria and settlement obligations in perpetuity. While the ACCC (sub. DR129) considered the issue of access to the NPP, it ultimately decided that the eligibility criteria and settlement

[123] At launch, Board members include an independent chair, a second independent director, the CEO of NPPA (non-voting director), and representatives of the RBA, major banks, Bendigo and Adelaide bank, CitiBank, Cuscal and ING Direct (NPPA 2017d).

obligations were not unduly restrictive. However, concerns about the potential for conflicts of interest were also raised during the ACCC's consultation processes, though no concerns have been raised with the ACCC since final authorisation was given (ACCC 2017b; sub. DR129).

In our Draft Report, we recommended that the PSB should impose an access regime on the NPP to facilitate third-party access. An access regime ensures third parties are treated fairly when applying to access the NPP. Further, an access regime can be arranged to protect the intellectual property of a potential applicant, such as an overlay service provider.

Several stakeholders supported an access regime for the NPP (Ai Group, sub. DR127; ASBFEO, sub. DR101; Fintech Australia, sub. DR111; NSX, sub. DR103; TransferWise, sub. DR58; Xinja, sub. DR67). In a sample of Australian fintechs, over 80% were unconvinced about the ease of access to the NPP and believed there should be more transparent access points for fintechs to connect (EY 2017a).

The NPPA (sub. DR122) disagreed with the need for an access regime, stating that the NPP was designed to support fair and open access and has structured its governance arrangements to avoid and manage potential conflicts of interest in four key ways.

First, the NPPA stated that the eligibility criteria for new applicants are clear, transparent and risk-based. While some of the authority to progress applications is delegated to management, we remain concerned that the final decision rests with the potentially conflicted parties — the members of the NPPA Board. Further, an unsuccessful applicant can appeal the board's decision, but the review is undertaken by a sub-committee of the board, not an independent reviewer. We remain concerned that rejected applicants may not have the opportunity for their application to be independently reviewed. One of the key benefits of an access regime is that those unfairly denied access can ask the PSB to enforce its regime.

Second, one of the NPPA's constitutional objectives is 'facilitating fair access to the NPP as mutually owned utility infrastructure' (NPPA 2016, p. 5). The NPPA notes that this obliges it to balance fair access with system safety, reliability and efficiency. This is a worthy objective. However, it can be difficult at times to discern whether an application is denied on the basis of system stability or competition. Again, the opportunity for independent review would allay concerns that applicants are denied because they are a competitive threat.

Third, the NPPA (sub. DR122, p. 9) and some of its initial members (ANZ, sub. DR74 and Cuscal, sub. DR98) suggested that there is a commercial incentive to encourage participation in the NPP.

> It is in NPPA's commercial interest to maximise volumes across the platform in order to keep the wholesale transaction fee low enough to be competitive with alternative payment methods.

However, this incentive is unlikely to hold much sway when it comes to approving small new entrants that present a material competitive threat to incumbents in other product markets. Those already connected to the NPP, including the major banks, make up the vast majority of payments in Australia. And growth in NPP transactions is mainly expected to come from a shift of existing bank transfers, again dominated by the same players, to the NPP.

Finally, the NPPA stated that the RBA has a standing right to appoint a director to the NPPA Board. This gives the RBA oversight of board deliberations and broader operations of the NPP. Moreover, if there are any doubts around access, the RBA could then argue to impose an access regime at that time.

Several shareholding members of the NPP also believe that given it just launched in early 2018, it is too early to impose an access regime on the NPP and that the PSB should assess the need for an access regime in light of any specific issues that arise (ANZ, sub. DR74; CBA, sub. DR79; Cuscal, sub. DR98; NAB, sub. DR94). Indeed, the RBA (sub. DR82, p. 9) has taken a wait-and-see approach to access regulation for the NPP.

> The Bank considers that it is appropriate to allow this system to mature and assess if there are genuine access difficulties once new players submit concrete proposals for entry. At that point, if there are material access and public interest issues, the Bank would consider designating the NPP and imposing an access regime. This approach is consistent with the requirement of the *Payment Systems (Regulation) Act 1998* that the PSB must explicitly consider the public interest before taking such steps, as opposed to situations – for example, in parts of the telecommunication industry – where legislation requires the regulator to impose an access regime.

We agree that active monitoring will be essential. The principal query with this caution is whether monitoring will observe innovation discouraged. As the banking system itself is heavily constrained by the presence of market power, it is likely that innovation using major technology shifts such as the NPP represents the most likely source of future competition.

The Commission considers this is precisely the time when an access regime would be most useful. Potentially limiting early access on this new advanced platform may mean incumbents can cement their dominant position on the platform and in the broader market, making it more difficult for innovative new entrants to compete down the track.

The NPP is a significant piece of national infrastructure and more transparency and regulation around the process for access is needed to avoid conflicts of interest unduly restricting competition. It is particularly important to ensure there are avenues for new entrants to access the NPP without relying on their potential competitors.

Broadening access to the NPP for specialist payment providers

Among support for an access regime were some suggestions on how such a regime could be used to further improve access to the NPP and increase competition overall.

Under the NPP Regulations, an entity must be an ADI in order to connect directly to the NPP (NPPA 2017e). TransferWise (sub. DR58) suggested the requirement to be an ADI to connect to the NPP, creates a financial barrier to entry and should be removed.

To practically participate in the NPP, an entity would only technically need an Exchange Settlement Account (ESA) held with the RBA. The RBA does not require that an institution holds an ADI licence to operate an ESA. Yet, the requirement under the NPP Regulations to be an ADI means that ESA holders that are not ADIs are unable to connect directly to the NPP. Under the current bank transfer system, a qualified ESA holder can participate without the need to be an ADI (APCA 2017a). Payment providers do not necessarily need to hold customer deposits in order to operate.

In addition to lowering barriers to entry, allowing ESA holders to access the NPP could mean payment providers are not reliant on their competitors to operate. In 2017, the Bank of England (2017, p. 1) changed its policies to allow non-bank payment providers to apply for a settlement account directly, reducing their dependence on competitors to access the payments system.

> These changes will enable non-bank [Payment Service Providers] to compete on a more level playing field with banks. In turn, reduced dependence on bank competitors for access to payment systems will allow non-bank [Payment Service Providers] to offer a wider range of payment services. These factors will all help to increase competition and innovation in the provision of payments services.

The NPPA (sub. DR122) noted that the requirements for being an ADI are more extensive than those for holding an ESA and that the NPPA relies on APRA's supervision of ADIs to ensure the integrity and stability of the platform. Further, those with a conditional ADI licence (such as PPFs) or a restricted ADI licence under APRA's new licensing regime are eligible to apply.

The Commission considers that even if the PSB persist in operating without an access regime for the NPP, it should allow qualified ESA holders to access the NPP, without the more onerous requirement to be an ADI. This can reduce new entrants' reliance on their competitors to access the NPP. The PSB should consider developing a new breed of 'specialist payment providers', like those in the United Kingdom. The PSB would likely need to more closely regulate and monitor these specialist payment providers to ensure they meet the operational and security requirements expected of an institution that wishes to take part in the NPP.

NPP transaction fees should be closely monitored by the PSB

There will be a range of fees covering the cost of various NPP processes.

- The NPPA will charge shareholder participants a fixed-dollar fee for every transaction processed. NPPA (2017c) have stated that these fees will be set on a cost-recovery basis.
- The RBA will charge a transaction fee capped at 1 cent, split between the sender and recipient's institution, to recoup settlement costs (RBA, pers. comm., 3 October 2017).
- There may also be a fee for using the PayID addressing service.

The NPPA (sub. DR122, pp. 1–9) also stated it 'does not expect to be profit-driven' and that 'there are no plans to pay dividends or repatriate capital'. These are worthy goals for a significant piece of national infrastructure such as the NPP, but the PSB should monitor developments to ensure the goals of this 'utility payments infrastructure' remain.

Given advice from the PSB and the NPPA, we expect that overall the transaction fees are likely to be low relative to other payment methods. Further, as the number of transactions through the NPP increases, the fee is likely to be lowered. That said, there is merit in the PSB reviewing the NPPA's methodology for setting transaction fees to determine whether they are set at a level that recovers costs, and if not, consider regulating transaction fees as part of its access regime.

If the cost to merchants in processing NPP payments is competitive with card schemes, this may even put downward pressure on card fees. However, not all institutions are directly connected to the NPP. Many, even some shareholder participants, rely on a directly-connected shareholder to process their payments. These institutions must come to a commercial agreement on price and service. Therefore, it is unclear how much these institutions, such as some acquirers, and subsequently merchants, will end up paying in transaction fees. As we have seen with card interchange fees (section 17.2), the ability to create tolls at points of interaction is very substantial in this industry. And once established, almost impossible to remove.

The Commission considers that the PSB should monitor and review the fees added on to NPP fees by participants of the NPP, as part of an effective access regime.

Access to NPP data can provide a competitive advantage

One of the NPP's benefits is the ability to send richer information with payments. The NPP uses a global standard for electronic data interchange between financial institutions (NPPA 2017a). Each payment generates basic data elements, such as the details of the parties involved. The standard also allows additional data to be carried with the payment message, such as text written by the sender (up to 280 characters, compared to 18 under the current system), links to externally hosted documents and data generated by overlay services (NPPA 2017b; RBA 2015a).

Data generated by the NPP can be valuable to gain insights into customer behaviour and spending patterns. Currently, different types of NPP institutions can access different data (table 17.3).

Table 17.3 **Data access under the New Payments Platform**

	NPP institution[a]	*Overlay service provider*	*NPPA*	*RBA*
Aggregated data[b]	✓	×	✓	✓
Aggregated data specific to NPP institution	✓	×	✓	✓
Aggregated data specific to overlay service	×	✓	✓	✓
Individual transaction data[c]	✓	×	×	✓
Individual transaction data using overlay service[c]	✓	×	×	✓

[a] Any NPP institution that is a subscriber (not provider) of an overlay service. [b] Refers to the aggregated de-identified traffic reports. [c] Sent through the NPP institution.

Source: NPPA (pers. comm., 14 August 2017)

Providers of overlay services have access to aggregated traffic reports of the payments made using their service. This means if an NPP institution is also a *provider* of an overlay service, they too have access to these reports for their overlay service. NPP institutions that are not overlay service providers (that is they merely *subscribe* to an overlay service) do not.

However, we have identified an issue whereby overlay service providers that are owned by NPP institutions have a competitive advantage in the level of data captured compared to overlay service providers that are not.

> Theoretically, an NPP Participant could become an overlay service provider of a new payment service, to which other financial institutions, NPP Participants and end users subscribe. If it did, it would be entitled to the same type and amount of de-identified aggregated data about its service as any other [overlay service provider] is entitled to access. The only additional data that such an NPP Participant would have is the transaction data generated by processing the transactions to which it is a party, that is for and on behalf of its own customers. It has this data whether it is also the Overlay Service Provider, or not. (NPPA, sub. DR122, p. 10)

This transaction data can be very valuable to provide insights into individual customer activity. Of course, new overlay service providers can attempt to contract a right to access these data as part of the terms and conditions of subscribing to the service. However, incumbent NPP institutions may then prefer to subscribe only to overlay services that do not require access to these data instead, as a way of maintaining exclusive data access.

This may have implications for competition. While we cannot be sure of the outcomes at this stage, we are confident that control of data is likely to be a serious competition issue in a digital future. Those entities with a fuller data picture that compete with those that do not may have a competitive advantage in providing their own overlay services. This might delay or deter new overlay service providers. To avoid the potential for these entities to hold a significant competitive advantage over new overlay service providers, we consider that *de-identified* transaction-level data that uses an overlay service should be shared with the overlay service provider. The PSB should include this requirement as part of an access regime for the NPP and consult with the ACCC on the final design of the data sharing obligations, having regard to any implications from impending Open Banking reforms.

If the NPP persists in operating without an access regime, the ACCC should take a close interest in both intellectual property and data sharing associated with this national asset.

RECOMMENDATION 17.7 ACCESS REGIME FOR THE NEW PAYMENTS PLATFORM

As a significant piece of national infrastructure for which the competition benefits hinge on widespread access of both financial system providers and consumers, the New Payments Platform (NPP) should be subject to an access regime imposed by the Payments System Board (PSB). As part of the regime, the PSB should:

- allow specialist payment providers that hold an Exchange Settlement Account to connect to the NPP without the need to be an authorised deposit-taking institution
- review the fees set by NPP institutions and transaction fees set by New Payments Platform Australia Limited
- require all NPP institutions that use an overlay service to share de-identified transaction-level data with the overlay service provider. The PSB should consult the ACCC on the final design of the data sharing obligations, having regard to impending Open Banking reforms.

The NPP could do more to improve customer switching

Switching behaviour is very useful to creating competitive markets at the retail level. But it is held back by — among other things (chapter 5) — the complexity of shifting regular payments that are attached to a bank account.

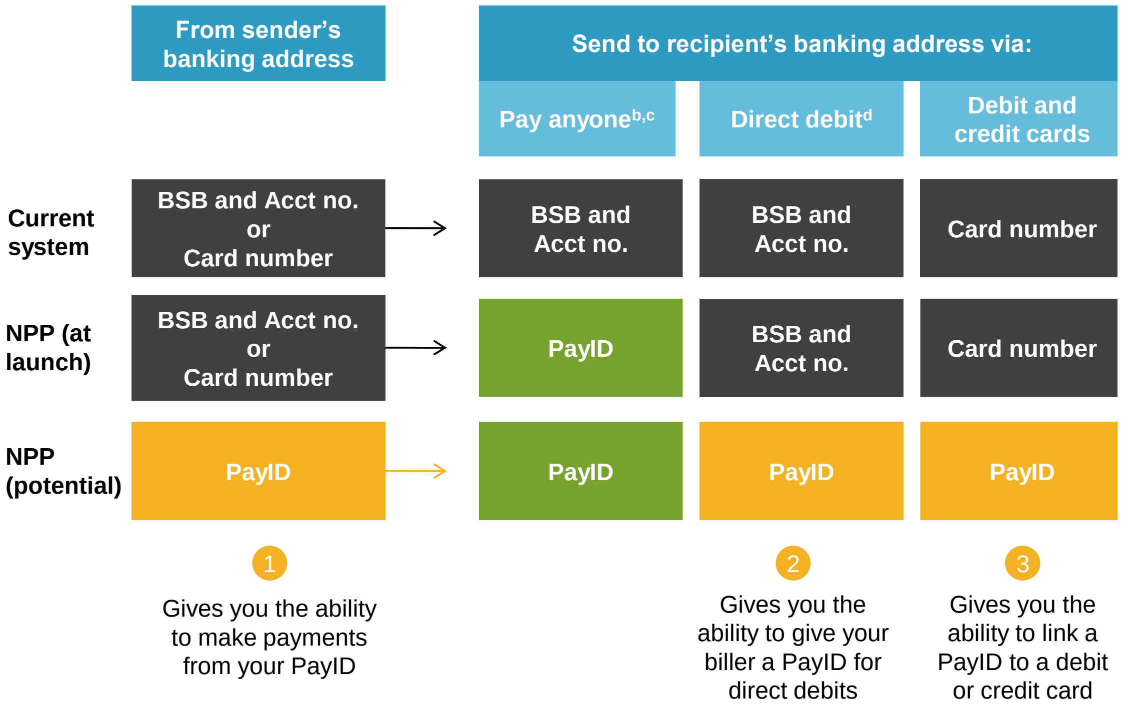
The NPP provides the potential to reduce the effort involved in changing some billing arrangements. Customers can apply for a 'PayID' — an easy-to-remember alias that is linked to their BSB and account number. Currently, customers can use a phone number, email address or organisation identifier (such as an ABN) as their PayID alias. But, there is potential for PayID to offer additional identifiers in the future.

Initially, people can only 'push' a bank transfer to a recipient using their PayID. You can give your friend a PayID to receive funds or pay a friend using their PayID. This is a very limited use of the PayID functionality and does little to relieve the burden of switching bank accounts, a perennial issue in banking. Figure 17.12 shows three ways that PayID under the NPP can be improved to ease switching.

First, a payment can only use the recipient's PayID, not the sender's. If instead you could set up recurring payments, such as a gym membership, from your PayID, then you would only need to change the account linked to your PayID *once*, rather than cancelling and re-establishing each recurring payment.

Figure 17.12 **The potential for PayID to ease customer switching**

Bank account address details under different systems[a]



[a] PayID will not replace BSBs and Account Numbers. [b] The sender initiates payment. [c] Some institutions may offer recurring payments using a recipient's PayID. [d] The recipient 'pulls' funds from the sender.

Source: NPPA (pers. comm., 7 November 2017)

Second, this does not allow for 'pull' payments, such as direct debits (NPPA, pers. comm., 7 November 2017). Ideally, you should be able to give your biller a PayID to direct debit, rather than a BSB and account number. Then, if you switch bank accounts, you would just need to change the account linked to your PayID *once*, rather than the potentially laborious task of updating your bank details with each biller separately.

Finally, financial institutions could give customers another PayID that is linked to a card account, instead of a bank account. In this case, you could give billers your card-related PayID (such as a 'CardID'), rather than giving card details to each biller. Then, if you switch debit or credit cards, you just need to change the card details associated with the CardID *once*.

Several members of the NPP accepted that PayID can do more to improve customer switching (CBA, sub. DR79; Cuscal, sub. DR98; NAB, sub. DR94; RBA, sub. DR82). However, the NPPA (sub. DR122, p. 11) suggested that it is not necessarily straightforward to implement some of these features.

> … there are technical and contractual challenges with linking existing direct debit arrangements to payer PayIDs. Direct debits are processed via the legacy, batched, overnight direct entry system, while PayID is designed only to be used with the new NPP platform and 24/7/365 messages. We accept the Commission's proposition that there are opportunities to use PayID to support real time

> authorisation and 'debit-like' functionality, and we are actively considering the technical development required to support maximising those opportunities in the medium to longer term.

We recognise that it may be difficult to implement some of these features. But it should not necessarily rely on trying to link into existing systems, such as the legacy direct debit system. For example, the NPPA could set up direct debit-like functionality for PayID.

Additional functionality for PayID has significant potential to create more value for consumers and ease switching, thus improving the ability of consumers to apply competitive pressure on providers. There may also be other areas where functionality of the NPP can be improved that may increase competition from consumers or between providers. As competition champion, the ACCC — in consultation with the PSB — should investigate different ways that the NPPA and its participating financial institutions can improve the functionality of the NPP, including PayID, to promote competition within the NPP and across the payments system more broadly.

RECOMMENDATION 17.8 IMPROVING FUNCTIONALITY OF THE NEW PAYMENTS PLATFORM

The ACCC, in consultation with the Payments System Board, should investigate different ways that New Payments Platform Australia Limited and its participating financial institutions can improve the functionality of the New Payments Platform (NPP) to promote competition within the NPP and across the payments system more broadly.

This includes investigating the feasibility of additional functionality for PayID to give customers the ability to both send and receive recurring bank transfers, direct debits and card payments.

The investigation should be completed by mid-2019, with a view to implementing additional functionality by end-2019.

18 Where does competition fit in the regulatory architecture?

Key points

- Australia has a well-established system of financial regulation, which has served the country well in times of crisis.
- The regulatory system aims to ensure stability within financial markets. Although regulators are required to consider competition issues in their decisions, the weight of evidence shows that Australia's policy and regulatory settings, as well as the regulatory culture, focus more on stability than on improving competition in the financial system.
- The lesser priority given to competition by the Australian government and regulators is generally in line with the current global approach to financial regulation, and in particular prudential regulation, although the United States and United Kingdom have made some moves to diminish regulatory restrictions introduced immediately after the global financial crisis.
- Regulators generally equate stronger competition with fear of excessive risk. A former Governor of the RBA has said as much.
- As a result, competition is occasionally curtailed intentionally, to maintain or improve financial stability. However, the costs of limiting competition are often too lightly dismissed or, even worse, ignored.
- Competition and stability in the financial system can — and should — coexist. But expecting a single regulator, such as APRA, to internally balance the two, while also crafting regulation in a global environment that prioritises resilient financial institutions, is at best unrealistic.
- Due to an unfortunate lack of transparency, it is difficult to establish whether the approach taken by regulators is justified in all cases. At the moment, regulators judge their own performance with little systematic oversight. In our view, it would be possible to achieve greater transparency without complicating the governance of individual regulators.
- Statements of Expectations (SoEs) are important vehicles to promote accountability and transparency for regulators. SoEs for each of the financial regulators should be published as a matter of priority. Regulators should report regularly on actions taken in line with the government's expectations.

Australia's financial regulators are well respected institutions, at home and overseas. External assessments of our regulatory system found that it is effective in achieving financial stability, an important outcome in the wake of the global financial crisis (GFC) (IMF 2012).

However, a key question for this Inquiry is how government and regulator actions affect competition, and whether the way they work to achieve financial stability improves or detracts from competition in the Australian financial system. In this context, competition will improve if regulators aim to create a stable financial system while minimising barriers to both entry *and* innovation, and are able to provide effective scrutiny of the way market power is created or abused (chapter 2).

18.1 Australia's system of financial regulation

Australia's system of financial regulation, based on separating different regulatory responsibilities, was put in place following the Wallis Financial System Inquiry (FSI) in 1997 and was unique at the time (Cooper 2006). It has been refined since then in response to evolving challenges, and other countries have adopted similar models.

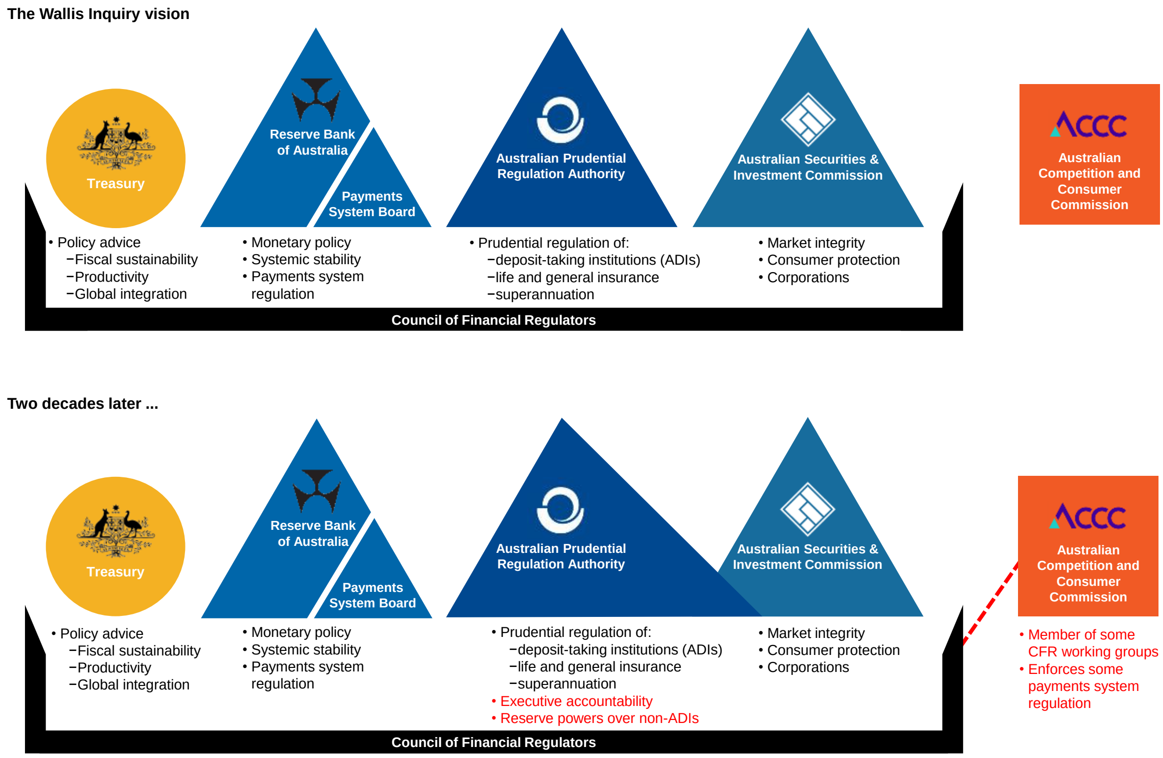
Three regulators share responsibility for overseeing the financial system.[124]

- The Reserve Bank (RBA), *the system regulator* — is responsible for monetary policy (through the Reserve Bank Board), payments system policy and regulation (through the Payments System Board), and ongoing analysis of the stability of Australia's financial system and broader economy. Through its monetary policy decisions, the RBA has a substantial influence on the interest rates offered to depositors and borrowers, and, in turn, competition in the banking system. It also works to increase stability and competition in the payments system, in its role as payments regulator (chapters 7, 17).
- The Australian Prudential Regulation Authority (APRA), *the risk regulator* — is responsible for ensuring the stability of the financial system by setting and enforcing prudential standards. These standards, as well as the more specific interventions undertaken by APRA, have a direct effect on competition, as they determine who can compete and how, in which market and at what cost (chapters 6, 7).
- The Australian Securities and Investments Commission (ASIC), *the product regulator* — is responsible for regulating market conduct and consumer protection in the financial system. ASIC ensures that institutions comply with responsible lending requirements, and that disclosure requirements are in place to alleviate some of the information asymmetries in the financial system (chapters 10, 12).

124 Our labels — *system, risk, product* — are not designed for ultimate accuracy of purpose for each regulator (they have many purposes) but rather to assist in analysing the governance of competition. Other regulators also have roles in the financial system — appendix B contains a full discussion. Chapter 17 discusses the role of the Payments System Board.

The ‘twin peaks’ regulatory system (an odd but common descriptor of a system with three regulators) introduced by the Wallis FSI was based on a clear separation between prudential and conduct regulation. Over the past two decades, these boundaries have become increasingly blurry (figure 18.1). For example, APRA’s recent Bank Executive Accountability Regime is in effect regulating conduct — which on functional lines could be seen to be ASIC’s responsibility. Further, although APRA was set up to regulate deposit-taking institutions, new legislation will give it the power to intervene in non-ADIs’ operations (currently overseen by ASIC) if it identifies ‘material risks of instability in the Australian financial system’ (The Treasury 2017f, p. 4).

Figure 18.1 **The responsibilities of the prudential regulator have expanded**



Regulators work closely together to achieve financial stability

While the responsibility for overall financial stability is shared between the RBA and APRA, only APRA can enforce prudential rules. The Australian system is unusual compared to other developed countries, in that it formally separates prudential regulation from the central bank — in most other countries, prudential regulation is determined by the central bank (either by the board or a dedicated committee within the central bank) or an external committee that is chaired by the central bank or the ministry of finance (IMF, FSB and BIS 2016).

The success of our regulatory system in achieving its objectives hinges on strong, yet often informal, relations between the RBA, APRA and ASIC. Informal networks of cooperation are particularly evident between APRA and the RBA (the former having originated within the latter) (box 18.1).

Box 18.1 Regulator coordination in practice — the case of residential property lending

Some of the RBA's publications offer insights into the way financial regulators coordinate their activities and interventions in the market. This coordination is achieved through formal and informal channels, including the Council of Financial Regulators (CFR). When trying to temper risk-taking by authorised deposit-taking institutions (ADIs), particularly in credit markets, such coordinated efforts may combine: APRA imposing prudential and other limitations on banks' actions; ASIC intensifying its supervision of market conduct; and the RBA analysing market behaviours and communicating key messages to the community.

The measures taken in 2014 and in 2017 in the residential property lending market are a case in point. In a letter to ADIs setting a 10% benchmark for growth in investor credit, APRA explained that this benchmark was chosen 'by APRA, after advice of CFR agencies, taking into account trend nominal household income growth and recent market trends' (APRA 2014c, p. 2). Further, APRA stated that:

> With the current risk environment in mind, APRA has been discussing with other members of the [CFR] further steps that could be taken to reinforce sound lending practices and mitigate any speculative pressures that may be building.
>
> … Together with other members of the CFR, APRA will continue to monitor and assess the risks in the housing market as they evolve. (APRA 2014c, pp. 1–3)

The close cooperation between the agencies is evident in further measures implemented in 2017, constraining growth in interest-only mortgage lending.

> The [CFR] has been monitoring and evaluating the risks to household balance sheets, focusing in particular on interest-only and high loan-to-valuation lending, investor credit growth and lending standards. In an environment of heightened risks, [APRA] has recently taken additional supervisory measures to reinforce sound residential mortgage lending practices. [ASIC] has also announced further steps to ensure that interest-only loans are appropriate for borrowers' circumstances and that remediation can be provided to borrowers who suffer financial distress as a consequence of past poor lending practices. The CFR will continue to monitor developments carefully and consider further measures if necessary. (RBA 2017p, pp. 1–2)

The regulators believe that their coordinated actions have been successful in moderating credit growth and changing the composition of new lending. However, there are questions as to whether they have been successful in communicating with the public about their intent and achievements.

> Another challenge was maintaining public focus on the aims of policy — maintaining prudent lending standards and resilience to shocks — rather than more transparent metrics such as housing price growth. Both APRA and the [RBA] reiterated this message in speeches and testimony. It is not clear that these communications were completely effective, given the public attention on housing prices as an indicator of affordability. (Ellis and Littrell 2017, p. 150)

When APRA was first split from the RBA following the recommendations of the Wallis FSI, its close relationship with the RBA was supported by personal relationships between staff who remained at the RBA and those who moved to work at APRA (Ellis and Littrell 2017). These relationships were replaced over time with more formal arrangements, including:

- ongoing circulation of relevant internal analysis between the two agencies — this includes the Financial Stability Review, which is circulated by the RBA for comment to APRA, ASIC and the Treasury
- analysts from both agencies attending meetings and presentations to discuss their work
- staff secondments
- senior staff at both agencies being expected to maintain and build close relationships with their counterparts (RBA and APRA 2012).

All financial regulators have signed bilateral Memoranda of Understanding (MoU) to facilitate information sharing and coordination of regulatory actions (CFR nd). In the case of the RBA and APRA, the MoU establishes a coordination committee, which meets frequently to discuss developments across the system and in specific institutions (RBA and APRA 2012).

The Council of Financial Regulators (CFR) is the most senior coordinating forum, involving all financial regulators and the Treasury. It was established in 1998, as part of the redesigned system of financial regulation recommended by the Wallis FSI, with the stated objective 'to contribute to the efficiency and effectiveness of regulation and to promote stability of the Australian financial system' (CFR nd). It is chaired by the governor of the RBA and meets quarterly (or more often if required) to discuss developments in the financial system and coordinate responses to any areas of concern. It also operates a number of working groups (RBA and APRA 2012). Although it provides a forum for the consideration of proposed regulatory changes, the CFR does not have a formal mandate or powers separate from its members, and is not a decision-making body (The Treasury, sub. DR126).

And the CFR does not publish the minutes of its discussions. This limits the ability of non-CFR members to assess how policy has been evaluated for its effects on competition (which is the focus of this Inquiry) or other implications. It also deprives the regulators on the CFR of a potentially useful tool for influencing market behaviour. However, for those involved, this is a preferred way of working.

Chapter 19 presents recommendations for strengthening the role of the CFR and increasing the transparency around its deliberations. These changes to the CFR would not only minimise the possible adverse effects of regulation on competition; they would also enhance regulator accountability more broadly, by creating a formal process for regulators to assess the implications of actions proposed by their peers, and make their conclusions public.

Competition does not play a central role in the regulatory system

When designing Australia's system of financial regulators, the Wallis FSI chose not to include a financial system competition regulator that could assess both market behaviours and the effect interventions by other regulators could have on competition.

> Anti-competitive behaviour is not unique to financial markets, and it is preferable to establish both the bounds of acceptable competitive behaviour and rules for mergers and acquisitions which are common to all industries. Accordingly, the case for specialised arrangements in this area is relatively weak (Wallis et al. 1997, p. 189).

The Murray FSI (2014a) accepted the position that there is no requirement for a competition regulator dedicated to the financial system.

Nonetheless, it identified a range of regulatory and policy gaps, and made a series of recommendations intended to strengthen regulators' ability to consider competition, and to assess the effects of their actions on competition. The most important recommendation was for the Australian Government to update ASIC's mandate to include 'a specific requirement to take competition issues into account as part of its core regulatory role' (Murray et al. 2014a, p. 254). This is now being legislated to give ASIC an additional duty to 'consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system' (The Treasury 2018b, p. 5) (table 18.1).[125]

Table 18.1 **Progress in implementing the recommendations of the Murray FSI to improve regulators' consideration of competition**

Financial System Inquiry recommendations	*Australian Government response*	*Progress since 2014*
• Give ASIC a specific requirement to take competition issues into account.	• A commitment to introduce competition into ASIC's mandate by the end of 2016.	• Legislation introduced in March 2018.
• APRA, ASIC and the PSB to undertake an immediate review of their rules and procedures to see if they create inappropriate barriers to competition, and how these can be addressed.	• The Government did not address this part of the recommendation specifically in its response.	• None.
• Through annual reports, APRA, ASIC and the PSB to demonstrate explicit consideration of competition in their regulatory design.	• The Government planned to address this issue in the updated Statements of Expectations, to be provided by mid-2016.	• A new Statement of Expectation for ASIC has been issued but not yet published. • There is no public information on progress towards updated Statements of Expectation for APRA and the PSB.

Source: Australian Government (2015); Murray et al. (2014); O'Dwyer (2018a, 2018b)

125 The *Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018* was introduced to Parliament in March 2018 (O'Dwyer, K. (Minister for Revenue and Financial Services) 2018b).

The changing role of the ACCC

As a result of the approach taken by the Wallis FSI and accepted by the Murray FSI, the financial markets have been treated as a part of the wider economy as far as competition policy is concerned.

This does not mean that the financial system has been ignored. As it does in other parts of the economy, the Australian Competition and Consumer Commission (ACCC) has taken action in the financial system in the past, to enforce compliance with the *Competition and Consumer Act 2010* (Cth) (CCA), including the review of mergers between different financial institutions (ACCC, sub. 17). The ACCC considers that recent amendments to the CCA, focusing on misuse of market power and concerted practices, 'are likely to significantly improve [its] capacity to tackle anti-competitive conduct in the financial services sector' (sub. 17, p. 4).

The ACCC has signed Memoranda of Understanding with the key financial regulators, and works alongside ASIC (sub. 40) to coordinate their consumer protection actions, and the RBA's Payments System Board, to monitor competition in the payments system (RBA, sub. 29). The ACCC is a member of the CFR Competition Working Group and has a record of collaboration with financial regulators and the CFR on a range of competition-specific matters (ACCC, sub. DR129). However, the ACCC is not a permanent member of the CFR, despite decisions by CFR members strongly affecting competitive conditions in the financial markets.

It is relatively uncommon in the Australian regulatory system for the ACCC not to be pre-eminent in competition matters. Even where Parliament has sought to direct competitive behaviour explicitly — for example, in telecommunications or energy — the ACCC remains at the centre of regulatory judgments on competition. But not so in the financial system.

Nonetheless, the ACCC's oversight of the financial system has expanded recently. In the 2017-18 Budget, the ACCC received funding for a new Financial Services Unit, which has a mandate to examine specific financial system competition issues. The ACCC considers that the creation of the Financial Services Unit will give it the ability to support APRA, ASIC and the RBA in their consideration of competition issues (ACCC, sub. DR129).

This is a notable shift in the potential role of the ACCC.

The ACCC is the party most likely to be called upon to investigate a substantial lessening of competition. Therefore, its presence as a proactive force <u>before</u> anti-competitive decisions are taken (whether inside boardrooms or among regulators) could — if effective — significantly change the regulatory and broader culture of the financial sector. As has become evident in utility industries, such as electricity and ports, had the ACCC been an accepted presence in government decision-making before businesses changed hands, a different and more pro-competitive outcome may have resulted. And current controversies in these industries might have been avoided.

However, the ACCC's ability to act effectively in financial services will depend substantially on co-operation. No laws are changing with the establishment of this unit. In the 20 years since they were established, financial regulators have displayed very limited co-operative behaviour towards agencies outside of their immediate circle. Thus the ACCC will have to establish a significant precedent in order to be effective; or receive explicit support from the Treasurer to take a role within the formal and informal forums that shape financial regulation.

Currently there is no entity in Australia's regulatory system with clear ability to do more than *react* to abuses of dominant firm behaviour. As a result when persistent apparent abuses occur, external review is eventually imposed.

It need not be this way. The system has the capacity to re-balance in favour of *proactive* competition reform.

Chapter 19 discusses a series of recommendations set to change the ACCC's role in the financial system, to one of 'competition champion'.

18.2 The regulators' biggest challenge: balancing competition and systemic stability

The interaction between competition and financial stability is a conceptual and practical challenge for financial regulators globally. It is common for regulators here and overseas to see genuinely rivalrous behaviour as a risk, believing that it may erode standards of conduct across the banking industry and lead to systemic instability. This regulatory culture is based on the notion that constraining competition has the potential to insulate financial institutions from crises. For example, the former governor of the RBA, Ian Macfarlane, saw the low levels of competition between Australian banks as part of the reason they came through the GFC relatively unscathed:

> [W]hen you have intense competition among inadequately regulated banks, it always leads to excessive lending, underpricing of risk, excessive risk taking and a financial crisis.
>
> … Why didn't it happen here? Well, there was certainly competition and there is competition to provide banking services to customers and I think there was some increase in risk taking by our banks and a reduction in lending standards. … it happened here to some extent but nothing like the degree seen overseas.
>
> It's hard to avoid the conclusion that the difference was there was no competition for corporate control in Australia. That saved us from the worst excesses that characterised banking systems overseas. (Macfarlane 2009, pp. 42–43)

For regulators to manage and constrain competition requires deep awareness of the myriad factors that are usually left to markets to solve elsewhere in open economies. But in finance the systemic fear of exuberance encourages a regulatory belief that markets must be made to behave conservatively.

Some see competition and stability policies working together to prevent market operators from becoming 'too big to fail', and to deliver better products for consumers (Berger, Klapper and Turk-Ariss 2009). Given the possible tensions between stability and competition, achieving both these goals while implementing prudential policies is an almost impossible balancing act.

The extent to which regulators pursue both competition and stability objectives is a matter of judgment. Australia's history shows how these judgments can vary at different times:

> For thirty years following World War II, the highly regulated Australian banking system experienced not a single failure in which any Australian bank depositor lost a cent. Yet this same banking system could offer consumers only one type of mortgage, was rated as the most expensive banking system in the world in 1980, and would not lend to women.
>
> When the system was deregulated following the Campbell Report in the early 1980s, it became both more competitive and more innovative but also less stable — the first bank failures in more than half a century were recorded in the early 1990s. But by then consumers (including women!) had experienced a whole new world of innovative mortgages, card payments products and market-linked investment accounts. (Harper 2012, p. 1)

In the aftermath of the GFC, regulators globally have emphasised the need for more stable financial systems. With the GFC exposing multiple vulnerabilities across global financial markets, the stability of financial systems has increasingly been defined in terms of the resilience of those systems to stress, external shocks and cyclical forces (BCBS 2010).

Nonetheless, regulators overseas — in countries where the GFC has caused significant financial damage — have shifted their focus, towards a more balanced view of the relationship between stability and competition. In 2014, the UK's Prudential Regulation Authority was given the responsibility to facilitate effective competition, in addition to its primary objective of achieving a stable financial system (Fisher and Grout 2017). In 2018, the US reversed some of the prudential restrictions imposed on smaller financial institutions after the GFC, in an attempt to support their ability to compete in the market (Rappeport and Flitter 2018). Recent changes to Australia's prudential framework aimed at reducing barriers to entry, such as the staging of requirements to become an ADI (chapter 4), are welcomed, but the regulatory emphasis remains firmly on stability.

Financial risks and regulations to address them both impose high costs

The costs of financial instability — such as those arising from destructive financial crises — can be substantial. Financial crises effects include (but are not limited to): lost jobs; the prospect of long-term unemployment; increased housing stress and the prospect of homelessness; and increased stress for small business owners and the heightened potential for the failure of their business. One estimate suggests that an 'average' financial crisis could put up to 900 000 Australians out of work, while an 'average' to 'severe' crisis could cost the Australian economy between $950 billion and $2.4 trillion (in 2013 dollars) in total before it is resolved (Murray et al. 2014a).

But setting up the financial system to avoid all financial failure is an unrealistic and costly objective, particularly as the Australian economy depends on importing capital. As the GFC illustrated, global capital flows can be disrupted by unexpected international events, potentially leading to domestic bank insolvency if governments do not intervene. This interconnectedness and the confidence of foreign capital sources also make adherence to the objectives of the Basel system very important for Australia. Beyond international effects, any banking system, like ours, that is based partly on short-term deposits being used to fund long term borrowing, has embedded domestic risk. The task is to manage these risks, at least cost.

Not every risk can be fully mitigated and increasing regulation to attempt this impossible task comes at an ever increasing cost.

For example, a single central issuer of all loans and manager of all deposits might be safer (and easier to regulate) but such models have been shown to suppress innovation and adaptability. A lack of innovation can lead to stagnancy and serious inefficiencies over time, to the detriment of consumers.

There will generally be a level of prudential regulation beyond which the reduction in economic growth imposes a greater cost on the community than the benefit derived from the reduced probability of a financial crises. But it is often hard to know where to draw the line, and obtaining effective external advice on this judgment — an effective way to mitigate the risk of excessive intervention — can be difficult, unless that adviser is also a trusted part of the regulatory structure. At present, APRA can only rely on Treasury or the RBA for such advice. But both these organisations must inherently also favour stability in designing regulatory intervention.

The incentive structure regulators themselves face is skewed towards stability. There are asymmetric rewards from the choice of tailoring intervention to have the least impact on competition, compared to broader intervention (where the plaudits fall to those who kept us safe, regardless of the cost). This is a particularly asymmetrical choice where the post-GFC environment is summarised repeatedly and publicly as a search to be 'unquestionably strong'.

And choosing interventions that promote success can become a part of the regulatory culture, which entrenches the preference for stability, and the tendency for regulation to go unchallenged.

Views on competition and stability in the Australian regulatory system

Both the RBA and APRA have expressed the view that competition and stability are not mutually exclusive. For example:

> It is sometimes asserted that there must be a trade-off between stability and competition in the financial system. That is not our view. Competition in the financial sector can bring welcome innovation and enhanced outcomes for customers, and good regulatory settings can deliver

> financially strong competitors, creating both financial stability and a dynamic and innovative marketplace for financial services. (APRA 2017f, p. 3)

Nonetheless, for both organisations, maintaining financial stability is the pre-eminent goal:

> APRA's pursuit of system stability, even if it at times may, at the margin, reduce competitive pressures, is predicated on delivering the important community benefit of a stable financial system. (APRA, sub. DR116, p. 4)

> The [Reserve] Bank agrees that competition in the financial system can be promoted without necessarily increasing risk. …. The Bank also agrees that, when formulating prudential regulatory measures, it is important that any potential effects on competition be considered. … That said, financial stability goals necessarily attract a high weight in regulators' considerations because the cost of instability is high … Crises also tend to be detrimental to competition as providers fail, withdraw from the market or merge, and funding tends to be more readily available to large, established institutions. Indeed, an increase in concentration was observed in a number of economies, including Australia, following the global crisis (CGFS 2018). Financial crises are low frequency but very high cost events. (RBA, sub. DR82, p. 4)

At times, regulators have viewed competition as a possible risk to stability. In exercising its powers, APRA states that it aims to maintain sustainable competition, but there are times when it needs 'to actively temper competitive spirits within the financial sector' (APRA 2017f, p. 3).

> One circumstance where regulators may weigh competition and stability very directly is where there is a concern that competition may result in increased lending to non-creditworthy customers. This would not be in the long-term interest of consumers, financial institutions or the financial system more broadly. (RBA, sub. DR82, p. 4)

When considering the existing levels of competition in the financial system, each of the regulators offered a slightly different view, reflecting in part the lens through which they view the financial system (box 18.2).

APRA faces an unrealistic balancing act

APRA's legislation (*Australian Prudential Regulation Authority Act 1998* (Cth)) requires it to:

> … balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, […] promote financial system stability in Australia.

The explicit requirement to balance competition, among other objectives, in the pursuit of financial stability, creates a substantial challenge for APRA. From the limited information available on how the prudential regulator makes decisions, it is evident that implications for competition are considered — but financial stability is prioritised.

This is not to criticise APRA. Given the costs of a financial crisis, a focus on financial stability by APRA is desirable. Rather, the legislation places APRA in an untenable situation. The regulator faces, what at times will be, an unrealistic balancing act while its key objective is — and should remain — financial system stability.

Box 18.2 Regulators' views of the current state of competition in the Australian financial system

In their submissions to this Inquiry, APRA, ASIC and the RBA identified different levels of competitive behaviour in different parts of the financial system. For example, APRA stated:

> There appear to be strong indicators of competition in certain financial services product markets, for example residential mortgages. Other segments, however, appear less competitive given a reduced number of providers, which appears driven in part by a lack of expertise and systems capabilities, along with an aversion to higher risk activities by certain entities. (APRA, sub. 22, pp. 4–5)

ASIC and the RBA offered a range of reasons for this observation:

> There are a range of factors that may limit supply-side competition from working effectively in markets for financial products and services, as in all markets, including where there is low 'contestability' and high barriers to entry, and a lack of transparency in the provision of products and services.
>
> However, the presence of behavioural biases and other factors weakening demand-side competition (e.g. lack of financial capability) could also provide opportunities for firms to exploit these to maximise profit, particularly where their interests are misaligned with those of consumers (e.g. conflicted remuneration structures). (ASIC, sub. 40, p. 5)
>
> … periods of more intense competition in individual markets have typically come from new models and new entrants rather than existing players …
>
> New entrants, particularly those with new business models or low costs, are therefore likely to be important in determining the future competitive environment. Such entry cannot be easily engineered; the role of authorities is to provide a supportive regulatory and competitive environment, with no unnecessary impediments, while ensuring that the system remains safe, both systemically and for individual customers. (RBA, sub. 29, p. 40)

The ACCC considered the effects that the level of competition has on consumers:

> Retail banking markets in Australia are characterised by oligopolies comprising the large banks, who can influence products, prices and other conditions in important markets either alone or together. The ACCC considers that in situations of oligopoly, all else being equal, a market structure that enables a competitive fringe of second tier firms to effectively challenge the price and service decisions of large incumbents is likely to produce significantly better outcomes for consumers than one that does not.
>
> When we look at retail banking markets in Australia we observe a number of indicators that, taken together, suggest that the current oligopoly structure is not vigorously competitive and has not been for some time. (ACCC, sub. 17, p. 8)

Competition or competitive neutrality?

In its submission to this Inquiry, APRA contended that its actions are often motivated by competitive neutrality:[126]

126 In this context, competitive neutrality refers to a regulatory framework that applies equally across all similar regulated entities. Some stakeholders (for example, CBA (sub. 25), ABA (sub. 11) and Regional Banks (sub. 37)) argued that regulators should treat all competitors in the same way.

> APRA also endeavours to maintain competitive neutrality in its prudential framework and supervisory activities by minimising unnecessary or artificial regulatory distinctions between different entities undertaking activities which exhibit similar risk profiles.
>
> … However, in establishing and implementing the prudential framework for regulated institutions, APRA also takes the approach that the framework should be proportionate, such that smaller institutions are subject to expectations commensurate with the scope and complexity of their risk profile. This means that APRA avoids a 'one size fits all' approach where possible. (sub. 22, p. 7)

But, as discussed in chapter 2, a goal of competitive neutrality is *not* equivalent to pursuit of competition. Indeed, competitive neutrality between market participants could well stifle innovation and be to the detriment of consumer outcomes.

Further, some of APRA's interventions in the market, while done in a way that is perceived by the regulator to reflect competitive neutrality, have been blunt. Submissions to this Inquiry make a strong case that the lack of precision in directions has had negative effects on competition (chapter 7).

The form of competitive neutrality most evident in the Inquiry's review of the financial system is neutrality *within* a group of equivalent risk-assessed entities, such as treating the major banks in an even-handed manner, while *separately* treating in an even-handed manner a set of smaller institutions that all have equivalent risk standards. This is desirable and seems generally well implemented by APRA.

But such competitive neutrality considerations are often tempered by the overarching concern for financial stability and the global prudential framework. APRA's approach to narrowing the gap in the risk weights for housing lending used by major banks and other ADIs (following on from Murray FSI recommendations) is a case in point. Rather than lowering risk weights for other ADIs, which may have enabled them to compete more aggressively, APRA chose to raise the risk weights of major banks (chapter 6 discusses this issue in detail).

Of course, there is a risk to lowering weights rather than raising them. But the alternative course deserves consideration and for this the system requires a well-informed advocate. No such party is evident in the current regulatory structure.

Prudential regulation considers only a limited set of alternatives

The Wallis FSI acknowledged that prudential regulation can have a detrimental effect on competition. However, it assumed that market discipline and competition will cause providers to act responsibly — prudential regulation was seen as an 'extra layer of oversight' (Wallis et al. 1997, p. 300).

This has not proven to be the case.

Over time, developments in local financial markets (particularly the HIH collapse in 2001) have led policy makers and regulators to believe that competitive pressures can lead to an erosion in systemic stability, and this requires them to adopt stronger prudential regulation (Ellis and Littrell 2017).

Particularly since the GFC, the view among financial regulators globally has been that ill-supervised competition can contribute to systemic risk when it results in real or perceived excess risk-taking, and so constitutes a potential threat to financial stability (IMF 2013). This trend has been exacerbated by central bank interest rate policy that has been driven far from traditional norms since the GFC, with limited capacity now and for the foreseeable future to influence risk-taking as a principal target. In the current environment of historically low interest rates and inflation targeting, APRA arguably has more influence on significant aspects of Australia's financial markets than the RBA.

APRA does not operate in isolation. It is responsible for the implementation of new international financial standards (Basel III) that are premised on the view that financial institutions must become more stable and resilient, and that competition must be managed in a way that minimises systemic risk (IMF 2013). These principles are being implemented in all developed countries. Further, macroprudential interventions, from direct restrictions on loans to broadening the scope of regulation beyond banks, have become common globally (IMF, FSB and BIS 2016).

APRA does adapt certain aspects of its policies in applying Basel standards, and has consulted on its proposed standards before implementation. But in its Regulatory Impact Statements, APRA has emphasised the importance of keeping in line with global standards, even when this imposes a cost on the community (box 18.3). The guiding principles behind much of its actions are determined by a global board of central banks and prudential regulators (including APRA and the RBA). Given Australia's essential long-term dependence on international capital flows, it is not unreasonable that our regulators mainly act in accordance with global changes.

APRA is committed to protecting the interests of depositors; but the interests of other parts of the community have relatively little representation in APRA's framework.

> In considering the potential impact of regulatory proposals on competition, APRA seeks to assess whether they will result in unnecessary regulatory costs that could impact on the competitiveness of entities within the relevant industry. APRA does not interpret its mandate as requiring it to assess the potential impact of a regulatory proposal on the ultimate price paid by consumers for financial products. (APRA, sub. DR116, pp. 8–9)

The fact that borrowers (and indeed all Australians) bear the cost when banks need to respond to an increase in prudential requirements is not given substantial weight. Borrowers are assessed primarily as the source of demand pressures, which may lead banks to weaken lending standards and may eventually trigger an increase in risk. But borrowing and subsequent investment are a key driver of economic growth.

The consideration of impacts on financial industry stakeholders also seems limited. APRA conducts consultations with industry on some of its policies, and it has taken positive steps to improve its communications. But the perception among stakeholders is that their views are very much subordinate to the regulator's own predispositions (APRA 2016c).

Box 18.3 APRA's Basel III Regulation Impact Statements — who pays for regulatory change?

In the course of preparing for the implementation of the Basel III prudential framework, APRA released a series of Regulation Impact Statements (RISs). These short documents contained only limited quantitative analysis of the expected effects, which were based on strong assumptions. In the case of capital reforms, APRA asked ADIs to estimate the effect of the changes on their loan pricing, but chose to use lower price changes in its calculations (APRA 2012c). In the RIS for the liquidity reforms, APRA assumed some of the planned changes would occur even if regulation did not change, as a result of 'investor pressures' (APRA 2012d, p. 20).

In both RISs, APRA acknowledged the fact that the reforms would impose substantial costs, and assumed these costs would be passed onto 'customers through the re-pricing of loan and deposit products' (APRA 2012d, p. 15). It did not attempt to quantify the costs across the economy, nor discuss the equity and efficiency implications of such a re-pricing. When considering the effect of capital reforms, APRA simply stated:

> The 'cost' impact in the chain of economic effects of higher regulatory capital ratios is:
>
> - higher equity ratios for ADIs;
> - higher weighted funding costs (including debt and equity funding) and lower return on equity;
> - banking institutions increase lending rates to restore some of their lost return on equity;
> - borrowers increase their aggregate borrowings more slowly than would otherwise have been the case; and
> - gross domestic product (GDP) grows more slowly than would otherwise have been the case, for most of the business cycle.
>
> The 'benefit' chain is:
>
> - higher equity ratios for ADIs;
> - safer ADIs, which can therefore borrow funds and raise capital more cheaply;
> - reduced failure of ADIs and impairment rates; and
> - reduced risk and potential depths of financial crises. (2012c, p. 9)

The extent of APRA's analysis of costs and benefits in this case is questionable, in particular given the scale of the expected effects. The Basel III implementation in Australia was clearly a major policy decision — and hardly one that should be justified without robust quantitative analysis, which has been done by other inquiries (for example, Murray et al. 2014a).

APRA can hardly be faulted for deliberately giving precedence to financial stability. Its legislation is structured to favour that. Moreover, the Government endorsed the recommendations that followed from the Murray FSI's conclusion that the benefits of greater resilience outweighed the associated costs. This collective reinforcing of sentiment is highly relevant to our Inquiry: quite evidently, both the Government and its regulator are of one mind when it comes to resilience. So where does the alternative view, in each intervention, gain any consideration?

At times, it is likely that the regulator's understandable preference for stability should be tested. Regulation that results in higher cost may not be in the wider public interest. Moreover, internalising the debate on the costs and benefits of stability policy to the organisation primarily preoccupied with stability does not always result in policies that align with community expectations.

A preferable course is to see draft regulatory decisions better exposed to rigorous and informed debate before they are made. The CFR can do this, but there is no specific obligation on it to do so. Further, the CFR currently does not include among its members a designated champion for competition. The opportunity is therefore open to redress the imbalance in current prudential policy evaluation via the CFR, without altering the final legal ability of APRA to make the necessary call. This option is discussed in detail in chapter 19.

FINDING 18.1 APRA NOT WELL PLACED TO CONSIDER COMPETITION EFFECTS

APRA is not well placed to balance the cost to competitive behaviour in its regulatory actions. Although the legislation that requires APRA to give weight to competition is valuable, its remit quite reasonably must favour system stability — even where its actions could impose a significant cost to competition.

The capacity to generate timely and trusted debate among relevant regulators on the question of whether the public interest is served by restricting competition is a desirable addition to the regulatory structure. This is particularly the case given our finding that key financial markets are characterised by large institutions that hold substantial market power. The Council of Financial Regulators is a valuable forum with the scope and leadership in which to deliver this debate.

In the absence of such a debate, consideration of competitive effects will inevitably continue to be subordinate to stability.

18.3 Who regulates the regulators?

This Inquiry is not alone in taking an interest in the question of a voice or perspective additional to that of the regulators themselves.

The regulatory architecture envisaged by the Wallis FSI in the late 1990s gave thought to an oversight body for the financial regulators, such as a system-wide policy board — but decided against the need for it.

> The Inquiry regards this general oversight role as belonging essentially to the Treasurer, as the Minister with responsibility for the financial system. The Treasurer's oversight role could not be devolved onto a system wide board without creating a two-tier structure of regulatory agencies, which would introduce substantial costs and complications. The Inquiry believes that if the mechanisms for external review and coordination function as recommended, there will be no need for a system wide board. (Wallis et al. 1997, pp. 545–546)

However, the Murray FSI found that the Australian Government did not have a framework or a process for effective external review of the performance of its financial regulators. The oversight provided through Parliamentary inquiries did not readily examine the regulators' strategic priorities and the way they balanced their competing priorities (Murray et al. 2014a).

The ASIC Capability Review also found that the Parliamentary oversight function lacked focus on long-term strategic issues and comprehensive accountability (ASIC Capability Review Panel 2015).

In the case of APRA, Parliamentary inquiries raised questions about the way APRA viewed the implications of its decisions on competition, but generally just accepted the regulator's views (see, for example, HoRSCE 2016d, pp. 9–13).

The Murray FSI made a series of recommendations to improve the accountability framework and the way regulators addressed competition, in particular through clearer guidance to regulators in Statements of Expectation, increased use of performance indicators and the creation of a Financial Regulator Assessment Board to advise Government on how regulators had implemented their mandates (Murray et al. 2014a).

The Australian Government did not accept the recommendation to create a Financial Regulator Assessment Board, as it considered the same objective can be achieved through the Regulator Performance Framework as well as the Financial Services Advisory Council (Australian Government 2015) (table 18.2). The Council was reconstituted in 2016, and specifically mandated to 'provide advice to the Government on the performance of the financial system regulators' and has members with 'experience in a wide cross section of the financial services sector' (O'Dwyer 2016). However, since that announcement, no further information has been published about the council's activities, except for a short consultation in September 2017 seeking stakeholders' views on the performance of the financial regulators, for the council to discuss at its meeting in November 2017 (The Treasury 2017a).

In 2018, the Australian Government decided to suspend the council until the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry completes its work.

Even if the council resumes operating, it is hard to imagine how the performance of regulators is fully reviewed by a body composed of those regulated. While one important aspect of the performance impact of a regulator is how it is viewed by those being regulated, in the case of the financial system the impacts run far beyond the institutions themselves.

Table 18.2 Progress in implementing the recommendations of the Murray FSI to improve regulator accountability

Financial System Inquiry recommendations	*Australian Government response*	*Progress since 2014*
• Establish a new Financial Regulator Assessment Board, to review how the regulators are balancing the various components of their mandates.	• The Government considered that existing mechanisms, such as the Regulator Performance Framework, were sufficient to strengthen regulator accountability. • The Government agreed to reconstitute the Financial Sector Advisory Council, with refreshed terms of reference to include providing advice on the performance of regulators.	• APRA and ASIC developed metrics to measure their performance in line with the Regulator Performance Framework. The RBA developed a framework for assessing its regulatory actions in regards to the payments system. All three regulators completed self-assessments against the framework. • The Financial Sector Advisory Council was reconstituted in 2016. Its operations were suspended in 2018.
• The Government should provide more clarity around its expectations of regulators. • Regulators to develop better performance indicators.	• Statements of Expectations for APRA, ASIC and the PSB to be updated by mid-2016.	• An updated Statement of Expectations for ASIC has been agreed but not yet published. • There has been no public indication on progress towards updated Statements of Expectations for the PSB and APRA.
• Conduct capability reviews for ASIC, APRA and the PSB every six years.	• The Government agreed to periodic consideration of regulators' capabilities (timing as appropriate) and noted the capability review for ASIC had commenced in mid-2015.	• ASIC capability review was completed in December 2015. Recommendations were directed both at ASIC and the Australian Government. ASIC committed to implementing most recommendations by 2017, and in an update to the Senate in March 2017, stated that implementation was 'nearing completion'. The Government is progressing the recommendations that were addressed to it. • No capability reviews have been announced for the other financial system regulators.

Source: APRA (nd); ASIC (2016, 2017); Australian Government (2015); Murray et al. (2014); O'Dwyer, K. (Minister for Revenue and Financial Services) (2018); O'Dwyer (2016); The Treasury (2015; sub. DR126)

Statements of Expectations are important — and overdue

Statements of Expectations for regulators are important in assisting both the regulators and the government in delivering better outcomes to the community.

> This process [of issuing statements of expectations] brings a certain degree of formality, as well as integrity and credibility to the relationship between the regulator and the executive and could

> potentially help resolve potential conflicts or misunderstandings between the regulator and the executive. … If the statements provide guidance on the direction of the regulatory activities, they can potentially bring clarity to the respective roles of the regulator and the executive and serve as an incentive to strengthen and improve internal processes (for example by providing guidance on better regulation policies or clarifying performance indicators). (OECD 2016a, p. 25)

We consider that such statements can be an effective tool to provide financial regulators with the government's perspective on their strategic direction and allow assessment after the fact to see if performance matches expectations.

The Minister for Revenue and Financial Services announced in March 2018 that the Government had settled on an updated Statement of Expectations for ASIC (2018a), but this has not yet been published. The Statements of Expectations for the other financial regulators have not been updated since 2014 and the Treasury should therefore also update and publish them — in clear language as far as practicable — as a matter of priority.

Regulators issued with Statements of Expectations should respond by publishing Statements of Intent, outlining how they intend to act in order to fulfil the Australian Government's expectations. They should include information in their annual reports on the actions taken in line with their Statements of Intent, so they remain accountable to government and the community.

As both documents should be future-oriented, it should be accepted that they are indeed about expectations and intents, and not guarantees that particular results will be achieved. One area of public policy that is experienced in the use of expectations is the area of monetary policy, where a regularly-updated Joint Statement by the Treasurer and the Governor of the Reserve Bank sets out the objectives of monetary policy and how it will be conducted (see, for example, RBA 2016a).

RECOMMENDATION 18.1 STATEMENTS OF EXPECTATIONS FOR REGULATORS

Updated Statements of Expectations for regulators, as agreed in the response by the Australian Government to the Murray Financial System Inquiry, should be published as a matter of priority. They should be written in clear language and updated at regular intervals thereafter.

Regulators should publish Statements of Intent within three months of receiving the Statements of Expectations.

In their annual reports, the financial regulators should provide information on the actions they have taken in line with their Statements of Intent and outcomes on performance measures.

Limited transparency leaves important questions unanswered

The financial regulators publish a wide range of reports and other papers (appendix B). But although there are numerous ongoing reporting requirements and external reviews being undertaken, there is only limited information provided on how regulators make some of their most important decisions and how they consider the effects of their decisions on competition in the financial system.

Particularly in the case of the RBA and APRA, much of what we know about how they design their policies and measure their effectiveness comes from the RBA's periodical publications, occasional speeches and conference papers.

A single conference paper provides the most detailed account on how the two agencies worked together to design and implement these interventions, and their views on their achievements and challenges (Ellis and Littrell 2017).

Further detail on the interaction between RBA and APRA that preceded the intervention was only made available in response to a Freedom of Information request. Treasury's and APRA's submissions to the Draft Report of this Inquiry do provide some insight into the development of these interventions. It is notable that these submissions appear to be the first time that these options and considerations have been included in a public document.

APRA complies with the requirements for consultation imposed on all regulators and has made changes to some policy proposals in response to industry consultation (APRA, sub. DR116). But its consultation papers and Regulation Impact Statements taken as a whole leave the impression that the direction of prudential policy is a fait-accompli (box 18.3). Few, if any, policy actions with such far reaching implications are subject to so little external scrutiny and evaluation.

This Inquiry accepts that the art in the conduct of monetary policy — and even some aspects of prudential supervision — requires a level of covertness. But internationally, we can observe other central banks and prudential regulators (such as the Bank of England and the Reserve Bank of New Zealand) making more effort to both inform and influence the public response to their efforts by more tailored contributions to an informed debate.

The Reserve Bank of New Zealand, for example, released consultation papers and asked for submissions before it set and subsequently amended restrictions around high LVR lending in 2013, 2015 and 2016. A Regulatory Impact Statement on the initial restrictions was published in 2013 (RBNZ nd). The Reserve Bank of New Zealand also consulted during 2017 on the possible addition of debt serviceability restrictions to its macroprudential toolkit, but concluded that they did not need to be deployed at present (RBNZ 2017).

The lack of transparency surrounding prudential regulation has been raised in Parliamentary inquiries, without much progress:

> The [House of Representatives Standing Committee on Economics] asked APRA whether it still maintained the view that its activities and assessments in relation to individual financial institutions, such as CommInsure, should be conducted confidentially and not in public.
>
> … [APRA's] Chairman responded that APRA is required under its legislation to act confidentially and that this underpins its ability to act successfully.
>
> … The Chairman further stated in response to this question that this way of operating was not unique. The Chairman stated:
>
>> It is the way prudential regulators around the world do operate. I know there is always a public desire to know more, but many of the things we deal with are best dealt with behind the scenes. They get fixed, and the community has continued confidence in the system. (HoRSCE 2016c, pp. 17–18)

Confidentiality is very important for some prudential interventions, in order to prevent misinterpretations by the community that could have far reaching consequences. Nonetheless, in the case of systemic interventions, such as those affecting residential property lending, such confidentiality can be counterproductive. A culture of secrecy can eventually erode business and broader community confidence in the regulator's actions.

This lack of transparency extends to the CFR. The council's discussions are likely to shape much of the regulatory action — including quite significant restrictions on competitive behaviour — taken by its members, but there is only limited information available on its discussions. Up until 2002, the CFR published annual reports, providing a summary of the topics raised and the activities of its members (see, for example, CFR 2002). After that time, the CFR's activities have been mentioned in the annual reports of member organisations, primarily the RBA's Financial Stability Reviews (RBA nd). As the chair of the CFR, the RBA has recently increased the level of detail provided about the activities of the CFR in its half-yearly Financial Stability Review and intends to continue with this approach (RBA, sub. DR82).

Various reviews of Australia's regulatory arrangements have suggested that there is a need for increased transparency around the CFR's deliberations. The IMF, for example, acknowledged the major role played by the CFR in planning Australia's response to the global financial crisis, but noted:

> While the CFR has been effective, there is scope to make its role more prominent by highlighting its work and enhancing the transparency of its deliberative process. A more explicit report of the CFR's deliberations in the Financial Stability Review would be a first step toward this goal. (2012, p. 28)

Australia's financial regulators should adopt a much more transparent approach (chapter 19), and in particular should show how they assessed the competition effects of their decisions or actions — rather than only enabling potentially ill-informed guesses.

Open data can be a first step towards greater transparency

Open data policies can also enhance transparency and accountability. The financial regulators collect vast amounts of data, both in the course of their routine operations and as part of ad hoc collections. However, this data is not always used to its full potential. For example, the ASIC Capability Review identified gaps in data management and use. It recommended a range of improvements, including for ASIC, in conjunction with the CFR, to develop a forward work program to design and implement open data policies and data analytic collaboration (ASIC Capability Review Panel 2015). Such policies would support further transparency and improve access to data collected by regulators. As a first step towards this objective, ASIC should publish a list of the datasets it collects and uses in its research projects and reports, and release all non-sensitive datasets.

Increasing the availability of data on the financial system is line with the government's strategy to improve Australia's data use (DPMC 2018). The government has committed to adopting the recommendations made by the Commission in its *Data Availability and Use Inquiry* (2017c), including publishing registers of publicly-funded datasets and releasing high-value datasets.

RECOMMENDATION 18.2 ASIC TO PUBLISH DATA

The financial regulators already collect large amounts of data, which is a valuable public resource. Subject to privacy requirements, much more such data should be made publicly available.

As a first step towards improving the availability of data, ASIC should publish a list of the datasets collected and used in its research projects and reports and release any non-sensitive datasets.

19 Reforming the regulators to support competition

Key points

- Changing the way the financial regulators interact to address competition is highly desirable — given the market power of financial market participants, full analysis of the effect of regulators' actions on competition is critical.
- Weighing up competition and stability requires financial regulators to conduct comprehensive analysis of potential material competitive effects of prudential measures.
  - However, there is no agency that currently has this as a primary task.
- Addressing this gap in the regulatory architecture requires designating an entity as the champion for competition in the financial system, and specifically in the financial regulatory discussions at the Council of Financial Regulators (CFR). This offers the minimum disturbance to current regulatory arrangements, while maximising the effectiveness of competition advice.
- The Commission recommends the ACCC — which has the expertise to assess competition issues and expanding financial system knowledge — take on the role of competition champion in the financial system.
- To do this effectively, the ACCC would need to:
  - become a member of the CFR
  - build on its expertise of the financial system, acquiring both commercial and prudential regulation expertise
  - continue its shift from a reactive to proactive stance on competition in finance
  - convince regulators of its capacity to ensure competition considerations are practical when applied to prudential objectives.
- The Commission is confident APRA can give the competition champion a fair hearing. It has a legislated obligation to do this.
- Similarly, ASIC should be encouraged to consider trade-offs between competition and other regulatory objectives. As recommended by the Murray Financial System Inquiry, and currently before Parliament, an explicit requirement to consider competition should be added to ASIC's mandate.
- The updated Statements of Expectations for each of the regulators should reflect the ACCC's role as financial system competition champion and the need for each regulator to consider the competition impacts of reforms.
- The CFR should use transparency as a tool, at its judgment:
  - The analysis of the competition champion should be discussed by the CFR and confirmation of this made when the regulatory intervention is announced.
  - The minutes of CFR meetings should be published in a timely manner.
- The ACCC should publish a bi-annual financial system competition report, which would be the competition equivalent of the RBA's Financial Stability Review.

The high levels of regulatory intervention in the financial system are unsurprising in the aftermath of the global financial crisis (GFC), when the G20 countries decided to work towards global reform that will build more resilient financial institutions (FSB 2017b). This has given stronger licence to regulatory activity that can invoke safety. However, such regulatory activity does not support — and, at times, actively hampers — competition. It did this before the GFC, but it does so more actively now via what are popularly termed macroprudential measures.

The Commission considers that the competitive effects of regulator actions should become more robustly and openly considered, alongside stability. The regulators contributing to this Inquiry all argue, as we do, that these two objectives must both be pursued; but only this Report proposes a clear structural obligation that can survive change in personalities or practice, as sound regulation requires.

Creating a regulatory system that supports competitive outcomes will require an explicit recognition for the role regulators play in restricting competition and a cultural shift towards considering pro-competitive action.

The Commission proposes achieving this by strengthening existing organisations and processes, rather than creating new regulators. We identify an organisation — on balance, the ACCC — to act within regulator forums as a champion for competition; and create mechanisms for transparent reviews within the Council of Financial Regulators (CFR), that will enable the regulatory system to demonstrate support for more competitive outcomes.

The Commission considers these changes can be achieved without changing the existing legislative framework.

In sum, we are asking regulators to do more of what good regulatory practice requires everywhere: to listen to alternatives, and to be more open.

19.1 A champion for competition

In the existing system of financial regulation, there is currently no organisation principally responsible for promoting competition. Regulators all have an interest in competition (although apparently misunderstanding at times how it differs from competitive neutrality), but none is required to lead on the topic (chapter 18).

> [An] effective but inconvenient truth of the current Australian financial system landscape [is that] there is no lead regulator for competition in Australia and, in general, competition is not adequately part of the DNA of all regulators. (FinTech, sub. DR111, p. 39)

Given the important benefits competition in financial services can bring, as well as the significant effect regulators themselves have on the level of competition, designating a champion for competition among the financial regulators should be a priority for government.[127] Such a champion for competition would be able to apply dedicated resources to review the questions that arise when a regulatory intervention may require that competition make way for stability; identify existing gaps in competition policy within the regulatory system; and may take a public stance more generally on competition issues in the financial system as required.

Such review *could* take place quite readily between the three primary regulators — the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the RBA — prior to regulatory interventions. But the limited evidence available does not show that a review of the competition implications of proposed regulatory interventions has been routinely occurring.

There is no current requirement for competition to be considered, beyond the suggestion in APRA's legislation that it should take competition into account, which has resulted in the prudential regulator internalising the debate in what would, at times, be an unrealistic balancing act (chapter 18). The Australian Government has not authorised any entity to take up such a review role, even though a vehicle that could be used to broaden regulators' consideration of competition — updated Statements of Expectations — has been recommended and accepted following the Murray Financial System Inquiry (FSI).

Improving competition considerations without fundamental reform to the regulatory structure

Other than taking a wholesale reform approach to the Australian 'twin peaks' system of financial regulation — and the competition grounds for such a wholesale reform do not exist — the only other method of simply and effectively giving more explicit consideration to competition implications prior to a material regulatory action is for the co-ordinating body across the regulators — the CFR — to include a member that is resourced to focus on competition.

The Commission envisages that the role of the designated competition champion will not be regulatory in nature, but advisory. The current financial regulators (the RBA, APRA and ASIC) would all retain their decision-making powers. The competition champion would have no power of veto on any matter, to reassure some respondents to the Draft Report. But it would ensure as thorough a consideration of competition implications as possible, in the relevant circumstances.

[127] Other structural options, such as establishing a dedicated competition council for the financial system, would only add to the multitude of government bodies interacting with the sector. The National Competition Council (NCC) in its current form is not suited for this role. A replacement for the NCC — the Australian Council for Competition Policy — was recommended by the Harper review. Such a council may be able to take on a role in the financial system, but the process towards its establishment has stalled (HoRSCE 2016e).

To be effective, this reform will require coordination among the financial regulators. The financial regulators seem to have well-established, cooperative relationships and further co-operation in the CFR seems entirely plausible, from our examination.

Stakeholder support for a competition champion

The majority of Inquiry participants who expressed a view on the Draft Report recommendation for a financial system competition champion supported the idea. Smaller financial institutions saw a need for this reform, and possibly a larger role for the competition champion (for example, Regional Banks, sub. DR107), while the major banks were more tentative in their support. Regulators and the Treasury were generally unconvinced, but submissions showed a number of apparent misunderstandings regarding the extent of the competition champion's intended role (box 19.1).

In our Draft Report we identified two possible candidates that could champion competition in the financial system: the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investments Commission (ASIC). The majority of participants who identified a particular organisation for competition champion suggested the ACCC was the natural candidate (box 19.2).

The ACCC as a champion for competition in the financial system

In the past, the ACCC's role in the financial sector has been largely reactive – intervening when an abuse of competition has occurred. However, it has recently expanded its presence in the financial system, taking on pro-active investigations. The Commission considers it is well placed to take on the role of the competition champion.

The ACCC is tasked with administering and enforcing the *Competition and Consumer Act 2010* (Cth). It sees itself as responsible for 'making markets work for consumers, now and in the future' (ACCC nd). It has power to act in relation to market participants' breaches of competition law in the financial system, and it has a long track record of taking action when it identifies activities that contravene the Competition and Consumer Act. The Act was amended in 2017, to prohibit cooperation between firms or conduct that 'substitutes or is likely to substitute, cooperation in place of the uncertainty of competition'. The ACCC (sub. 17, p. 4) believes this amendment will 'significantly improve [its] capacity to tackle anti-competitive conduct in the financial services sector'.

The ACCC also has the expertise to assess competition issues across many parts of the financial system, as evidenced by their merger reviews. The Wallis FSI (1997) concluded that the underlying factors that affect competition in the financial system were not unique. However, where the financial system differs from other parts of the economy is the extent to which the regulated risk (systemic instability in this case) can have widespread effects across all parts of the economy — and hence, the scope for regulatory action that minimises that risk to have substantial impacts on competition.

Box 19.1 Most industry stakeholders welcome a competition champion

Many Inquiry participants supported the draft recommendation for a competition champion in the financial system (including CALC, sub. DR130; CHOICE, sub. DR97; COBA, sub. DR72; FPA, sub. DR81; HSBC, sub. DR102; MyState, sub. DR68; National Stock Exchange of Australia, sub. DR103; Regional Banks, sub. DR107; Xinja, sub. DR67).

Others, while not specifically addressing the recommendation, provided a view on who should be the champion (including AFG, sub. DR71; ASBFEO, sub. DR101; FBAA, sub. DR85; Institute of Public Accountants, sub. DR93; P&N Bank, sub. DR88).

Only one of the major banks addressed this recommendation directly in its submission. CBA (sub. DR79, pp. 29) supported the draft recommendation in principle, but 'urge[d] caution and further consultation with regulators'. Representing a larger group of banks, the Australian Banking Association noted that its members do not hold a universal view on the recommendation. The ABA (sub. DR119, p. 1) said it '[does] not believe a strong case has been made that a gap exists in our regulatory architecture for a new competition champion to be appointed'.

The RBA preferred the status quo but agreed that competition considerations should be taken into account in the pursuit of financial stability. Further, it was 'open to consideration of how the transparency of the CFR could be improved' (sub. DR82, p. 10).

APRA suggested 'the most effective means to establish a stronger 'voice' for competition within APRA's regulatory decision-making will be to strengthen the working relationship between APRA and the Australian Competition and Consumer Commission' (sub. DR116, p. 9).

ASIC supported 'regulators working together to consider competition issues in the financial system' (sub. DR123, p. 31).

Treasury noted it 'has performed this role when macroprudential and other financial stability measures are discussed' but is supportive of 'heightened awareness and consideration of competition issues by regulators, including a more pro-active agenda to strengthen competition' (sub. DR126, p. 12).

The ACCC is 'firmly of the view that it is important for competition to be given greater significance in the regulatory decision making process' and during the hearings suggested many of the responsibilities proposed for the competition champion are aligned with the mandate of the ACCC's Financial Services Unit (FSU), which was established in 2017 (ACCC, PC transcript, 2018, pp. 52–3). In its submission, the ACCC (sub. DR129, p. 9) noted that 'with the establishment of the FSU, the ACCC now has the ability to support APRA, ASIC, and the RBA in their consideration of competition issues within the existing regulatory architecture'.

Box 19.2 Strong support for ACCC to be the competition champion

In their responses to the Draft Report of this Inquiry, numerous stakeholders voiced support for designating the ACCC as the competition champion. Submissions in support of the ACCC came from industry bodies, individual institutions and consumer groups. For example:

- [T]he ACCC is preferable … Both [ASIC and ACCC] could be relied upon to be transparent and consultative, so it is the singularity of the ACCC's competition mandate that is particularly appealing. To perform this role effectively, the ACCC will need to be a member of [CFR]. (Regional Banks, sub. DR107, p. 23)
- The ACCC's expertise in assessing competition is vital and would provide a clear mechanism for an objective 'outsiders' assessment of and input into the regulation and oversight of the financial system and its participants … We support the inclusion of the ACCC, as the expert regulator of competition, as a member of the CFR. (FPA, sub. DR81, pp. 14–15)
- The ACCC is more naturally suited to the role of competition champion and would therefore become a permanent new voice on the [CFR] … The lack of an advocate for competition is a mistake that should be corrected. (COBA, sub. DR72, p. 6)
- [We support] a mandate for the ACCC to be a more formidable counterweight to APRA's focus on financial stability. (P&N Bank, sub. DR88, p. 9)
- The banking regulator, APRA, has an important role to play in ensuring a competitive playing field, but we believe the ACCC as the competition regulator also has a role to play. We see the merit in the ACCC being an additional member of the Council of Financial Regulators. (Bank of Queensland, PC transcript, 2018, p. 114)
- [W]e support the proposal for a competition champion. We recommend that the ACCC play this role as it is well-placed to focus on competition. We support ASIC [being] given competition among its objectives, but we do not consider that competition should be its main focus. (CALC, sub. DR130, p. 14)

A small number of submissions supported giving ASIC the role of competition champion (AFG, sub. DR71; ASBFEO, sub. DR101; MFAA, sub. DR86). Xinja (sub. DR67) noted ASIC's current consumer protection activities had the 'potential to evolve to include promoting competition' but also saw a role for the ACCC. Other stakeholders (for example, CHOICE) also suggested that ASIC's mandate should be broadened to include competition — a reform the Australian Government is currently advancing.

The Finance Brokers Association of Australia (sub. DR85, p. 12) suggested the champion should not be sourced from regulatory bodies, rather this role should be 'performed by a broad mix of people with deep understanding of market dynamics and economics'.

The ACCC's more pro-active role in the financial system has been established by the Treasurer's 2017-18 Budget announcement to create a permanent team within the ACCC 'to investigate competition in our banking and financial system' (Morrison 2017b).

It is set to grow further, as the government announced the ACCC will play a central role in the implementation of Open Banking and the Consumer Data Right (Australian Government 2018b). The recent Review into Open Banking recommended the ACCC should be the lead regulator. This would include primary responsibility for determining the rules for Open Banking and the Consumer Data Right in consultation with ASIC, APRA, RBA and other relevant regulators (Farrell 2017).

The ACCC itself indicated a desire to undertake this role of competition champion within the financial system.

> We agree with the [Productivity] Commission that there is a particular need for greater competition advocacy in the financial system … With our strengthened mandate from government we believe the ACCC is well placed to bring its singular focus on competition to important regulatory decisions in the financial sector. Our approach seeks to be driven by market dynamics and be unfettered by the limitations of regulatory regimes.
>
> We believe there is considerable scope for us to work more closely with APRA, ASIC and the RBA in considering and providing advice on the impact of key measures they take, or in helping to inform their decision making in relation to competition issues. Such an approach would ensure that nothing falls through the cracks. (ACCC, PC transcript, 2018, p. 52)

Challenges ahead for the ACCC

The ACCC has no power to affect the regulatory decisions made by the financial regulators, or the legal mandate to intervene in order to lower barriers to entry or competition imposed by other regulators (Murray et al. 2014a). We do not propose changing this. Rather, we ask regulators to listen, a highly desirable but relatively cheap concession to improving the quality of interventions.

A proactive and committed exchange on competition impacts needs a common commitment among the parties. All the regulators have assured us of their desire to improve one or more aspects of this process.

However, authorisation — permission to try — is still required, from the Government. Updated Statements of Expectations should form the required permission device, by explicitly noting the ACCC's role of reviewing regulatory interventions prior to implementation, and the expectation that an open discussion of the review's findings occurs among the regulators at the CFR (chapter 18 discusses Statements of Expectations in detail).

For each of the financial regulators, and for the ACCC, this would involve some element of culture shift, but all have done this in the past.

Achieving competition outcomes that benefit the community depends not only on the resources available to regulators, but also on their culture and the extent to which they take a proactive and systemic view of the market they oversee. The Commission's study into Consumer Law Enforcement and Administration revealed concerns regarding the risk averse culture among some Australian consumer law regulators (PC 2017b). Although the ACCC is probably not such a body, nevertheless it is a new task for it to hold to account another regulator in the course of its functions.

The ACCC has recognised the need for it to become more proactive and to continue to expand its knowledge into additional areas of the financial system, including prudential regulation and analysing the implications of regulator actions on competition.

> The ACCC is the national competition champion. We cannot, however, be the competition champion if we are only reactive. Equally, we cannot be the competition champion if we don't fully understand some of the complex markets we work in. Market studies give us the capacity to investigate how markets are really working and to develop a deep understanding of the commercial realities of those markets.
>
> Last year the Government gave us five Inquires to add to our already expanding market study portfolio. We are now engaged in more sectors in a focused way than ever before, including [Northern Queensland insurance and banking and financial services] … It is important to note that market studies are almost always the beginning of our work in a market, not the end. They provide us with essential knowledge, they put an industry on notice, and they provide a framework for future action. (Sims 2018a)

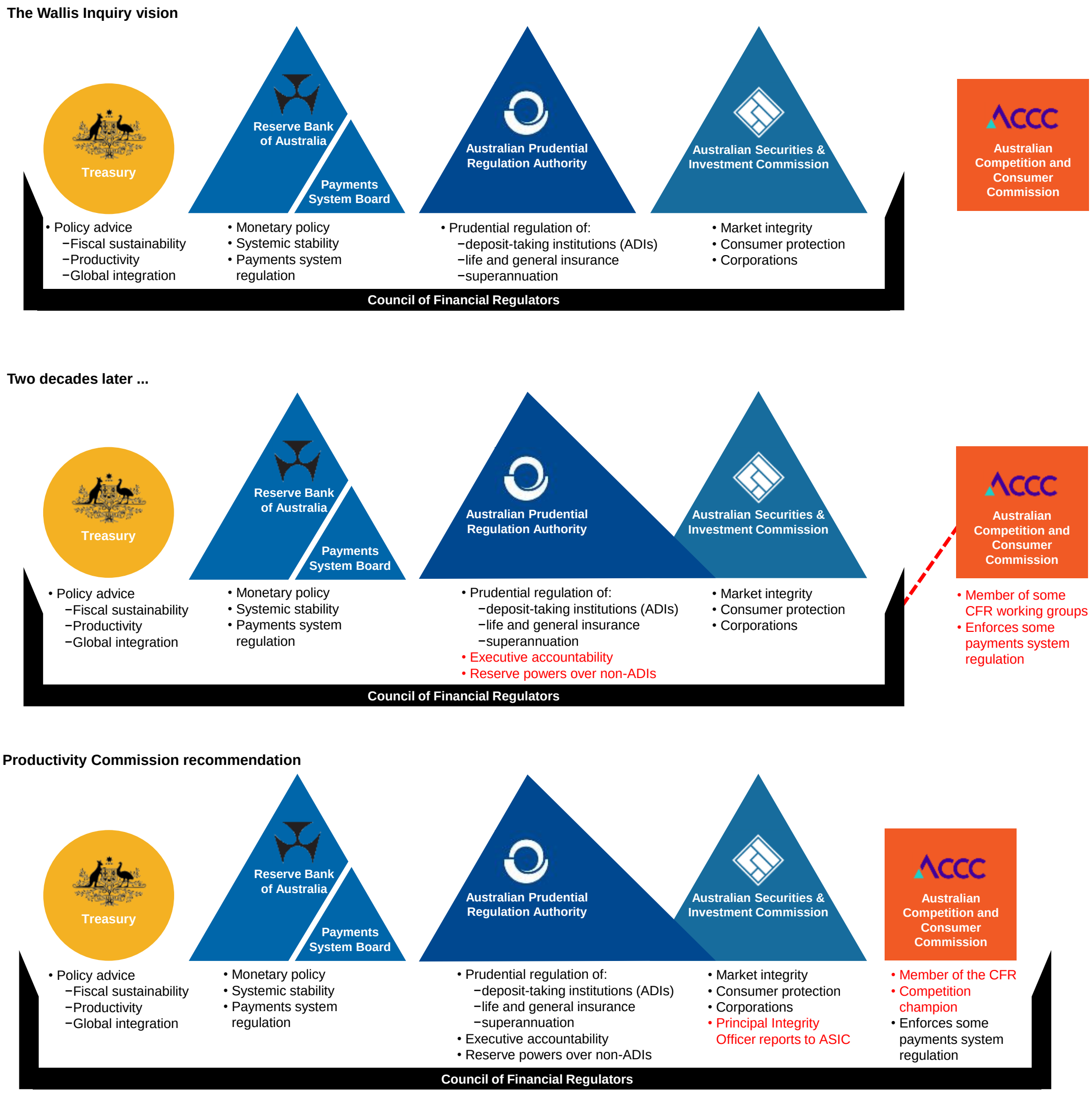
Beyond market studies, the ACCC will need to develop or acquire the resources to ensure it participates effectively in the high-level financial market discussions that occur at CFR. This would most likely necessitate employing staff with extensive expertise in financial markets analysis, who would be able to represent the ACCC at CFR meetings and in discussions with the financial regulators.

The ACCC's role in the Council of Financial Regulators

Currently, the ACCC is only invited to attend CFR meetings 'where appropriate' (RBA, sub. DR82, p. 9). This is not sufficient. CFR membership must be expanded to include the ACCC and a more formal, transparent review process must be introduced into the CFR deliberations (figure 19.1). This would enable the financial regulators to assess the market effects of regulations proposed by their peers *before* they are implemented.

The CFR has attractive characteristics — the necessary membership, the leadership of the RBA and the ability to discuss sensitive matters in a professional manner. If it did not exist, we would have to create it; and this task is sufficiently important that such a move would not be an unacceptable cost. But there is no cost to adding one more member.

Figure 19.1 The evolving structure of the Council of Financial Regulators



A new process of review

The ACCC should become a source of independent advice to the financial system's primary regulatory structure in relation to interventions that could impact on competition. Once it joins the CFR, the ACCC would be in a position to provide analysis of proposed regulatory interventions, to consider the implications for all market participants, including those that are not prudentially regulated (box 19.3).

Under this new process of review, the financial regulators would need to share their planned interventions with the ACCC before implementation. This would only apply to intended interventions that may have material effects on competition, such as macroprudential interventions and other substantial changes to prudential supervision in the case of APRA, changes to licensing regimes in the case of ASIC, and the payments system in the case of the RBA.

Box 19.3 **Addressing regulatory restrictions on competition**

The Hilmer review, which laid the foundations of Australia's current competition policy, recognised that 'the greatest impediment to enhanced competition in many key sectors of the economy are the restrictions imposed through government regulation' (Hilmer, Rayner and Taperell 1993, p. xxix). The review identified prudential policies as one example of regulation that may restrict competition, and its recommendations provide a useful framework for analysing future interventions in the financial system.

The review suggested a framework for reviewing existing and new regulation to identify and minimise their effects on competition. This framework was based on the principle that regulation should restrict competition only if it is clearly demonstrated that this is in the public interest (Hilmer, Rayner and Taperell 1993).

The Competition Principles Agreement, which COAG signed to facilitate the implementation of the Hilmer review recommendations, stated that :

> Legislation … should not restrict competition unless it can be demonstrated that:
>
> a. the benefits of the restrictions to the community as a whole outweigh the costs; and
>
> b. the objectives of the regulation can only be achieved by restricting competition (COAG 1995).

Following the COAG agreement, reviews of regulatory interventions reduced competitive restrictions in numerous parts of the economy. Nonetheless, in 2015, the Competition Policy Review identified areas of regulation that were still impeding competition, and called for a new round of regulatory reviews (Harper et al. 2015). A similar recommendation, focusing specifically on the financial regulators, was made by the Murray Financial System Inquiry (2014a), but has not been implemented.

To remove any doubt — the Commission does not envisage that this process would apply to the core functions of the RBA, including setting monetary policy, and other measures that do not amount to regulatory interventions, such as APRA's prudential standards, including risk weights. Rather, the ACCC as competition champion will only analyse proposed interventions that go beyond the routine operations of financial markets. It is only such interventions requiring the coordinated action of the financial regulators that are brought before the CFR — and it is in these cases that the voice of competition needs to be heard.

After working with the relevant regulator to advise on future interventions, the ACCC would put before the CFR a comprehensive review of the implications of the proposed interventions on competition in the market and consumer outcomes. The findings of the competition review — as well as any possible amendments to policies, such that identified risks to competition are minimised — would be discussed at the CFR (either at a scheduled quarterly meeting, or sooner if required). The CFR would publish a simple summary of the analysis conducted once the measure is implemented.

The ACCC has advised that their assessment of the competition effects of regulatory proposals would not be limited to the behaviour of regulated entities within a market, but would also consider consequences in related markets.

> These assessments consider the likely reactions of incumbents and prospective new entrants, and the likely consequences for consumers. This approach can help to reveal potential unintended adverse consequences of regulatory proposals and inform improvements to the final design of the regulation.
>
> A lack of product or process innovation among market participants may not be a concern for a prudential or conduct regulator as long as regulated firms remain solvent, the financial system is stable and/or markets operate in an orderly manner. However, this can be of significant concern to the ACCC as it signals a lack of dynamic efficiency. Competition is an important driver of dynamic efficiency in markets. (ACCC, sub. DR129, p. 9)

This new process of review is likely to require the regulators to revisit their information sharing arrangements. Currently, their respective acts impose limitations on sharing protected information.[128] The CFR, however, is one body with which APRA can share data, making membership of it clearly an advantage for the competition champion.

Concerns among the financial regulators are unfounded

Our intention is not to unnecessarily slow down decision making, which is a concern that was raised by participants (including RBA, sub. DR82, and CBA sub. DR79). For example, the RBA argued that:

> The proposed external analysis process has the potential to slow down decision-making. Even compared with an identical internal process, the need to fully educate an unfamiliar team on technical issues, share relevant information and data, analyse those data and then send the analysis to a meeting of the CFR for consideration, will necessarily take additional time. While this would not be a concern for some regulatory measures, on other occasions a more timely response may be required. (sub. DR82, p. 10)

This concern is likely exaggerated. In a crisis, as we saw during the GFC both here and overseas, no regulatory niceties prevent the national leadership from action. And a non-legislated step of putting an alternative voice in the room is not likely to prevent such action in the future. But it is just possible in circumstances short of a crisis, that alternative thinking might improve the final decision. Having the competition champion advise the CFR on the competition impacts of regulatory interventions is designed to improve transparency and accountability.

The Australian Government's Cabinet decision-making process, just to pick one of many common governance structures, includes the ability to hear from other well-informed views before final decisions are taken — and these decisions are certainly not trivial.

128 For example, the *Australian Prudential Regulation Authority Act 1998* (Cth) allows APRA to share protected information with a 'financial sector supervisory agency' or with the CFR, under specific circumstances.

That said, the process by which the CFR members might receive these views needs to be flexible, trusted and swift. APRA has noted (box 19.4) that they are already liaising with ACCC at an informal level. And it is important that this continues into the future, *beyond the existing relationships* between the current staff at the two organisations. To this end, the Commission sees the need for a formalised process of review.

Some members of the CFR, in their submissions to this Inquiry, argued that competition issues are already discussed at CFR and that formal inclusion of a competition champion would be an unnecessary addition:

> As chair of the CFR, the Bank can give an assurance that the CFR considers, and gives due weight to, competition matters. For example the competition effects of housing regulatory measures have been considered in the decision-making phase and discussed regularly since. More generally, the Australian Competition and Consumer Commission is invited to attended CFR meetings where appropriate. (RBA, sub. DR82, p. 9)

> As currently constituted, the CFR functions well as a key component of APRA's prudential policy-making process. The input from other regulators and Treasury is an important test in understanding the broader effects of APRA's proposed policies, including the impact on competition in the financial system. (APRA, sub. DR116, p. 4)

But as noted above, there is no evidence that review of the competition implications of proposed regulatory interventions has been routinely occurring and the potential scope of the impacts are such that this must happen. As a coordinating forum, the CFR is a desirable group. But the CFR could do better, in the interests of competition and market response more generally, by having a dedicated competition champion and by explaining its considerations where relevant to public interests (section 19.2).

Further changes to CFR, such as making it a decision-making body, are not necessary.

Additional responsibilities for the ACCC as the competition champion

The ACCC, as competition champion, would also be tasked with identifying existing gaps in competition policy within the regulatory system. And it will have the authority to take a public stance more generally on competition issues in the financial system as required.

To advance both these goals, the ACCC should publish a bi-annual financial system competition report, which would be the competition equivalent of the RBA's Financial Stability Review. This would also contribute towards holding other regulators to account, as a comprehensive review on competition will also touch on the effects of regulatory intervention on competition. The ACCC has already analysed some of these issues in its inquiry into mortgage pricing (ACCC 2018).

Another area the ACCC can direct its focus to is integration in the financial system, and its effects on competition, as highlighted in chapter 9. We recommend that the ACCC undertake 5-yearly market studies on the effect of vertical and horizontal integration on competition in the financial system. Such studies would inform its views on the market as the competition champion.

Box 19.4 **APRA and the ACCC working closer together**

APRA and the ACCC signed a memorandum of understanding, which covers policy coordination and information sharing, more than two decades ago (ACCC and APRA 1999). However, as noted by APRA (sub. DR116), the level of engagement between the two agencies has been limited.

Both agencies stated that the recent establishment of the ACCC's financial services unit (FSU), has brought them closer together.

> APRA is working to strengthen its bilateral collaboration with the ACCC, via the ACCC's newly-established Financial Services Unit. This should assist in enhancing APRA's ability to appropriately consider financial system competition issues as part of its decision making. This heightened collaboration could include information sharing on policy priorities, working plans and consultation on significant policy projects. Further, APRA considers that the ACCC could provide a helpful source of input into post-implementation reviews of material prudential policy changes. (APRA, sub. DR116, p. 19)

The ACCC highlighted other ways through which it can contribute to policy making in the financial system:

> The ACCC can provide advice to regulators on the likely impact on competition of different regulatory proposals under consideration, particularly where the proposal has potentially significant and wide-reaching impacts. The ACCC can also contribute to the design of regulation to minimise the adverse impacts on competition while still achieving prudential objectives, or undertake ex-poste assessments of the competition outcomes of a particular measure affecting the financial services sector. Importantly, our experience with competition issues in other sectors of the economy can also provide useful insights about regulatory innovations in other markets. (ACCC, sub, DR129, p. 9)

Interactions with the financial regulators beyond the CFR

The role we have in mind for the ACCC is to champion competition with regulators for its benefits to consumers and aspirant firms alike.

Both ASIC and APRA have highlighted their strong working relationships with the ACCC (subs. DR123, DR116). This is a relatively recent development in APRA's case, and one that has the potential to have significant influence on future policy directions, given that macroprudential and other interventions can pose a risk to competition (chapters 6 and 7).

This growing relationship could enable the two organisations to work together when regulatory interventions, including macroprudential measures, are planned, so that competition issues are given appropriate consideration (box 19.4). While informal relationships are important to create a culture of cooperation between regulators, Memoranda of Understanding, such as the one APRA and the ACCC have had for many years, fall in and out of favour without consequence among many government entities. There is a need for the parties to listen to each other, and this requires the Government to make such an expectation known, formally. A formalised process will continue to operate even if informal channels cease to be effective, due to staff or organisational changes.

In addition to the ACCC taking on a new role as competition champion, each of the existing financial system regulators needs to have the tools to support competition while pursuing their own regulatory objectives.

> Competition in financial markets is dynamic and evolving. Ensuring effective competition in the Australian financial system is an ongoing process. As a starting point, each regulator needs the right mandate and regulatory toolkit to promote effective competition. (ASIC, sub. DR123, p. 30)

APRA currently has a legislative requirement to consider competition, along with other objectives.[129] ASIC similarly needs a mandate to consider competition, particularly given 'there has been some uncertainty about if and how ASIC could consider competition factors' (ASIC, sub. DR123, p. 30). Submissions that considered the issue of expanding ASIC's mandate to include competition supported the idea, regardless of who ultimately has the role of the competition champion (including CALC, sub. DR130; CHOICE, sub. DR97; COBA, sub. DR72; FPA, sub. DR81).

Once ASIC and APRA both have a mandate to consider competition, and the ACCC takes on the role of financial system competition champion, the financial system regulators will be better placed to work through the competitive impact of their decisions.

Currently, the only regulatory body that has a clear mandate to promote competition in financial services is the PSB, which is part of the RBA. Its role is limited to 'promoting competition in the market for payment services, consistent with the overall stability of the financial system' (RBA, sub. 29, p. 30).

Over the years, the PSB has developed a range of pro-competitive policies in the retail payments system, particularly in the credit card market (chapter 17). These policies are implemented in conjunction with the ACCC.[130] For example, in 2016, the Competition and Consumer Act was amended to ban excessive payment surcharges. In effect, this gives the ACCC the power to enforce a policy that was developed by the RBA. The Commission considers this division of responsibilities should remain unchanged.

The ACCC is not currently responsible for consumer protection in financial services. That role is undertaken by ASIC (chapter 15). The Commission envisages that ASIC would retain its consumer protection role, as it holds licensing and conduct powers specific to the financial system that enable it to be an effective consumer protection body.

129 The UK's Prudential Regulation Authority, which is part of the Bank of England, was given a statutory secondary objective in 2014 to act, as far as is reasonably possible, to 'facilitate effective competition' when making prudential policy to advance its primary objectives (Bank of England Independent Evaluation Office 2016).

130 Since 1998, the RBA and ACCC have had a Memorandum of Understanding (MoU), which sets out their responsibilities in this space. The MoU states that the ACCC 'retains responsibility for competition and access in a payments system, unless the RBA imposes an access regime or sets standards for it' (RBA and ACCC 1998, p. 1).

Why not ASIC for the role of competition champion?

We identified ASIC as the other potential contender for the role of competition champion in our Draft Report. Inquiry participants, for the most part, did not support this option (box 19.5).

ASIC's mandate is set to change, as legislation to give effect to the Murray FSI recommendation to add competition to ASIC's mandate was introduced into the Parliament in early 2018.[131] The Explanatory Memorandum to the Bill notes that the updated mandate will require ASIC to 'consciously consider how its actions may impact on competition in the financial system'. However, the change is not intended to limit or expand the scope of ASIC's regulatory responsibilities and the ACCC will remain as the competition regulator across the economy (O'Dwyer 2018b).

Such a mandate is unlikely to support the type of role we have in mind for the competition champion, which goes beyond mere consideration of competition, and beyond ASIC's own regulatory remit.

Beyond its mandate, submissions raised other issues about ASIC's ability to take on the role of competition champion, including its focus on consumer rather than competition issues, and concerns about funding (box 19.5).

Unlike the ACCC, ASIC itself was unsure about the role. However, as it will not have legislative powers but will rely on persuasion, the competition champion will need to lead a cultural shift among financial regulators. The champion can only be successful if it is willing to fully place its reputation behind its competition analysis and advice.

At the public hearing, ASIC's view was confined to its mandate:

> We have been advocating for some time, including through the Financial System Inquiry, that we do have a bigger role in competition, whether we have a mandate. But that has been conceived up until now as very much focused on our own work in relation to conduct, not a broader immediate relation to other regulatory measures taken by other regulators.
>
> So it would be an additional step, as conceived in the report, for us to take on that role. And as I said, we're still working through the implications of that. (ASIC, PC transcript, 2018, p. 311)

And in its submission, ASIC did not directly address the question of who should become the competition champion, instead stating:

> We support regulators working together to consider competition issues in the financial system, and to learn from each other's expertise and perspectives, through whatever mechanism is ultimately chosen to achieve this. (sub. DR123, p. 37)

131 The Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018 was introduced on 28 March 2018.

Box 19.5 Could ASIC be a proactive champion for competition?

Submissions raised a number of concerns about ASIC's ability to take on the role of competition champion.

ASIC is currently focused on consumer rather than competition issues:

- Although ASIC has jurisdiction in relation to potential consumer law breaches relating to financial products and services (including misleading and deceptive conduct, unconscionable conduct and unfair contract terms), it does not have jurisdiction in relation to potential competition law breaches. In the context of a proposed market intervention, it is the competition law issues that are likely to be of greatest relevance, rather than the consumer law issues. (Institute of Public Accountants, sub. DR93, p. 13)
- ASIC is essentially a consumer protection body and its view of the world is shaped largely by the misconduct it takes action against. Whilst this represents a very high percentage of the work it performs, it represents only a very small percentage of participants in the industry. Without appropriate balance and a deeper understanding of the markets, not enough ASIC staff on the whole are adequately experienced in real-world matters for it to be a balanced 'champion'. (FBAA, sub. DR85, pp. 11–12)
- ASIC's expertise in the regulation of the financial system's market participants is fundamental for consumer protection but as the regulator, ASIC may be too deeply absorbed and motivated by the detail of its job of regulating market participants. (FPA, sub. DR81, p. 14)

And there were concerns about having the resource capability:

- ASIC at the moment probably isn't effectively resourced to take on a competition role. (CHOICE, PC transcript, 2018, p. 23)

Why not APRA, the RBA or Treasury for the role of competition champion?

We noted in our Draft Report that the other two financial regulators (APRA and the RBA) were not considered as potential candidates for the role of financial system competition champion as their primary focus is, and should remain, financial stability (chapter 15). This raised some misapprehension among the RBA, APRA and the Treasury.

This Inquiry is quite explicit: we do not doubt the bona fides of any CFR member in considering the impact on competition of measures that alter the incentives for market participants to compete. But we have seen clear signs that there is minimal communication by the CFR of its motivations for intervention; and ineffective pre-implementation competition analysis (chapter 18). The latter may be deliberate, in which case it is a mistake; but even if it is not, some improvement is necessary. It cannot be achieved in the ways suggested in submissions from Treasury and the regulators, as they did not present any mechanism that amounted to more than 'trust us'.

Further, financial stability is of such evident importance for current CFR members that it is likely to overwhelm good intentions every time, particularly when the responsibility for advancing competition does not reside with any specific agency. When all are accountable, the likelihood is that none are accountable.

The focus on stability was highlighted in the submissions of both organisations. For example, APRA submitted that:

> APRA's pursuit of system stability, even if it at times may, at the margin, reduce competitive pressures, is predicated on delivering the important community benefit of a stable financial system … . APRA does not interpret its mandate as requiring it to assess the potential impact of a regulatory proposal on the ultimate price paid by consumers for financial products. (sub. DR116, pp. 4, 9)

APRA also noted that in relation to its recent prudential interventions, that it 'sought to set the desired outcome … rather than dictate exactly how that should be achieved' (sub. DR116, p. 15). While this approach is commendable, in a market where some providers have substantial power and the incentive to use it adversely arises, the impacts on competition must also be given serious consideration. We do not propose to change APRA's laudable intent. We ask that it seek a professional independent view of competition implications, so that its intentions are not used by market participants as an opportunity to anti-competitively boost profits.

APRA queried why Treasury was not considered as a candidate for the role of competition champion. Indeed, Treasury itself has noted it 'already has the role of championing competition issues at the CFR' (Treasury sub. DR126, p. 1). We did not specifically consider Treasury in the role of champion in developing the Draft Report, although (as with the RBA) we recognised that it is a close observer of competition in all markets.

To have Treasury in the role of competition champion risks undermining the strength of APRA's stability interventions, particularly in times of stress in financial markets. On occasion, the competition champion will need to challenge APRA. We propose that the champion be known to have done so, via a simple report in the CFR Minutes. A situation where markets are aware that the government's key macroeconomic adviser has taken a position that opposes the prudential regulator would undermine credibility.

The Australian Financial Markets Association saw Treasury's role as balancing the view of different regulators:

> Government decisions draw principally on advice from Treasury as its own adviser, which is best placed to provide objective and balanced views on the other sources of advice, particularly from the independent financial regulators who may separately provide their own views. (Australian Financial Markets Association, sub. DR117, p. 8)

This view is consistent with the Treasury's mandate, 'to improve the wellbeing of the Australian people by providing sound and timely advice to the Government, based on objective and thorough analysis of options' (The Treasury nd). The Treasury's approach to APRA's interventions in the housing credit market exemplifies its approach, of examining different options to determine which delivers the outcome policy makers are looking for:

> Treasury agrees with the [Commission's] Draft Report that the measures have had some potentially negative effects on competition, including potentially for smaller banks. The recent Australian Competition and Consumer Commission's (ACCC) residential mortgage inquiry interim report also brings out negative effects on competition. Notwithstanding this and other downsides such as

> the repricing of the back-book (which may reflect an existing lack of competitive pressure), which have been recognised in discussions within the CFR, in Treasury's view the financial stability benefits of the interventions have outweighed the costs. (The Treasury, sub. DR126, p. 7)

Treasury may today and again in the future promote an alternative pro-competitive view to the regulators represented on CFR. But public exposure in such a role does not seem desirable from the stand-point of stability and public credibility. On the other hand, a challenge on competition grounds to specific policies from the ACCC offers no such risk, as markets know that the competition champion is not in a position to change a policy, once implemented.

Put bluntly, we expect that the Treasury, given its role at the centre of economic policy making, will always need to stand shoulder to shoulder with APRA when it intervenes in markets, and leave institutions with no scope for doubt about stability policies.

RECOMMENDATION 19.1 COMPETITION CHAMPION FOR THE FINANCIAL SYSTEM

To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, the ACCC should be given a mandate by the Australian Government to champion competition in the financial system, including in decisions taken by regulators that have or may have the outcome of restricting competition.

To minimise cost and disruption, this role should be implemented in substantial part through the Council of Financial Regulators (CFR) by making the ACCC a permanent member of the CFR.

There should be no change under this recommendation to the current legislated responsibilities of the regulators. Rather, the Australian Government should include in its Statement of Expectations for each of the financial regulator members of the CFR that the ACCC should be given the opportunity as a member of the CFR to advise the Council on regulator actions that may have material effects on competition, before they are implemented.

The functions of the ACCC within the CFR would be:

- preparing transparent analysis of competition impacts of material market interventions by financial market regulators
- publishing a bi-annual financial system competition report which would be the competition equivalent of the RBA's Financial Stability Review.

19.2 A new approach to transparency

While the financial regulators currently discuss proposed reforms at CFR, its deliberations are held far from the public eye. This lack of transparency does little to improve market and community understanding of regulators' motivations and objectives.

These concerns are particularly relevant to the 2014 and 2017 interventions in housing credit developed by APRA. While the implementation of these policies was coordinated with the RBA (and to a much more limited extent, ASIC) and discussed at the CFR, very little information is available on the way these policies — which have substantial effects on competition — have been developed (chapter 18).

Transparency in setting the direction of shifts in financial regulation — and particularly, for this Inquiry, the explanation of how competition may be affected and how a proposed macroprudential regulatory intervention is intended to occur — is valuable. But particularly in relation to the CFR, transparency is limited.

Stakeholders highlighted the importance of transparency during consultation:

> We do believe that there could be benefit to all financial market participants through greater disclosure and transparency of CFR decision making, provide (sic) the CFR continues to provide a full and frank source of discussion for its members. Consequently, we are not prescriptive on how CFR lifts transparency. (ABA, sub. DR119, p. 37)

> With the consistent scrutiny on increasing trust in the banking industry, we would like to see the CFR increase their transparency around their decision making. This is essential to ensure accountability and an active consideration of the effects on competition. (MyState, sub. DR68, p. 4)

The RBA has noted in a recent speech that transparency can bring a range of benefits.

> One of the critical roles of communication is a vehicle for accountability. That communication is directed to the parliament and the public, to whom the Bank is accountable. It is also important that the public and parliament have a good understanding of the inflation-targeting framework to enhance understanding as to why policy decisions are being taken. They may not always agree with them, but it is important that they can understand the rationale behind them. (Debelle 2018)

The emergence of the minutes of RBA board meetings is a good example of the evolving use of communication as a way of improving public confidence. As we have found (see, for example, chapter 18), equivalent institutions to the CFR do offer more open public information on their intentions.

In its submission, the RBA, which chairs the CFR, noted that 'the CFR is open to considering other measures that could provide greater transparency of its discussions related to macroprudential and other policies' (sub. DR82, p. 10).

Given the significance of economy-wide interventions setting revised prices for loans or conditions for related financial products, the cost (in terms both of resources and time) of adding additional responsibilities to the role of CFR to review and publish such analysis would have to be very large to justify inaction. The Commission currently can envisage it would be only a small cost, to enhance capability and to put together an analysis that is noted at the time macroprudential regulation is implemented. It should only be exceptional circumstances, as decided by the Chair, that merit non-disclosure.[132] As a further measure of transparency, the CFR should also publish minutes of its meetings, as the RBA board does.

RECOMMENDATION 19.2 TRANSPARENCY OF REGULATORY DECISION MAKING

The Council of Financial Regulators (CFR) should apply the ACCC analysis in a discussion amongst members on interventions that may have a material impact on competition in a product market.

The ACCC assessment of competition impacts should be published in a simple form and timely manner as part of a new commitment to publish Minutes of CFR meetings.

Conducting ex-ante assessments of expected effects of a macroprudential intervention is only part of the process. As with any regulatory intervention, post-implementation evaluations are very important in helping regulators craft more effective policies in future. There is very limited publicly available evaluation of the policies implemented by financial regulators, and in particular APRA.[133]

Although evaluating the effects of macroprudential policies is a complex exercise, regulators and researchers have been developing frameworks for such evaluations (FSB 2017a).[134] APRA should evaluate the effects of the macroprudential reforms it has been implementing, and make its findings public.

There has been support for our draft recommendation that APRA conduct and publish annually quantitative post-implementation evaluations of its macroprudential policies (for example from COBA, sub. DR72; HSBC, sub. DR102; Regional Banks, sub. DR107; ABA, sub. DR119). CBA (sub. DR79, p. 31) argued that 'it is important that APRA continues to clearly articulate the intent of proposed macroprudential policies, consults widely and evaluates the outcomes'.

132 One example of exceptional circumstance raised during consultation is a discussion about a failing financial institution (Regional Banks, sub. DR107, p. 23).

133 One exception is a recent ANAO review of the prudential regulation of superannuation entities. It found a range of issues, including inconsistent application of supervision frameworks and no quality assurance framework (ANAO 2016).

134 The IMF, the Bank of International Settlements and the European Central Bank have released the results of quantitative research evaluating the effectiveness, as well as the costs and benefits, of macroprudential policies (Arregui et al. 2013; Behn, Gross and Peltonen 2016; Gambacorta and Murcia 2017).

RECOMMENDATION 19.3	ROBUST AND TRANSPARENT ANALYSIS OF MACROPRUDENTIAL POLICIES

APRA should conduct and publish annually quantitative post-implementation evaluations of its material prudential interventions, including costs and benefits to market participants and the effects on competition.

Is there a need for an external oversight body?

The Murray FSI recommended the establishment of a Financial Regulator Assessment Board, to review regulators' performance annually, including the way they consider the effect of their actions on competition (Murray et al. 2014a). The idea of having an oversight body was also raised during consultation on the Draft Report (Mair, PC transcript, 2018, pp. 75–78).

Reflecting the principles of the regulatory architecture and ministerial oversight put in place by the Wallis FSI, the ASIC Capability Review argued that such a board is unnecessary:

> [T]he Panel considered there was no compelling case for a 'regulator to regulate the regulators', with the attendant additional cost burdens involved for the regulated population. …. [T]he existing framework needs to be better used to fully realise its accountability potential. (2015, p. 48)

The Commission agrees. A 'regulator of regulators' is not a desirable outcome from this Inquiry.

A Inquiry conduct and participants

This appendix describes the stakeholder consultation process undertaken for the Inquiry and lists the organisations and individuals that have participated.

Inquiry Terms of Reference

The terms of reference for the Inquiry — reproduced in the preliminary pages of this report — was received from the Treasurer on 8 May 2017 with an advised Inquiry commencement date of 1 July 2017. The Inquiry was advertised in the *Australian Financial Review* on 14 June 2017 and an initial circular was emailed to representatives of the financial systems sector, government agencies and to individuals.

Consultations

The Commission held the following consultation processes throughout the Inquiry:

- three public Roundtable Hearings on 29 June 2017 (table A.1) with representatives from the financial regulators, the regional banks, and consumer groups
- a Roundtable discussion with representatives from non-bank financial institutions on 18 December 2017 (table A.2)
- separate discussions throughout the course of the Inquiry with around 90 businesses, business groups, government agencies, academics and other individuals (table A.3)
- 4 days of public hearings (in Sydney on 28 February and 1 March 2018 and in Melbourne on 5 and 6 March 2018), following the release of the Draft Report (table A.5)

The Commission received 137 public submissions (table A.4) during the Inquiry — 52 prior to the Draft Report and 85 in response to the Draft Report:

- 36 from the banking sector
- 20 from payments system operators
- 18 from mortgage or finance brokers and aggregators
- 13 from the insurance sector
- 10 from the financial advice and wealth management sector
- 11 from consumer and business groups
- 17 from individuals
- 12 from government agencies or regulators

The Inquiry website includes a copy of all public submissions received, as well as transcripts from the initial public roundtable hearings and the post-Draft Report public hearings. The public hearings were live streamed, and a video file is also available on the Inquiry website.

Data and information requests

The Commission made detailed data and information requests to a number of entities as input to the Inquiry (table A.6).

We are very appreciative of a number of other entities that voluntarily provided information to the Commission as input to the Inquiry. Where possible, given legislative provisions, the Commission has published this data and information in detail in the Inquiry report. A range of information was also provided to the Commission in-confidence, on the understanding that the Commission would not publicly release the information in a way that could be attributed to the providing entity.

The Commission collected some data and information for this Inquiry by serving formal notices under section 48 of the *Productivity Commission Act 1998* (Cth). For this purpose, the Commission served formal notices on the following entities:

- Bank of China (Australia) Limited
- Bank of China Limited, Sydney Branch
- Australian Prudential Regulation Authority
- Australia and New Zealand Banking Group Limited
- ANZ Lenders Mortgage Insurance Pty Ltd
- Commonwealth Bank of Australia
- Genworth Mortgage Insurance Australia Ltd
- National Australia Bank Limited
- QBE Lenders Mortgage Insurance Ltd
- Westpac Banking Corporation
- Westpac Lenders Mortgage Insurance Ltd

Documents produced by the Inquiry

The following public documents were prepared by the Commission in this Inquiry:

- Consultation paper — released 6 July 2017
- Draft Report — released 7 February 2018
- Final Report — delivered to Government on 29 June 2018 (to be publicly released within 25 parliamentary sitting days).

Table A.1 **Public roundtable hearings and participants**

Melbourne — 29 June 2017

Hearing 1: Financial system regulators

Australian Competition and Consumer Commission
Australian Prudential Regulation Authority
Australian Securities and Investments Commission

Hearing 2: Regional banks

Adelaide Bank
Bank of Queensland
Customer Owned Banking Association
ME Bank
Suncorp Group

Hearing 3: Consumer groups

CHOICE
Consumer Action Law Centre
Financial Counselling Australia

Table A.2 **Non-bank financial institution roundtable discussion participants — Sydney, 18 December 2017**

Pepper Financial Services Group
Redzed
Firstmac
Columbus Capital
Mortgage House
Resimac
Australian Securitisation Forum
Clayton Utz

Table A.3 **Consultations**

Alibaba Group
Allianz Australia
AMP
Ant Financial
AUSTRAC
Australia and New Zealand Banking Group
Australian Bankers' Association
Australian Chamber of Commerce and Industry
Australian Competition and Consumer Commission
Australian Financial Group
Australian Financial Markets Association
Australian Office of Financial Management
Australian Payments Network
Australian Prudential Regulation Authority
Australian Remittance and Currency Providers Association
Australian Retailers Association
Australian Securities and Investments Commission
Australian Settlements Ltd
Bank of China
Behavioural Economics Team of the Australian Government (BETA)
Brian Johnson (CLSA)
Bronte Capital
Business Council of Co-operatives and Mutuals
Citi
ClearView
Combined Industry Forum (CIF)
Commercial Asset Finance Brokers Association
Commonwealth Bank of Australia
Council of Small Business
Credit and Investments Ombudsman
Cuscal
David Murray
Deborah Ralston, Monash University
Department of the Treasury
eftpos
Equifax
Ernst and Young
Financial Markets Authority
Financial Ombudsman Service
Financial Planning Association
Financial Services Council
Fintech Australia
Genworth

(continued next page)

Table A.3 (continued)

Ian Ramsay (Prof), University of Melbourne
ING Direct
Insurance Council of Australia
Jeannie Paterson, University of Melbourne
Jonathan Mott and Rachel Bentvelzen
Judo Capital
Kevin Davis, UNSW
Liberty Financial
Maria Rigoni
MasterCard
Moody's
Mortgage & Finance Association of Australia
National Australia Bank
National Farmers' Federation
New Payments Platform Australia Limited
Oliver Wyman
Onmarket Bookbuilds
PayPal
Pepper Financial Services Group
Pin Payments
Promontory Financial Group
QBE
QBE Insurance Group
Rabobank Australia
Reserve Bank of Australia
Rod Maddock
Roy Morgan
Square Australia
TransferWise
Tyro Payments
Underwriting Agencies Council
Unhappy Banking
Visa
Westpac Banking Corporation
Xero
Xinja

New Zealand

Financial Markets Authority
Co-operative Bank
Kiwibank
Ministry of Business, Innovation and Employment

United Kingdom

Amelia Fletcher (Prof), University of East Anglia
Financial Conduct Authority
Mutuo

Table A.4 **Public submissions received**

Participant	*Submission no.*
Peter Mair	1, 4, 5, DR53
Australian Institute of Conveyancers WA Division	2
Winston Rodrigues	3
National Farmers' Federation	6
Credit and Investments Ombudsman	7
Dixon Advisory	8
Xinja	9, DR67
Eftpos Payments Australia Limited	10
Australian Bankers' Association	11
Judo Capital	12
Federation of Ethnic Communities Councils of Australia	13
Australian Payments Network	14, DR114
Credit Union Australia	15
Commercial Asset Finance Brokers Association of Australia Limited	16, DR92
Australian Competition and Consumer Commission	17, DR129
Finance Sector Union	18
PayPal	19
ING Bank Australia	20
Customer Owned Banking Association	21, DR72
Australian Prudential Regulation Authority	22, DR116
Consumer Action Law Centre	23, DR130
Financial Services Council	24, DR108
Commonwealth Bank of Australia	25, DR79
Financial Planning Association of Australia	26, DR81
Business Council of Co-operatives and Mutuals	27, DR90
Westpac	28, DR125
Reserve Bank of Australia	29, DR82
Australian Small Business and Family Enterprise Ombudsman	30, DR101
National Australia Bank	31, DR94
Insurance Council of Australia	32, 33, DR62, DR120
QBE Insurance Group	34, DR131
Bank of Queensland	35
Hero Broker	36
Regional Banks (AMP/Bendigo Bank/Bank of Queensland/ME Bank/Suncorp)	37, DR107
Equifax	38
Lateral Economics	39
Australian Securities and Investments Commission	40, DR123
Caji DeSouza	41
CHOICE	42, DR97
John Dahlsen	43
Genworth	44, DR121
Australian Lawyers Alliance	45

(continued next page)

Table A.4 (continued)

Participant	*Submission no.*
Maria Rigoni	46, DR118
Australian Finance Industry Association	47, DR110
Mortgage & Finance Association of Australia	48, DR86
ANZ	49, DR74
AMP	50
Heritage Bank	51
MLC Life	52, DR76
Peter Twigg	DR54
John Evans	DR55
National Insurance Brokers Association	DR56
Money Quest Australia	DR57
TransferWise	DR58
TradeOff	DR59
WEX Australia Pty Ltd	DR60
Chris Berg, Sinclair Davidson and Jason Potts	DR61
Lufthansa AirPlus Serviceskarten	DR63
McLean Roche Consulting	DR64
John Reischel	DR65
PetSure	DR66
My State Limited	DR68
Joseph Ripolles	DR69
Home Loan Experts	DR70
Australian Finance Group	DR71, DR132
Canstar	DR73
Australian Taxpayers' Alliance	DR77
Australian Institute of Superannuation Trustees	DR78
REA Group Ltd	DR80
Association of Financial Advisers	DR83
American Express	DR84
Finance Brokers Association of Australia Limited	DR85
VISA	DR87
P&N Bank	DR88
Gary Jackson	DR89
MasterCard	DR91
Institute of Public Accountants	DR93
Habitat Finance	DR95
Financial Services Institute of Australia	DR96
Cuscal	DR98
CMSPI	DR99
Alipay	DR100
HSBC	DR102
National Stock Exchange	DR103

(continued next page)

Table A.4 (continued)

Participant	*Submission no.*
Connective	DR104
Suncorp Group	DR105
Combined Industry Forum	DR106
Darren Nelson	DR109
FinTec	DR111
International Institute for Self-governance	DR112
Australian Retailers Association	DR113
Australian Lottery and Newsagents Association	DR114
Industry Super Australia	DR115
Australian Financial Markets Association	DR117
Australian Banking Association	DR119
NPP Australia Limited	DR122
Mortgage Experts	DR124
The Treasury	DR126
Australian Industry Group	DR127
Australian Remittance and Currency Providers Association	DR128
Australian Securitisation Forum	DR133
David Allen	DR134
Sue Holmes	DR135
Wealth Wisdom	DR136
Laminar Captial	DR137

Table A.5 **Public hearings and participants**

Sydney — 28 February 2018
CHOICE
Bendigo and Adelaide Bank
Westpac
Australian Competition and Consumer Commission
Xinja Ltd
Peter Mair
Sydney — 1 March 2018
Financial Services Institute of Australasia
MasterCard
Business Council of Cooperatives and Mutuals
Bank of Queensland
Customer Owned Banking Association
Commonwealth Bank
National Australia Bank
Melbourne — 5 March 2018
Suncorp Group
Lateral Economics
Consumer Action Law Centre
Finance Brokers Association Australia
Ms Maria Rigoni
Melbourne — 6 March 2018
MoneyQuest Australia
ANZ
Australian Securities and Investments Commission
ME Bank

Table A.6 Commission requests for data and other information from participants

Regulators
Reserve Bank of Australia
Australian Prudential Regulation Authority
Australian Securities and Investments Commission
The Treasury
Authorised deposit-taking institutions
AMP Limited
Australia and New Zealand Banking Group
Bank of China (Australia) Limited
Bank of China Limited, Sydney Branch
Bank of Queensland Limited
Bendigo and Adelaide Bank Limited
Citigroup Pty Limited
Commonwealth Bank of Australia
Credit Union Australia
Heritage Bank Limited
HSBC Bank Australia Limited
ING Bank (Australia) Limited
Macquarie Bank Limited
Members Equity Bank Limited
National Australia Bank Limited
Regional Australia Bank
Suncorp Group
Westpac Banking Corporation
Lenders mortgage insurance providers
ANZ Lenders Mortgage Insurance Pty Ltd
Genworth Mortgage Insurance Australia Ltd
QBE Lenders’ Mortgage Insurance Ltd
Westpac Lenders Mortgage Insurance Ltd

B The regulatory environment

The Australian regulatory system consists of a number of regulators: the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA), including the RBA's Payments System Board. Each has a specific scope and functions, though their objectives overlap in some areas (table B.1).

In addition, the Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Australian Competition and Consumer Commission (ACCC) have important roles to play in the regulation of the financial system.

Table B.1 **Regulator overview**

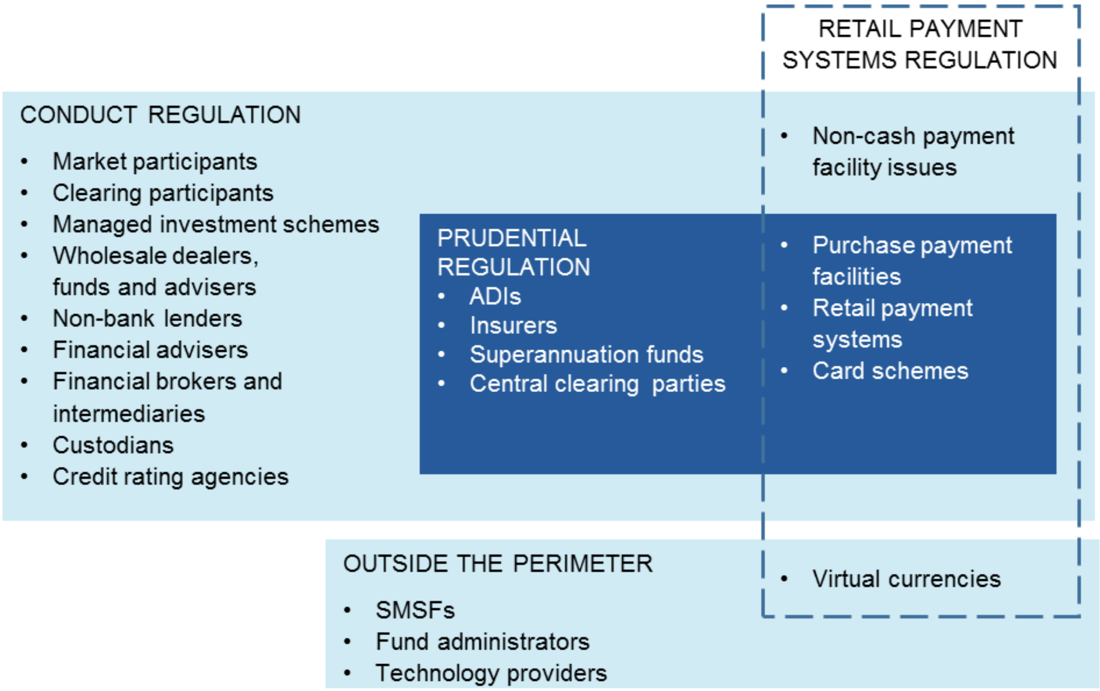
Functions and powers of key regulators[a]

	APRA	*ASIC*	*RBA*
Mandate	Financial system stability Prudential regulation	Promote fair and efficient markets Protect consumers	Financial system stability
Role	Prudential regulation	Conduct regulation Consumer education	Macroeconomic stability Payments system regulation
Scope	ADIs Insurance Superannuation	Creditor institutions Authorised financial markets All other financial services	Whole financial system
Regulatory functions	Licensing Monitoring/data gathering Prudential requirements (incl. capital adequacy) Investigation	Licensing/accreditation Maintain registers Administer consumer protections Investigation Prosecution of code breaches	Monetary policy Payments system regulation Liquidity support
Enforcement powers	Disqualifications Licence conditions Enforceable undertaking Appoint statutory manager Criminal proceedings	Disqualifications Pecuniary penalties Enforceable undertaking Criminal, civil and administrative proceedings	

[a] Table does not show all functions and responsibilities of these organisations — only primary functions and only those that are relevant to financial services regulation.

The Murray FSI defined the overlapping perimeters of different forms of regulation (prudential, conduct and payment systems) and the different categories of regulated entity (figure B.1).

Figure B.1 **Perimeters of regulation by institution**



Source: Murray FSI (2014b)

In some circumstances, regulatory boundaries will overlap. This may occur where different regulators cover a different aspect of a business's functions. Payments systems provides an example of this. All three regulators cover payments systems — the RBA (through the PSB) regulates payments systems generally, ASIC regulates all non-cash payment facilities and APRA regulates providers of purchased payment facilities (such as PayPal) as ADIs.

This appendix considers the financial sector regulators, with particular focus on their functions, enforcement powers, responsibilities in respect of competition, coordination, accountability and funding, as well as the changes that have occurred in recent years.

B.1 Regulator functions

APRA

APRA is responsible for prudential regulation of specific licensed institutions. It operates under the *Australian Prudential Regulation Authority Act 1998* (Cth) and administers a range of legislation covering the supervision of authorised deposit-taking institutions (ADIs), general insurers, life insurers, health insurers and superannuation funds (APRA 2018h).

APRA does not cover money market corporations, discretionary mutual funds, exempt public sector superannuation schemes, general insurance intermediaries, religious charitable development funds or wholesale funders.

APRA is responsible for setting and enforcing prudential requirements on financial institutions as well as supervising performance and assessing system stability. APRA's core mission is to:

> ensure that under all reasonable circumstances, the financial promises made by the institutions it supervises are met within a stable, efficient and competitive financial system. (APRA, sub. DR 116, p. 7)

As part of this function, APRA has regulations tailored to the products and operations of specific industries, as shown in table B.2.

Standard setting for capital adequacy and risk management

APRA's core regulatory regimes on risk management and capital adequacy are designed to quantify the different forms of risk in a financial service and ensure that regulated firms adequately provision against them. For example, the risk of a home loan is that it may default or fall into arrears. APRA's prudential standards look at the properties of the home loan, including the loan–to-value ratio and assign a risk weighting to the total value of the loan. The bank must then hold capital against a portion of the risk-weighted loan as provision for default. There are also requirements to hold capital against operational risk – the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events (APRA 2013d). Insurers have an additional risk category of product concentration. For example, if a home insurer has its policies concentrated in one area, the risk from a flood in that area will be higher than if the policies had been spread across different locations.

APRA also regulates other aspects of the operation of financial services businesses which may pose a risk to the survival of an individual financial institution or the health of the financial system as a whole. For banks, this includes areas such as credit quality. For insurers, this includes areas such as reinsurance management. With respect to banks, APRA's responsibilities are increasing in this area, with the introduction of the Banking Executive Accountability Regime (BEAR). This regime is designed to impose strengthened accountability requirements within banking organisations, which should improve attitudes to risk taking and consequently improve the soundness of those institutions.

Table B.2 **APRA regulation by institution type**[a]

	ADIs	*General insurers*	*Life insurers*	*Health insurers*	*Superannuation*
Capital adequacy	•	•	•	•	
Risk management	•	•	•	•	•
Credit/asset risk	•	•	•	•	
Insurance risk		•	•	•	•
Operational risk	•	•	•	•	•
Market and currency risk	•				
Interest rate risk	•				
Related entity risk	•	•	•		
Concentration risk		•	•		
Executive accountability (BEAR)	•				
Securitisation	•				
Liquidity	•				
Credit quality	•				
Reinsurance management		•	•		
Policy liability estimation		•	•	•	
Defined benefits					•
Outsourcing	•	•	•	•	•
Solvency status			•	•	

[a] This only covers key regulations, not all. A full list is available on APRA's website.

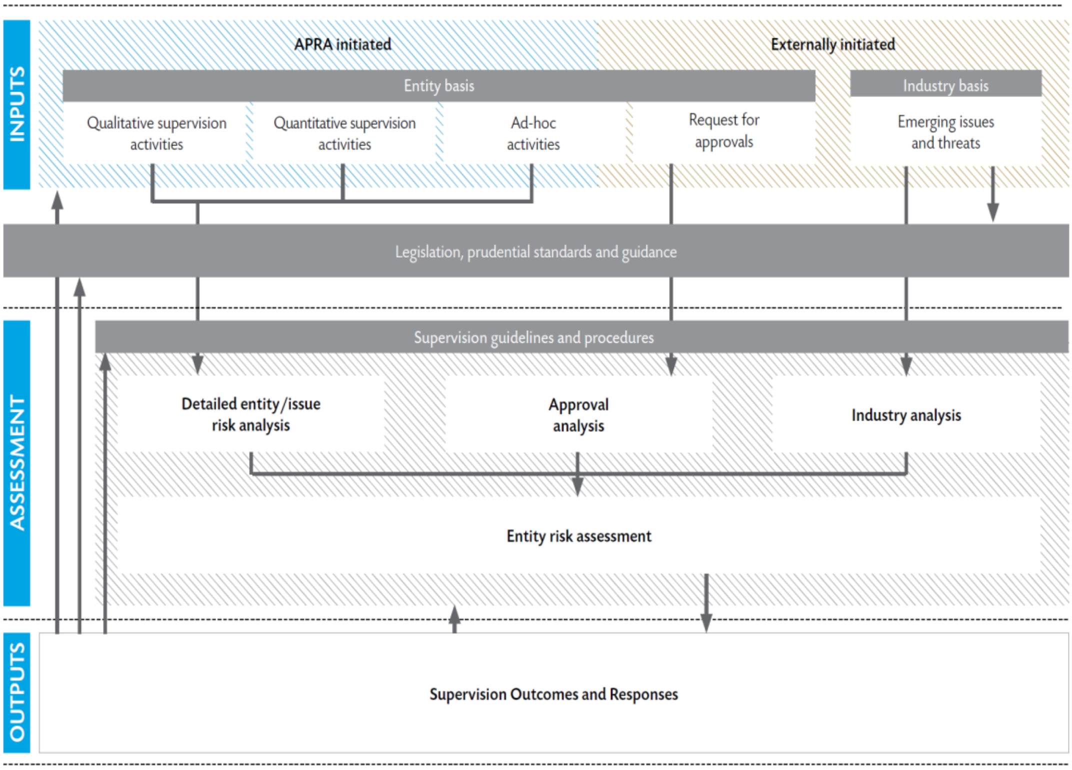
Source: APRA prudential regulations (various)

APRA works within the context of international standards, set out for example in the Basel accords, relating to banking, or the Insurance Core Principles set out by the International Association of Insurance Supervisors. The International Monetary Fund reviews compliance with international standards — on aspects such as anti-money laundering and countering the financing of terrorism; banking and insurance supervision; payments systems; and securities regulation — as part of its regular series of Financial Sector Assessment Program visits. Australia is one of 29 financial sectors to receive a review every five years, and the 2018 review is currently under way (Morrison, S. (Treasurer) 2017a).

Supervision and data collection

To aid in the effective enforcement of prudential regulations, APRA has substantial supervision and data collection powers. The supervision of regulated institutions also helps inform government on the emergence of new risks and guides the development of new regulations. Figure B.2 illustrates APRA's process of information collection and how it is fed back into the regulatory process.

Figure B.2 **APRA's supervision process**



Source: APRA (2015f)

Supervision requirements parallel the prudential requirements for an institution, typically quantifying the exact risks and other measures explicitly set out in regulation. Some exceptions to this include data collected for other agencies (such as the Australian Bureau of Statistics or the RBA) or ad-hoc data collections. Ad-hoc data collections allow APRA to investigate stability issues which are not examined through regular statistical collections.

Enforcement

APRA tends to take a cooperative approach to resolving prudential issues rather than waiting for circumstances to reach the point at which enforcement action becomes necessary. However, it has multiple tools for dealing with non-compliance. These tools include restraining orders, licence conditions, disqualification, appointment of a statutory manager or criminal action (APRA 2015d). These actions are rarely used. There have been two reported enforceable undertakings in the last four years and no disqualifications in the last ten years (these are usually managed by ASIC using its licensing powers) (APRA 2018f, 2018i).

Competition

In performing and exercising its functions and powers, APRA is required to:

> … balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia. (*Australian Prudential Regulation Authority Act 1998* (Cth), s. 8)

APRA submitted that through its prudential policy and supervisory interventions, it seeks to find 'an effective and appropriate balance between stability and competition considerations.' Where APRA's regulatory decisions impose costs to competition, APRA considers that these are:

> outweighed by the significant public benefits that result from curtailing unsustainable financial industry activity and ensuring the financial system is more resilient to deal with future systemic challenges. (sub. DR116, p. 8)

APRA's information paper on its policy priorities for 2018 (APRA 2018d) sets out how it seeks to balance the objectives within its mandate. Efficiency, competition, contestability and competitive neutrality are of most interest for the purposes of this Inquiry. APRA has also identified the following policy priorities as being driven by efficiency and competition considerations (DR116):

- ADIs: simpler capital requirements for small ADIs; phased licensing
- Insurance: role of appointed actuary; reinsurance requirements for life insurers
- Superannuation: post-implementation review of prudential and reporting frameworks
- Cross-industry: review of outsourcing standards and guidance.

Table B.3 **Elements of APRA's mandate**

Objective	*Policy aimed at*	*Examples*
Financial safety	Financial soundness of individual regulated institutions	Minimum capital requirements for authorised deposit-taking institutions (ADIs) and insurers; risk management and governance expectations for all APRA-regulated entities
Efficiency	Least-cost regulatory option relative to delivery of prudential objective; avoiding distortion of resource allocation in the economy	Align regulatory requirements to industry sound practice; limit regulatory reporting to data that has most value in supervision or through publication
Competition	Institutions being able to compete with other regulated and unregulated providers through prices and features offered on their products and services	Focus on risk alignment rather than product-specific requirements; consideration of level playing field in policy options and simpler options for smaller entities
Contestability	Not hindering ease of entry and exit; new entities able to enter the market at reasonable cost	Regulatory requirements for new APRA-regulated institutions are flexibly applied in a manner proportionate to risk to the community
Competitive neutrality	Classes or types of institutions not favoured over others	Consistent regulatory requirements across classes of institutions; any differences in minimum financial soundness, governance or risk management expectations across regulated entities are necessary to align with scale, complexity and risk
Financial system stability	Resilience of credit, savings, insurance and investment markets and operations; maintenance of public confidence in financial sector	Minimum capital and liquidity requirements for ADIs and insurers; recovery planning expectations; the Financial Claims Scheme; expectations for assessment of outcomes provided to superannuation members

Source: APRA (2018d)

ASIC

ASIC is responsible for conduct regulation and consumer protection. ASIC's responsibilities include licensing of financial institutions, administration of the National Consumer Credit Act and investigation and regulatory actions in relation to financial service provider conduct failures. ASIC also has responsibility for business registration as the corporate regulator — managing the registration of all corporations and their obligations under the *Corporations Act 2001* (Cth).

The dual role — financial system and corporations more broadly — reflects overlapping conduct and disclosure regulations between financial service providers and corporations in general. This broad scope means that not all of ASIC's functions are relevant to competition or stability in financial services. Consequently, this section focuses on financial services licensing, market regulation, consumer credit regulations and ASIC's supervisory functions.

ASIC's legislation gives it the authority to regulate any financial market or financial advice provider. ASIC has a range of criminal, civil and administrative remedies.

Licensing

Any individual or entity providing financial advice, establishing a financial market or selling a financial product needs an Australian Financial Services licence, issued by ASIC. These licences can cover the employees of an entity. The licence may also cover authorised representatives of a licensed firm (though the licensee must notify ASIC). The licensing arrangements mandate adequate resourcing, disclosure and conduct for the service provided. Adequate resources includes trained and competent employees, solvency, liquid funds, risk management systems, appropriate information technology systems and insurance (ASIC 2017ac). The licence also mandates requirements for product disclosure statements and conflict of interest management.

Market regulation

ASIC also regulates and supervises market operators such as the Australian Securities Exchange (ASX). As part of its market operation oversight, ASIC has real-time trading supervision functions, which monitor data on Australia's domestic licensed markets, including the ASX. ASIC uses this information to inform its enforcement and market integrity reporting.

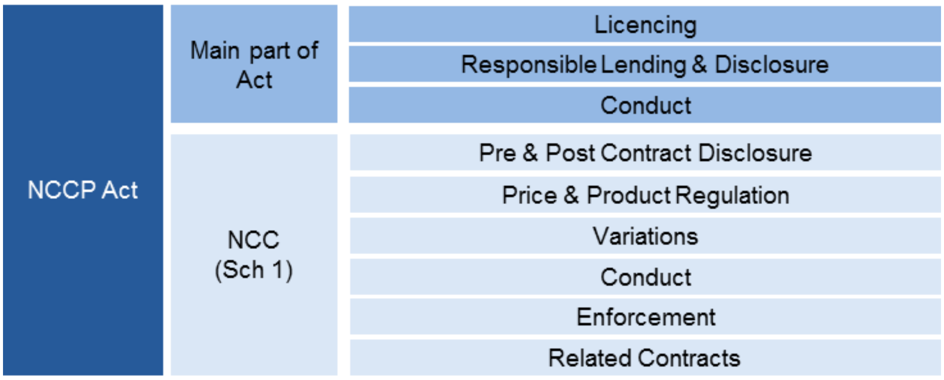
National Consumer Credit Act

ASIC administers the *National Consumer Credit Protection Act 2009* (Cth) (NCCP) including the National Credit Code (schedule 1). The NCCP covers licencing, conduct, disclosure and responsible lending rules for credit providers as shown in figure B.3.

The NCCP regulates almost all loans provided to consumers (as opposed to businesses). It applies to any entity in the business of providing credit — a definition which covers more of the market than targeted APRA regulation (capturing intermediaries such as brokers and non-ADI lenders).

To provide NCCP regulated credit, an entity must hold an Australian Credit Licence or represent a credit licensee. For example, a mortgage aggregator may hold a license while one of their brokers may operate as a representative. One notable exception to the licence requirement is point-of-sale retailors (commonly known as introducers).

Figure B.3 **Overview of National Consumer Credit Protection Act**



Source: Paterson & Howell (2018)

The NCCP general conduct provisions require licensees to manage conflicted interests, maintain competency (including competency for representatives), maintain internal and external dispute resolution processes, set out compensation arrangements and use adequate risk management processes (if not regulated by APRA). In addition, the NCCP has a broad conduct obligation to only engage in efficient, honest and fair credit provision.

The NCCP also requires licensees to provide specific disclosure to borrowers before contract. Each credit contract requires a key fact sheet called a credit guide as well as specific guides for specialised products such as mortgages or credit cards. The various fact sheets are designed to simplify credit arrangements into information understandable to most borrowers.

The responsible lending provisions of the NCCP require that credit provided to a borrower is ‘not unsuitable’ to their needs and circumstances — a definition understood to impose a lesser obligation than ‘suitable’ credit provision (Paterson and Howell 2018). Though responsible lending obligations impose very general obligations to perform ‘reasonable’ steps to discover borrower needs, inquire about the borrower’s financial situation and verify the borrower’s financial situation, ASIC has taken successful action under these provisions.[135]

Additional to the main provisions of the NCCP, the National Credit Code covers the following areas (Paterson and Howell 2018):

- pre-contractual disclosure;
- content obligations for credit contracts and related mortgages and guarantees;
- price regulation;
- unilateral and agreed changes to credit contracts;
- hardship variations to credit contracts;

135 For example, ASIC v The Cash Store *(in liquidation)* [2014] FCA 926.

- unjust transactions and unconscionable interest and charges;
- ending and enforcement of credit contracts and related mortgages and guarantees; and
- related sale and insurance contracts.

Monitoring and enforcement

To enforce obligations under the NCCP, AFS licence and general corporate obligations, ASIC regularly undertakes targeted monitoring programmes. These can range from analysis of high level market data to in-depth investigation with onsite visits. ASIC sets out its plans for surveillance in its corporate plan and provides a snapshot of its surveillance coverage of regulated populations in its annual report (ASIC 2017a, 2017g).

ASIC (2013b) has a wider range of enforcement powers than the other regulators. Enforcement action available to ASIC includes:

- prison terms and court orders
- criminal financial penalties
- civil financial penalties
- disqualification (does not require court ruling)
- revocation of licences (does not require court ruling)
- injunction
- forced correction of disclosure
- seek damages on a wronged party's behalf
- negotiated action (enforceable undertaking — does not require court ruling).

ASIC provides regular reports of the use it has made of its different powers (figure B.4).

Figure B.4 **ASIC enforcement actions**
July to December 2017

Source: ASIC (2018b, p. 5)

In its submission to the Murray FSI, ASIC highlighted large differences between the maximum penalties available to it and those available to other international conduct regulators.

In response to the Murray FSI's recommendations in this area, the Government established the ASIC Enforcement Review Taskforce in October 2016. The Taskforce reported in December 2017 and the Treasurer announced on 20 April 2018 that the Government would strengthen criminal and civil penalties for corporate misconduct and boost ASIC's powers to protect consumers from corporate and financial misconduct (Morrison, S. (Treasurer) 2018a). As a result, ASIC will have the ability to impose stronger penalties than previously available (table B.4).

Table B.4 **International comparison of penalties for individuals[a] (A$) and availability of disgorgement [b]**

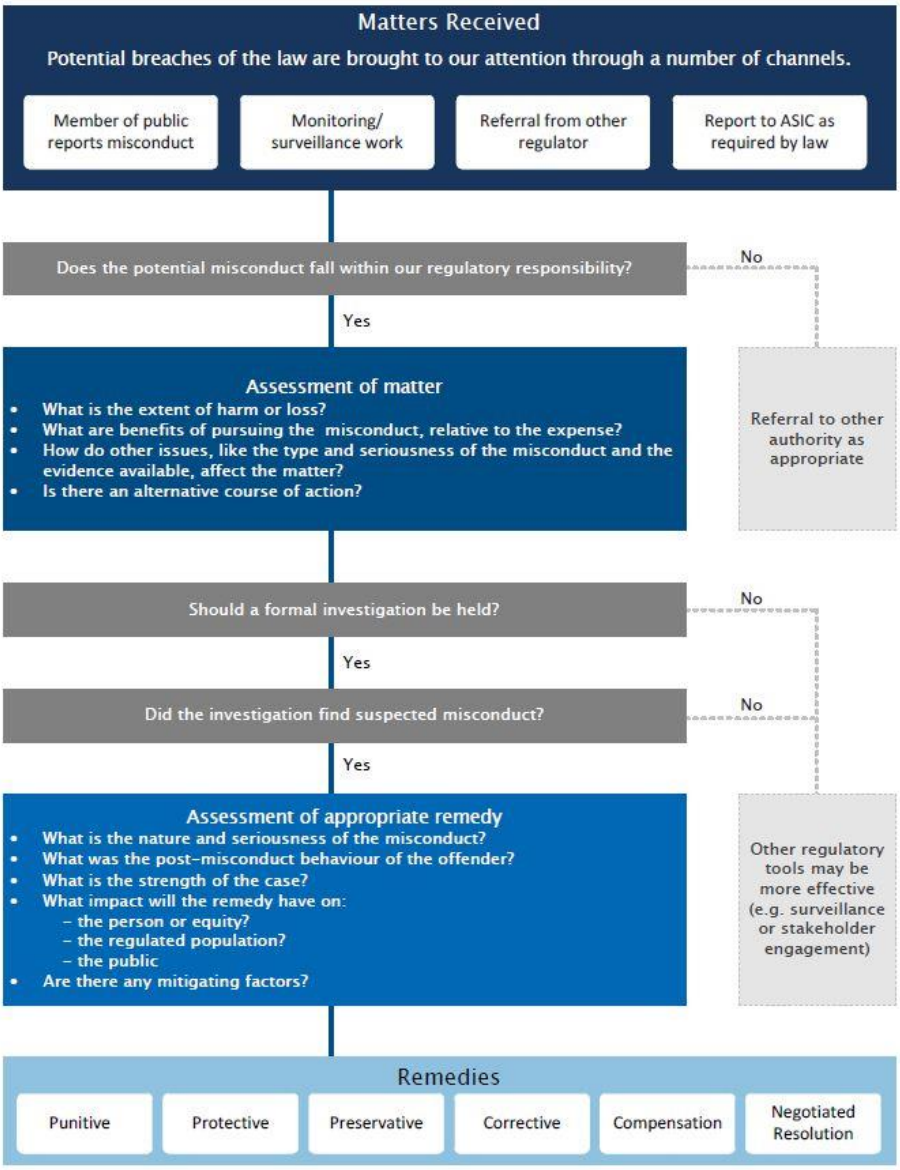
	Insider trading	*Market manipulation*	*Disclosure*	*False statements*	*Unlicensed conduct*	*Inappropriate advice*
Australia (current)	Civil: $200 000 ✗	Civil: $200 000 ✗	Civil: $200 000 ✗	– ✗	– ✗	Civil: $200 000 ✗
Australia (proposed)[b]	Civil: $525 000 ✓	Civil: $525 000 ✓	Civil: $525 000 ✓	– ✓	-– ✓	Civil: $525 000 ✓
Canada	Admin: $1.05 million ✓	Admin: $1.05 million ✓	Admin: $1.05 million ✗	Admin: $1.05 million ✓	Admin: $1.05 million ✓	Admin: $1.05 million ✓
Hong Kong	Admin: unlimited ✓	– ✓	Civil: $1.12 million ✗	– ✓	– ✗	Admin: $1.4 million, or 3 times the benefit gained ✗
United Kingdom	Civil and admin: unlimited ✓	Civil and admin: unlimited ✓	Civil and admin: unlimited ✓	Civil and admin: unlimited ✓	– ✗	Admin: unlimited ✓
United States	Civil: three times the benefit gained ✓	Civil: greater of $111 000 or the benefit gained ✓	Civil: greater of $111 000 or the benefit gained ✓	Civil: greater of $111 000 or the benefit gained ✓	Civil: greater of $111 000 or the benefit gained ✓	Admin: $83 850 ✓

[a] Civil and administrative penalties only, not criminal penalties, [b] Disgorgement remedies involve the removal of benefits illegally obtained or losses avoided, and can apply separately from any civil or administrative penalty.

Source: ASIC (2014b, p. 48); Australian Government (2017a)

Because of ASIC's broad role and finite resources, it is selective in its investigation and enforcement procedures and operates a series of tests (figure B.5) before moving to each stage of its enforcement process (ASIC 2013b).

Figure B.5 **ASIC's approach to enforcement**



Source: ASIC (2017e, p. 12)

Competition

ASIC does not have any formal responsibility to promote competition in the financial system, though it will have a duty to 'consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system' if Parliament approves the proposed changes to the *Australian Securities and Investments Commission Act 2001* (Cth) which were introduced into Parliament on 28 March 2018.

ASIC's submission stated that it considered competition in carrying out its work, and sought to promote effective competition by developing regulatory solutions that deal with barriers to demand-side competition and by addressing supply-side issues that lead to poor consumer outcomes (ASIC, sub. 40, p. 7).

ASIC recognised that there had been uncertainty about if and how it could consider competition factors in taking its decisions, but that a broad mandate would allow it to factor and appropriately balance competition into its regulatory decision making; and address market failure as a driver of misconduct or poor consumer outcomes (ASIC, sub. DR123).

Box B.1 ASIC initiatives to promote competition

Supply side initiatives

Initiatives designed to assist new businesses to enter the market or develop new products which may increase competition

Regulatory sandbox

ASIC's regulatory sandbox allows eligible fintech businesses to test certain specified services for up to 12 months without an AFS or credit licence (ASIC 2018m). In the 2017-18 Budget, the Government indicated its intention to introduce an 'enhanced regulatory sandbox' that will allow more businesses to test a wider range of new financial products and services without a licence (Morrison, S. (Treasurer) 2017c). The Treasury launched a consultation on the draft legislation and regulations to allow this in October 2017 (Australian Government 2017d).

Innovation Hub

The Innovation Hub helps support start-ups with innovative new business models to navigate the regulatory system. Through the hub, eligible businesses can request informal guidance from ASIC on the licensing process and key regulatory issues that should be considered as they set up business (ASIC 2018h).

Demand side initiatives

Initiatives intended to increase the information available to consumers.

Greater transparency around ownership

ASIC has been working to increase the transparency of consumers' interactions with providers, and promote consumers' ability to assess and make decisions about financial products and services. This could include statements about the relationship of the intermediary to the product issuer, or the limited range of products that an adviser or broker is able to, or likely to, recommend.

Greater availability of data

ASIC is considering options to enforce greater public availability of private sector data (e.g. on life insurance claims outcomes) as this is likely to help drive demand-side competition and improve market outcomes.

ASIC also makes regulatory interventions designed to protect consumers where competition is not achieving the right outcomes — such as through interventions on payday lending, consumer leases and commissions for add-on car insurance.

As an outcome from the Murray FSI, ASIC is also due to receive a product intervention power to enable it to take a more proactive approach to reducing the risk of significant consumer detriment. The draft explanatory memorandum for the Bill stated that the power would allow ASIC to:

> … regulate, or if necessary, ban potentially harmful financial and credit products where there is a risk of significant consumer detriment. The power is intended to enable ASIC to take action before harm, or further harm, is done to consumers. (Australian Government 2017j)

Reserve Bank of Australia

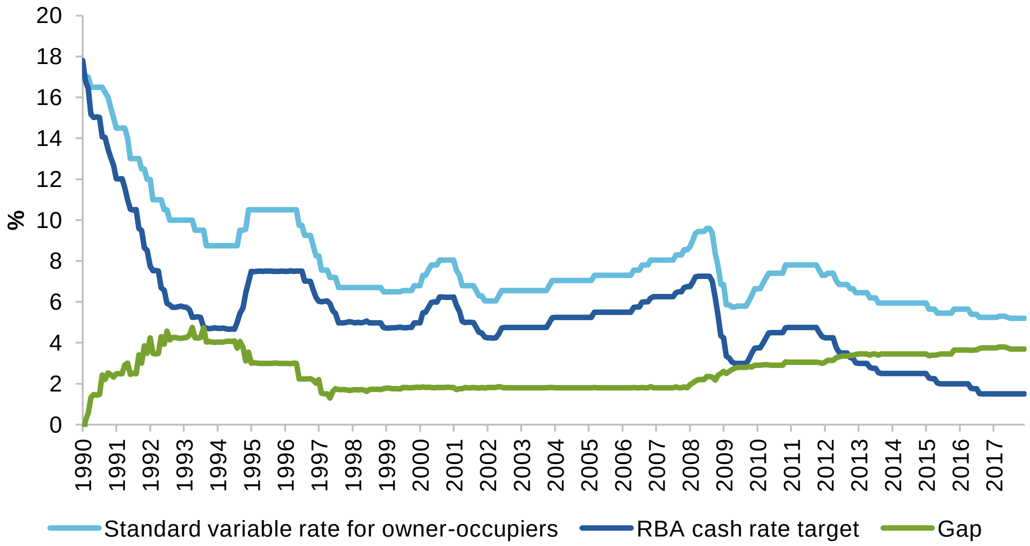
The Reserve Bank of Australia (RBA) has less explicit regulatory power, except in the payments system. The Reserve Bank's key roles are monetary policy, macroeconomic supervision and payments system regulation.

Monetary policy and market operations

Historically, one of the main interventions of the RBA in the financial system has been through its role in setting the cash rate through injecting or withdrawing inter-bank exchange settlement funds in the overnight money market (Bech and Monnet 2013). The intention is that the demand for exchange settlement funds is satisfied at or close to the cash rate target, and the RBA manages to achieve this almost all of the time (Hing, Kelly and Olivan 2016).

Unlike APRA or ASIC regulations which generally target specific institutions, the RBA's monetary policy affects the financial system and economy as a whole. Setting the cash rate influences all interest rates in the wider economy, and this affects borrowing and lending behaviour, aggregate demand and the level of inflation (RBA, sub. DR82). Where APRA and ASIC regulate through legal restrictions, the RBA's open market operations operate through forces of supply and demand for funds — aligning a bank's optimal funding market operations with the macroeconomic policy objectives. The RBA's setting of the cash rate (and its influence on bank interest rates) either incentivises savings when rates are high (more return on savings) or incentivises spending when rates are low (lower cost of finance). Overall, the cash rate is an important determinant of interest rates in the economy, though this is only one influence on banks' funding costs and the timing of its effects is dispersed. Since the global financial crisis the relationship between banks' mortgage rates and the cash rate has been more variable, in a pattern last seen in the mid-1990s (figure B.6). AMP Capital noted that the 'virtually fixed 1.8% gap between the standard variable mortgage rate and the cash rate only applied from 1997 to 2007' (AMP Capital 2017).

Figure B.6 **RBA cash rate and average standard variable mortgage rate**



Source: RBA (2018g)

Macroeconomic oversight and reporting

As a key macroeconomic oversight body, the RBA has various supervision and reporting functions. Among these functions, the RBA publishes the Financial Stability Review biannually (RBA 2017p) and a quarterly bulletin on developments in the financial sector and economy (RBA 2017j). The Financial Stability Review is the leading government publication of the systemic health of the Australian financial system. Each release focuses on new issues in the financial system which may affect system or market health. Other RBA research does not follow a regular publication schedule like the stability review or bulletin, instead it is conducted as needed.

Liquidity support

Because the Australian government holds relatively low levels of public debt, liquid government securities are less available to banks than in some other countries. To aid banks in their obligations to hold high quality liquid assets (as regulated by APRA), the RBA established the Committed Liquidity Facility (CLF) (RBA 2011). The CLF allows banks to offer certain assets to the RBA under repurchase agreements in exchange for liquid currency. This is a valuable resource for unexpected liquidity stress. The RBA and a bank will agree to a value of the liquidity commitment ahead of time and the bank pays a fee of 15 basis points per annum on the size of the commitment. This does not mean a bank will use the facility, instead it allows its use up to the agreed value, as long as APRA does not object to the drawdown and the RBA assesses that the bank has positive net worth. Currently, all banks which are subject to APRA's Liquidity Coverage Ratio rules have access to the CLF (APRA 2017j). The size of the liquidity facility offered by the RBA is determined by the sum of APRA regulated liquid asset holdings minus the value of other liquid assets available to banks (RBA 2017e).

The Payments System Board

The RBA is the primary regulator of the payments system, through the Payments System Board (PSB).

The PSB is statutorily required to have regard to efficiency, competition and stability in determining payments system policy and regulating the payments system (RBA 2015b).[136] Included in this role are interbank transactions (RBA operated) and other transfer platforms such as credit cards (RBA regulated). The RBA operates an inter-bank transaction platform, the Reserve Bank Information and Transfer System, which settles high-value obligations between banks and other financial institutions in real time. It is through this platform that the RBA manages the cash rate.

PSB policy and regulatory oversight

In pursuing competition in the payments system, the PSB focuses on two areas:

- Freeing up unwarranted restrictions on participation in individual payments systems
- Ensuring that the actions of any individual party are not adversely affecting the capacity of another party to compete (RBA 2015b).

Under s. 11 of the *Payment Systems (Regulation) Act 1998* (Cth) the PSB may designate a payments system, if it considers it to be in the public interest to do so. The PSB may regulate these forms of payment by, for example, setting standards that a designated system must comply with, imposing access regimes or accepting undertakings from payment system providers (RBA 2015h).

The PSB establishes standards for the safety and efficiency of the designated system. These may impose technical requirements, procedures, performance benchmarks or pricing as set out in table B.5 (RBA 2015f). For example, in 2016, the PSB set standards to improve the competitiveness and efficiency of its designated four-party and companion card systems, such as the MasterCard Visa and eftpos schemes. These standards imposed caps on interchange fees and limited customer surcharges to a merchant's cost of acceptance (RBA 2016d).

The access regimes determine the rules for participation in that system, including rules on access for new participants. For example, the PSB imposed an access regime on both

136 Under s. 10B of the *Reserve Bank Act 1959* (Cth) and s. 8 of the *Payment Systems (Regulation) Act 1998* (Cth).

MasterCard and Visa credit card systems (RBA 2017w). These access regimes mean that any ADI is eligible to apply to participate in the scheme, and any other entity may apply to participate in the scheme as long as they meet eligibility criteria set by the scheme provider.

In some circumstances, a payments system provider can provide a voluntary 'undertaking' in lieu of a standard determined by the PSB. For example American Express and Diners Club each made an undertaking that they would not impose rules that restrict the ability of merchants to surcharge customers for accepting their cards (RBA 2017w).

Table B.5 provides an overview of the payments system providers regulated by the PSB.

The PSB reviews and formulates payments system policy to meet its objectives. For example, in 2012 the PSB reviewed card payments regulation and produced a strategic review of innovation in the payments system (RBA 2012d). The PSB also works with industry to develop strategic objectives for the Australian payments system. The Australian Payments Council was formed in 2014 to facilitate a relationship between the PSB and the payments industry (PSB and APC 2015).

Table B.5 **Regulations for retail payments systems**

Payments system	*Designated system*	*Standards*[a]	*Access regime*	*Undertaking*
Credit cards				
MasterCard	✓	✓	✓	✓
Visa	✓	✓	✓	✓
American Express companion card	✓	✓		
American Express				✓
Diners Club				✓
UnionPay Credit Card				✓
Debit cards				
Debit MasterCard	✓	✓		✓
Visa Debit	✓	✓		✓
EFTPOS	✓	✓		
UnionPay Debit Card				✓
Prepaid cards				
MasterCard prepaid	✓	✓		✓
Visa prepaid	✓	✓		✓
EFTPOS prepaid	✓	✓		
UnionPay Prepaid Card				✓
ATMs				
ATM System			✓	

[a] Standards for interchange fees and merchant pricing.

Source: RBA (2017w)

Regulator cooperation in the payments system

The PSB has primary responsibility for payments system regulation. But there are several instances where other regulators, such as the ACCC, APRA and ASIC, also have a role. For example, debit card issuers and some purchased payment facilities are required to be an ADI, regulated by APRA and credit card issuers are required to adhere to ASIC's responsible lending obligations.

The ACCC is responsible for making sure that payments system arrangements comply with the *Competition and Consumer Act 2010* (Cth). This is important because payments systems often involve participants that are otherwise competitors, and these arrangements have the potential to contravene the Act. In these cases, the ACCC may 'authorise' payments systems to protect them from legal action under the Act. For example, it authorised some of the AusPayNet frameworks, such as BECS (ACCC 2015b). However, if the PSB decides to set a standard or access regime for a payments system provider, those participants are not at risk under the Act.

The effect is that the ACCC retains responsibility for competition and access regulation in a payments system, unless the PSB imposes an access regime or sets standards for it; designation does not, by itself, remove a system from the ACCC's coverage. Even if the RBA imposes an access regime, the ACCC retains responsibility for enforcing general competition laws, such as the abuse of market power laws, on the payments system. The basis for policy coordination and information sharing between the PSB and ACCC is set out in a Memorandum of Understanding signed in 1998 (RBA and ACCC 1998).

Some regulations also require the PSB and ACCC to work together. For example, in 2016, the Competition and Consumer Act was amended to ban excessive payment surcharges and provide new powers for the ACCC (2016). The amendment states that a payment surcharge is excessive if it exceeds the permitted surcharge referred to in the PSB standard (the cost of acceptance). Therefore, the PSB is responsible for setting the level of excessive surcharging, and the ACCC is responsible for enforcing the ban.

Self-regulation

The PSB and ACCC have the power to regulate the payments system if it is in the public interest to do so. However, the payments system is largely regulated by industry. This presumption in favour of self-regulation was set out in the explanatory memorandum to the Payment Systems (Regulation) Bill.

The PSB imposes regulation only where it considers it necessary in the public interest and where the industry is unable or unwilling to address its concerns (RBA 2015b).

The Australian Payments Network (AusPayNet) is the industry-led regulatory body for the payments system in Australia. The main role of AusPayNet is to develop and manage frameworks for participation across each payment method:

- cash — Australian Cash Distribution & Exchange System
- cheques — Australian Paper Clearing System
- cards — Issuers and Acquirers Community[137]
- direct entry — Bulk Electronic Clearing System
- high value — High Value Clearing System.

These frameworks generally involve a set of regulations and procedures that participating payments system providers must agree to. This allows them to clear and settle transfers between each other.

AusPayNet also administers the Community of Interest Network (COIN) infrastructure. COIN is a multilateral bank transfer network that provides secure transmission of payment files and messages between participants (APCA 2018). It is an alternative to bilateral connectivity between participants. COIN is currently used to make cheque, direct entry (including BPAY) and eftpos transfers.

The New Payments Platform was established by NPP Limited (which is mutually owned by thirteen financial institutions). The platform enables real-time clearing and settlement, and has the potential to support additional overlay services or products. The NPP is not currently covered by an access regime, though the PSB would have the ability to impose one if it chose to do so.

ACCC

The ACCC is the statutory authority responsible for the enforcement of competition and consumer law across the economy. The overarching object of the legislation is to:

> enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection (*Competition and Consumer Act 2010* (Cth), s. 2).

The ACCC is the monitor of competition and market power — intervening in matters of abuse of market power, third line forcing, collusion or mergers. For example, on mergers, the ACCC assessed and approved Westpac's acquisition of St. George (ACCC 2008c) and the Commonwealth Bank's acquisition of BankWest (ACCC 2008b) and Aussie Home Loans (ACCC 2013a). The ACCC opposed NAB's acquisition of AXA Asia Pacific Holdings (ACCC 2010).

The ACCC has examined other issues in financial services markets, including examples of attempted cartel conduct, anti-competitive conduct and requests for authorisation of requests for collective bargaining and other arrangements.

137 The Issuers and Acquirers Community rules cover the eftpos scheme, but do not apply to commercial card schemes (APCA 2015a).

In May 2017, the Treasurer allocated $13.2 million over four years so that ACCC could establish a dedicated Financial Sector Competition Unit to undertake regular in-depth inquiries into financial competition issues. Its first task is an inquiry into residential mortgage pricing by the institutions affected by the Major Bank Levy (Morrison, S. (Treasurer) 2017e). It will also follow-up on various aspects of this Inquiry.

AUSTRAC

AUSTRAC is Australia's financial intelligence agency with regulatory responsibility for anti-money laundering and counter-terrorism financing, regulating primarily under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) and the *Financial Transaction Reports Act 1988* (Cth). AUSTRAC works to detect, deter and disrupt money laundering and terrorism financing risks and threats that affect Australia's financial system. Its objectives are to:

- help keep Australia safe from financial and other serious crime
- build and maintain trust in Australia's financial system as part of the global community. (AUSTRAC 2016)

Though information on illegal activity is not published for security reasons, AUSTRAC shares information on financial entities which do not comply with disclosure and monitoring standards. A recent example was the investigation into the alleged potential use of the Commonwealth bank's ATM network for money laundering (AUSTRAC 2017).

B.2 Coordination between regulators

There is no statutory requirement for cooperation between the regulators, but there is a network of memoranda of understanding between them. The RBA, ASIC and APRA all have legislative power to share confidential information and data acquired through regulation among institutions — this power is frequently used for investigation and general analytics. Regulators also use other cooperative vehicles such as staff sharing and the APRA/RBA coordination committee, which meets every six weeks (RBA and APRA 2012). APRA is also working to strengthen its bilateral collaboration with the ACCC, via the ACCC's Financial Services Unit (APRA, sub. DR116).

Council of Financial Regulators

The Council of Financial Regulators (CFR) is a forum of the Treasury, the RBA, ASIC and APRA established in 1998, and chaired by the RBA. The regular meetings of the CFR help to coordinate policy in financial markets. The CFR sometimes invites other regulatory agencies such as the ACCC or ATO to join the discussion where they can provide input or support regulatory coordination on a financial issue. The CFR (sub. DR126) has a number of working groups, including a competition working group, chaired by the Treasury. The

CFR regularly considers competition matters, for example, the competition effects of housing regulatory measures (RBA, sub. DR82).

The CFR can develop joint policy positions. For example, the CFR and the ACCC undertook a review of competition in clearing and settlement of Australian cash equities, which led to the CFR agreeing a set of Regulatory Expectations to apply to the ASX as long as it remained the monopoly provider of cash equity clearing and settlement.

B.3 Accountability

Australia's financial regulators are accountable to varying extents to the Australian Government, to Parliament and to the courts, and there are various reporting and transparency measures in place to support this (table B.6). The IMF also reviews the work and performance of the regulators as part of the regular Financial Sector Assessment Program.

The Treasurer has power to issue directions about the policies that APRA or ASIC should pursue, or the priorities they should follow, in performing or exercising any of their functions or powers.[138] The Treasurer may also direct ASIC to investigate certain matters if considered to be in the public interest.[139] These powers are seldom used.[140]

The IMF said in 2012 that the existence of this power 'could potentially diminish the ability of APRA and ASIC to carry out their supervisory and regulatory functions effectively.' But the Australian government and regulators responded that they did not view this power as undermining the independence of the regulatory agencies, instead, they view it as providing:

> a mechanism for transparent interaction with the government on policy grounds, and as an important check and balance on the powers of the regulatory agencies, for holding them accountable to Parliament, and ultimately, to the people of Australia. (IMF 2012, p. 27)

The Treasurer may also set a policy direction for the RBA in particular circumstances. Where the Government and the RBA disagree upon a monetary, banking or payments system policy, the Treasurer may recommend that the Governor General determine the policy to be adopted by the RBA under s. 11 of the Reserve Bank Act. There are arrangements in place to make sure that this process is undertaken transparently and after due process.

---

[138] Australian Prudential Regulation Authority Act, s. 12; Australian Securities and Investments Commission Act, s. 12.

[139] Australian Securities and Investments Commission Act, s. 14.

[140] The Murray FSI could only find one example, when in 1992 the Attorney-General required the Australian Securities Commission to establish increased cooperative arrangements with the Director of Public Prosecutions.

Table B.6 **Reporting requirements and transparency measures for financial services regulators**

	RBA[a]	*APRA*	*ASIC*
Statement of Expectations *(provided by the Minister)*	✘	✓	✓
Corporate plan *(required under s. 35 of the Public Governance, Performance and Accountability Act 2013 (Cth))*	✓	✓	✓
Annual report *(required under s. 46 of the Public Governance, Performance and Accountability Act)*	✓ Reviewed by the House of Representatives Standing Committee on Economics	✓ Reviewed by the House of Representatives Standing Committee on Economics	✓ Reviewed by the Parliamentary Joint Committee on Corporations and Financial Services
List of files created in previous six months *(to be published online in accordance with Senate Standing Order no. 12)*	✘	✓	✓
Annual self-assessment *(under the Regulator Performance Network)*	✓ (Payments System Board only)	✓	✓
Regulation impact statements *(to be published for major decisions)*	✓ (for decisions of the Payments System Board)	✓	✓
Performance audit by the Australian National Audit Office	✘	✓	✓

[a] The RBA is a corporate Commonwealth entity, so its reporting requirements differ from ASIC and APRA, which are deemed non-corporate Commonwealth entities and part of the general government sector.

Source: PC analysis

B.4 Funding

APRA is funded by levies collected from the financial sector, in proportion to reported assets or balances, or the number of health insurance policies in force. The amount of the levy is determined by the Minister for Revenue and Assistant Treasurer after industry consultation (APRA 2018j).

Following the Murray FSI, ASIC has been moving to an industry funding model, with the introduction of industry levies to recover the costs of ASIC's regulatory activities. The first levy invoices are due to be issued in January 2019 (ASIC 2018e).

The RBA earns net interest income from its assets and fee income associated with the Committed Liquidity Facility (RBA 2017e).

C The Australian banking and wealth management sectors

This appendix is a quantitative overview of the Australian banking and wealth management system.

Australia's banking system comprises authorised deposit-taking institutions (ADIs), which include banks and non-bank financial institutions (such as building societies and credit unions), and other financial intermediaries that are not ADIs (such as money market corporations, finance companies and securitisers). Although there are currently almost 150 ADIs, the banks are at the core of the financial system — particularly the four major domestic banks (the Commonwealth Bank of Australia (CBA), Westpac, National Australia Bank (NAB) and Australia and New Zealand Banking Group (ANZ)).

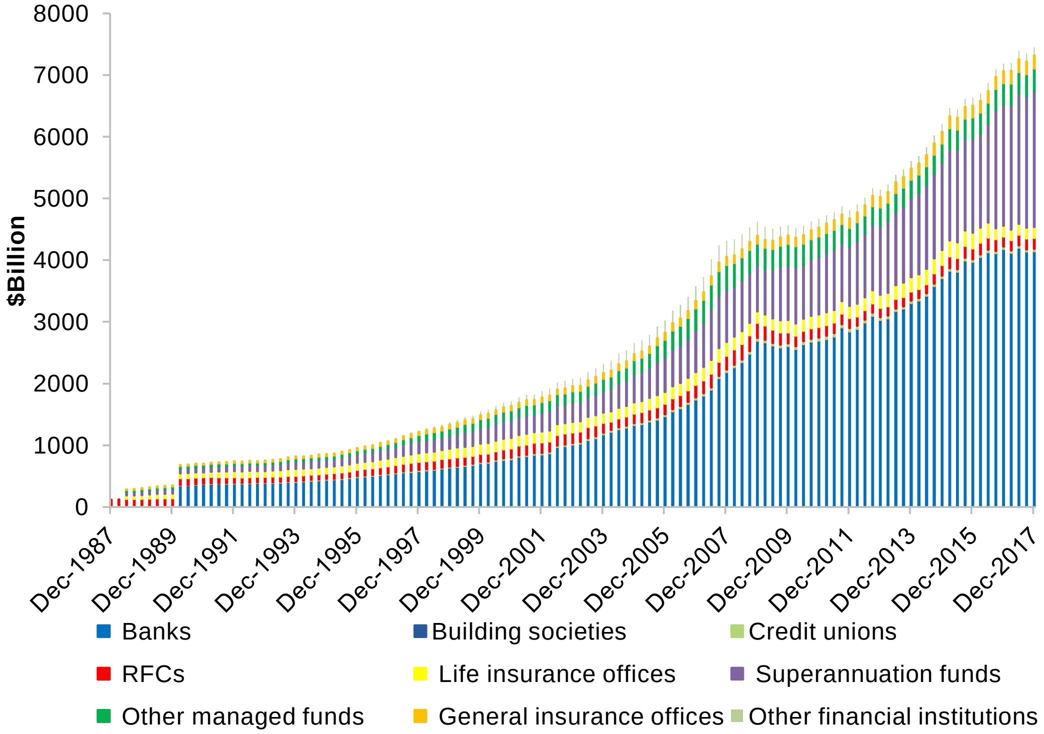
The major banks are also major players in the wealth management system, although other institutions — such as AMP and Macquarie — hold large market shares as well.

The data used in this appendix are drawn from a variety of public sources, including the Reserve Bank of Australia, the Australian Prudential Regulation Authority and submissions to this Inquiry. Data requested by the Commission from the ADIs have also been used where the relevant data have been provided.

C.1 Trends in the Australian banking system

Institutions providing banking services

Figure C.1 **Assets of financial institutions have grown significantly and are mostly held by banks[a]**



[a] The value of the financial sector's assets have increased from being roughly equivalent to Australia's GDP in the early 1980s to about four times Australia's GDP now. Banks now account for about 60% of the assets of Australia's financial institutions. RFCs refer to Registered Financial Corporations.

Source: RBA (2018a)

Box C.1 What is an ADI?

Authorised deposit-taking institutions (ADIs) are body corporates that have been authorised by APRA to carry on banking business in Australia under section 9 of the *Banking Act 1959* (Cth; the Act). They include:

- banks
- building societies
- credit unions.

All ADIs are subject to the same prudential standards set by APRA and must carry on a 'financial business', which:

- consists of, or includes, the provision of financial services; or
- relates, in whole or in part, to the provision of financial services (ss. 66(4)(c) and 66A(2)(b)).

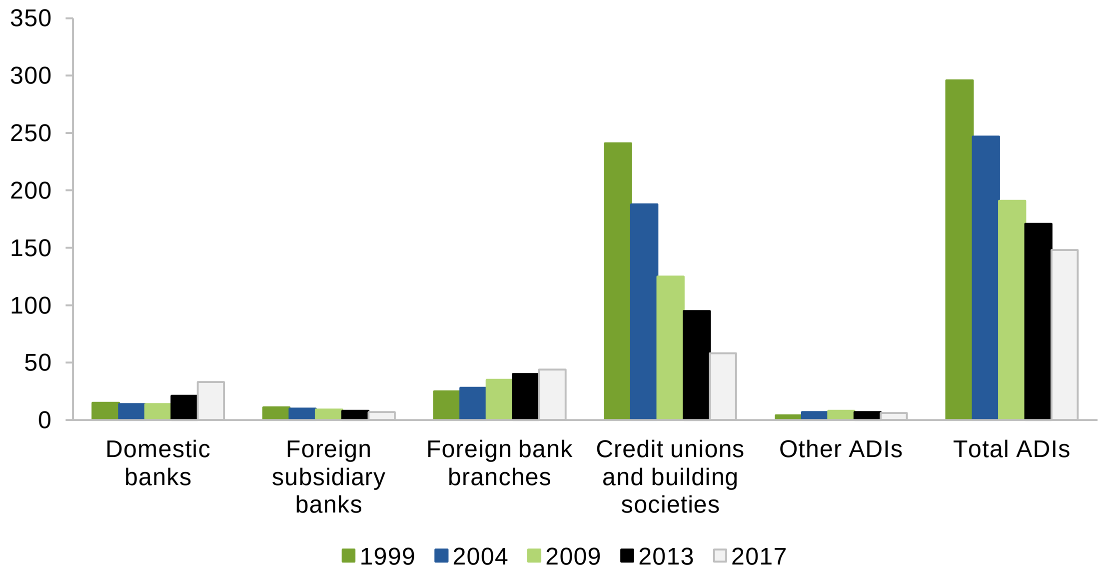
However, the term 'financial services' is not defined in the Act. APRA considers that this term includes:

- the provision of financial products as defined in the *Corporations Act 2001* (Cth)
- the provision of finance as defined in the *Financial Sector (Collection of Data) Act 2001* (Cth)
- banking business as defined in the *Banking Act 1959* (Cth) – this includes both accepting deposits and making loans (s. 5)
- investment business
- insurance business
- superannuation business
- borrowing, lending and other transactions (such as entering into hire-purchase agreements or financial leases or providing credit in other forms) in which the subject of the transaction is finance.

There are restrictions on whether these bodies can assume or use the word or expression 'ADI', 'bank', 'building society' or 'credit union' (s. 66). Under the Act, APRA may, by legislative instrument, determine the criteria for use of these expressions (s. 66(5)); hence entities must seek consent or an exemption from APRA to use them (s. 11). For an ADI to operate as a bank and to use or assume the expressions 'bank', 'banker' and 'banking', the ADI must hold at least $50 million in Tier 1 capital. Building societies and credit unions are subject to different corporate tests.

Source: APRA (2008a); *Banking Act 1959* (Cth)

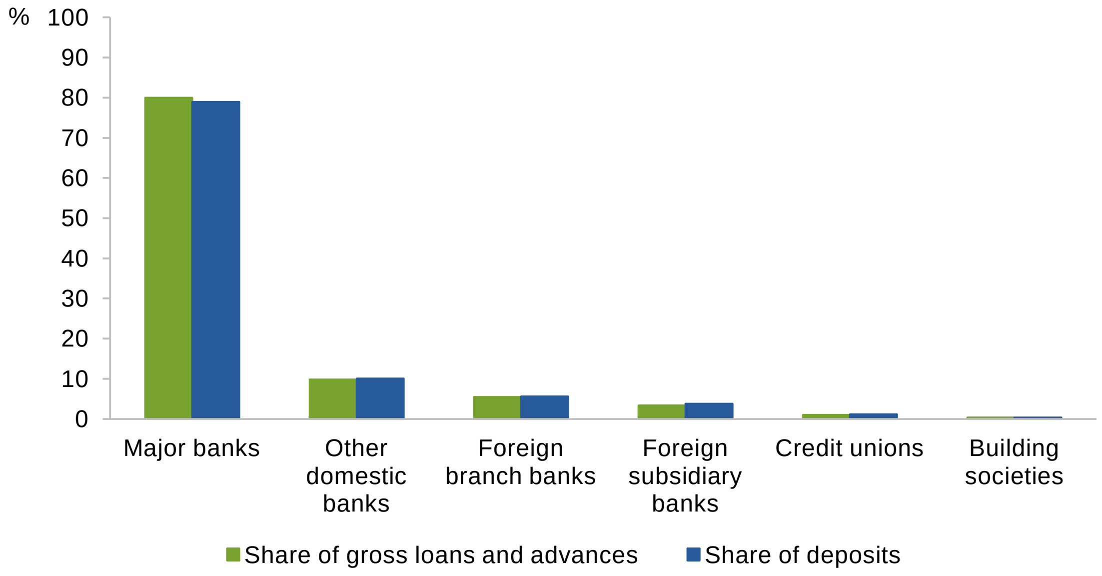
Figure C.2 **The total number of ADIs has declined**



Source: APRA (sub. 22, p. 9)

Figure C.3 **Major banks dominate lending and deposits[a]**

June 2017

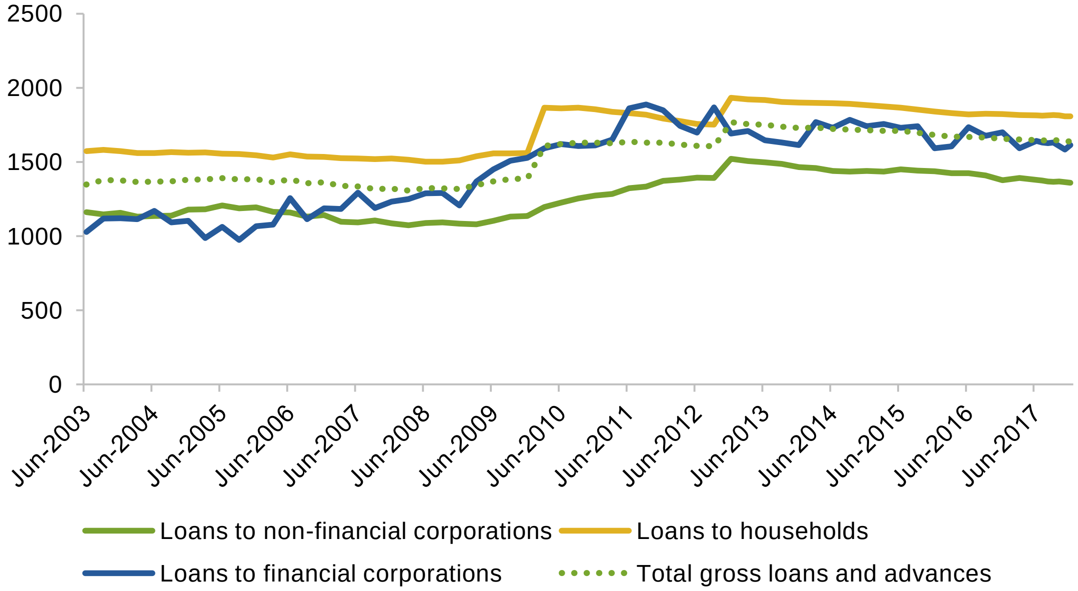


[a] Share of total gross value of loans and advances, and deposits of all ADIs (excluding ‘other ADIs’ or mutual ADIs). Major banks are CBA, Westpac, NAB and ANZ.

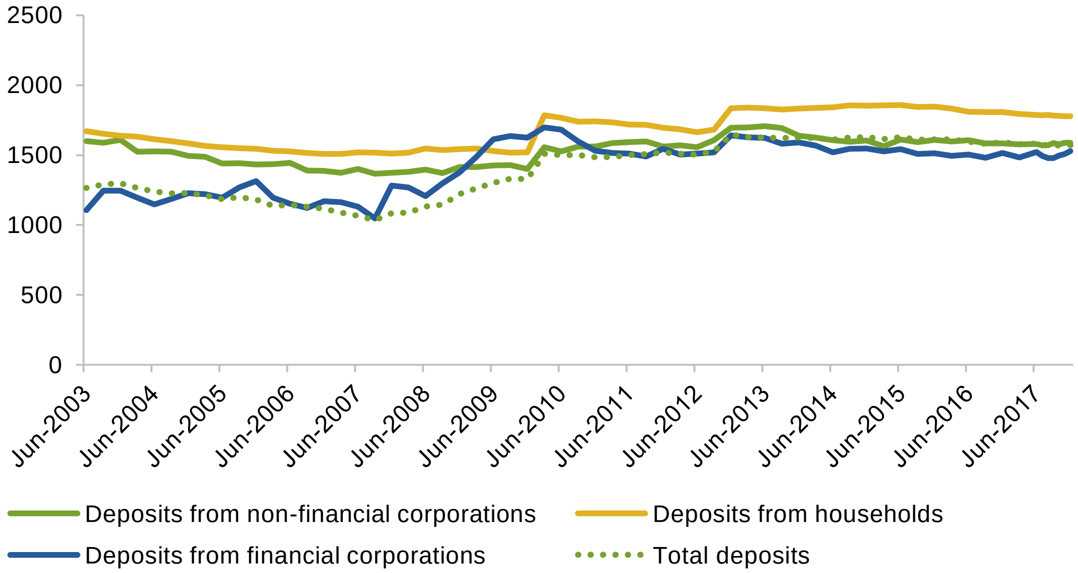
Source: APRA (2018p)

Figure C.4 **Concentration in lending and deposit markets has increased**[a]

Lending HHI



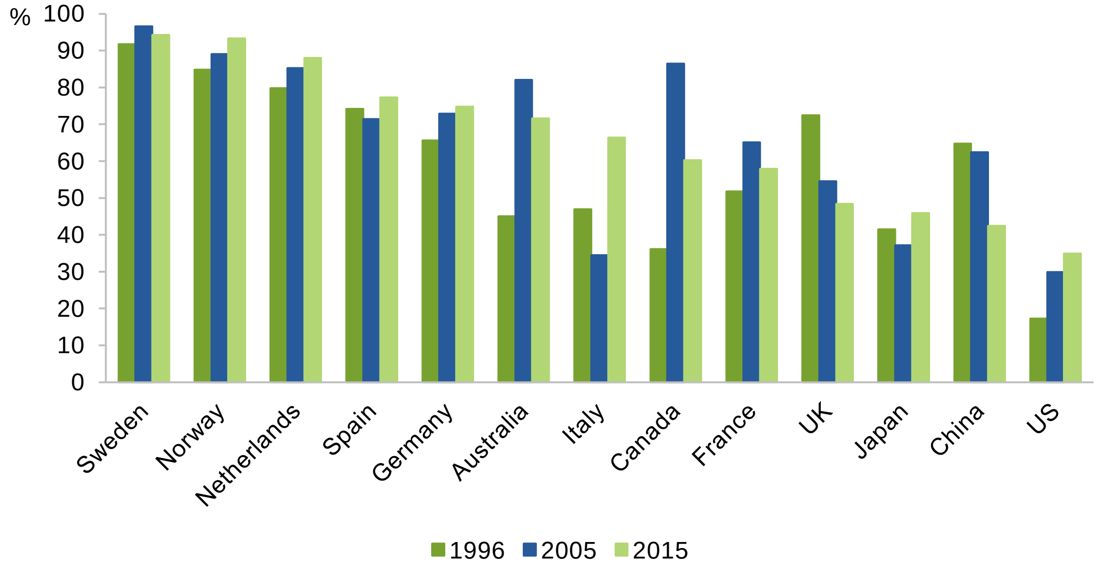
Deposits HHI



a Based on the Herfindahl Hirschmann Index (HHI). Calculations are based on APRA's monthly banking statistics only, and do not include all ADIs and Registered Financial Corporations. For this reason, the HHI overstates the level of concentration in terms of gross loans and advances in the entire financial sector. Small to medium-sized enterprises are included as non-financial corporations.

Source: Productivity Commission estimates based on APRA (2017n)

Figure C.5 **Australian banking system concentration relative to others**[a]

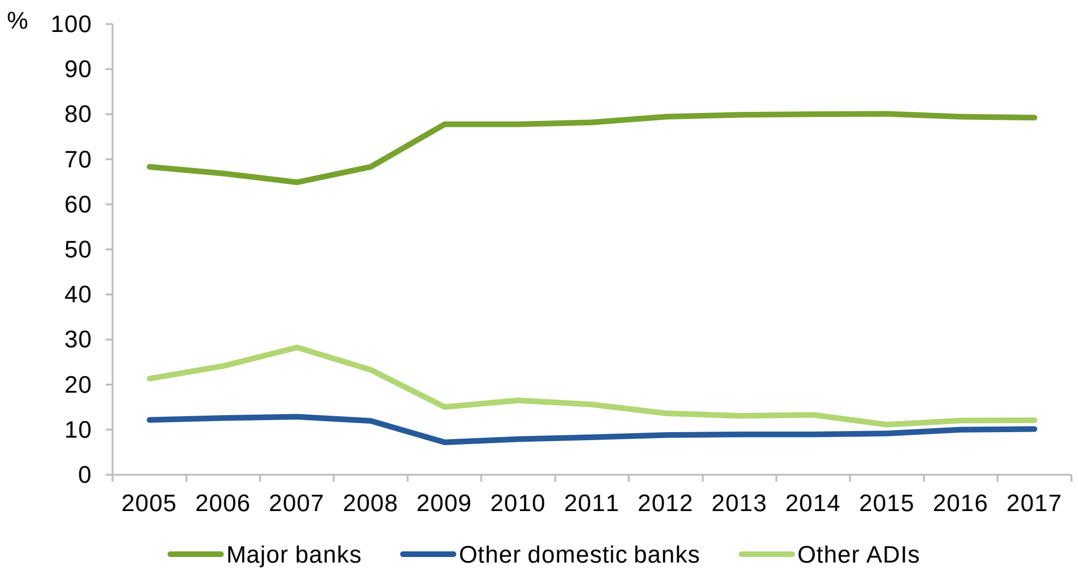


[a] Top five banks' share of assets.

Source: World Bank (2017)

Figure C.6 **The major banks have increased their deposit market share**[a]

Share of total deposits

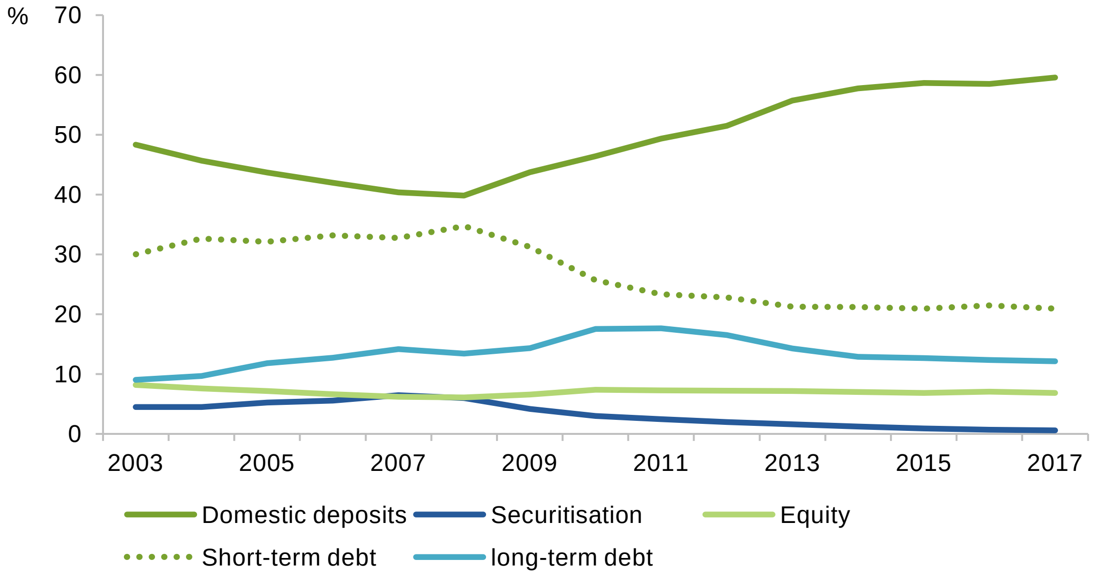


[a] Major banks are CBA, Westpac, NAB and ANZ.

Source: APRA (2017s)

Figure C.7 **Deposit share of funding has increased since the GFC**

Share of total finding

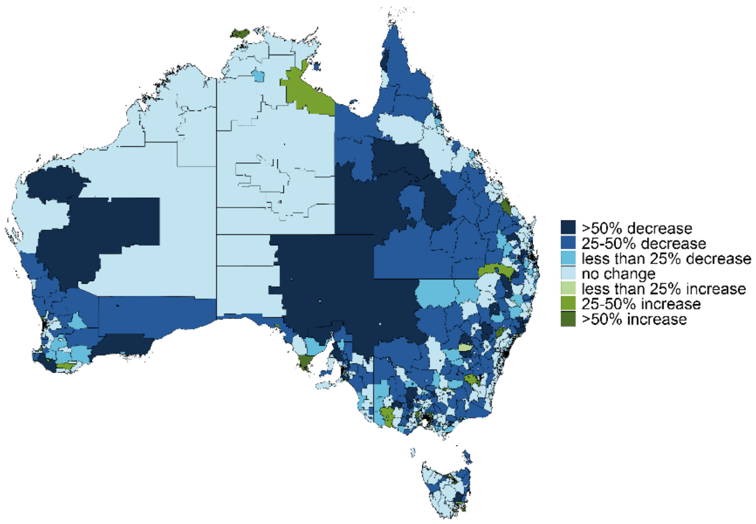


Source: Unpublished RBA data

Consumer banking patterns

Figure C.8 **The location of bank branches has changed**

Percentage change between 2008 and 2016



Source: Unpublished APRA points of presence data

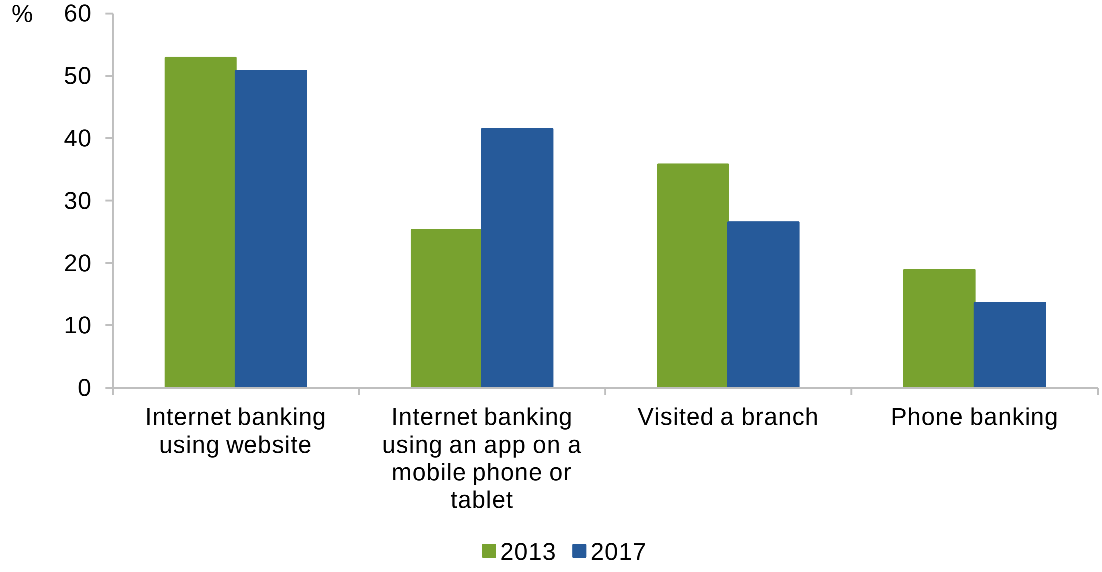
Table C.1 **Electronic transactions are becoming more common**[a]

Payment method	*2002*	*2005*	*2008*	*2011*	*2014*	
Cash	96	95	92	92	88	↓
ATM	73	78	80	84	87	↑
EFTPOS	71	74	76	80	83	↑
Direct debit	50	60	64	70	76	↑
BPAY	36	46	52	61	64	↑
Internet banking	28	40	51	63	72	↑
Mobile phone banking	na	na	na	14	53	↑

a Method of payment used for financial transactions. Arrows show that 2014 results are significantly different from the 2011 survey ($p < 0.05$). Internet banking with desktop/notebook and browser. Mobile phone banking with mobile phone or tablet using an internet browser or a mobile banking app. Mobile phone banking and internet banking were first asked in 2011. na = Not available.

Source: Adapted from ANZ (2015, table 4.2.a)

Figure C.9 **Internet banking by phone and tablet has increased, while branch use and phone banking have fallen**[a]

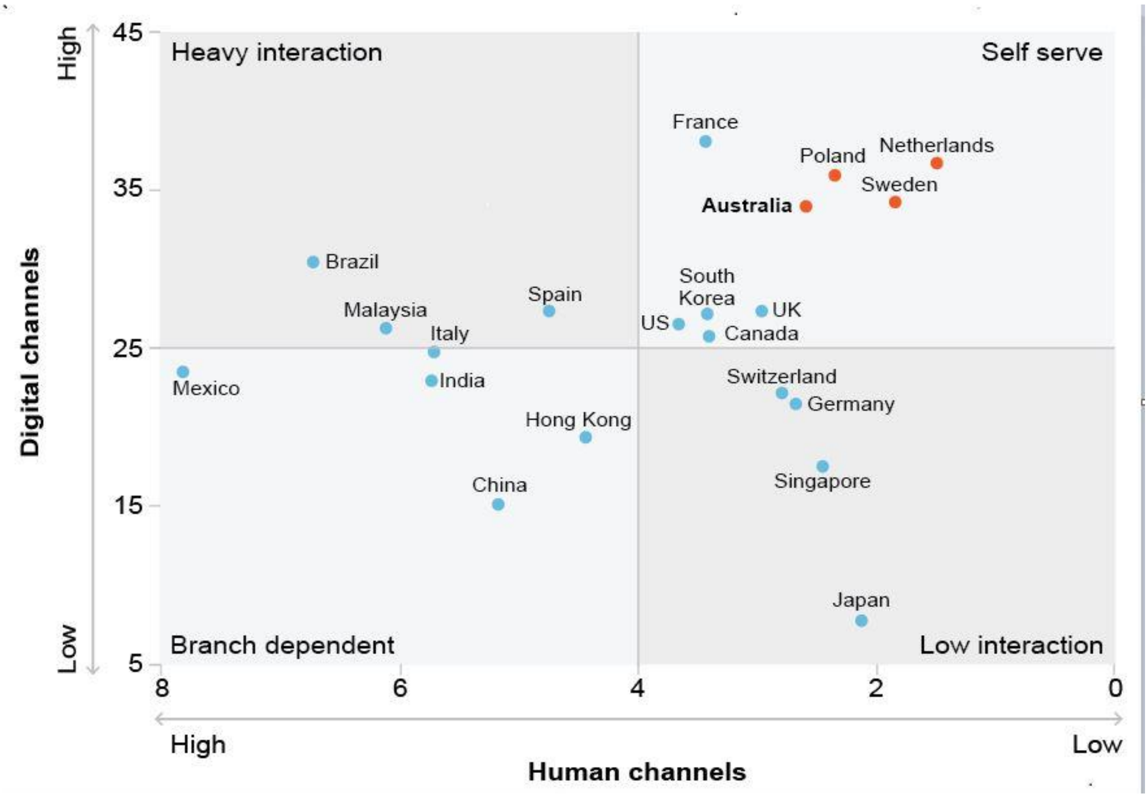


a Proportion of respondents using banking channel in the in the previous 4 weeks. Surveys conducted in the 6 months to June 2013 (n = 25 341) and in the 6 months to June 2017 (n = 25 815).

Source: Roy Morgan (2017)

Figure C.10 **Australians are among world leaders in embracing digital and self-serve banking channels**[a]

2016



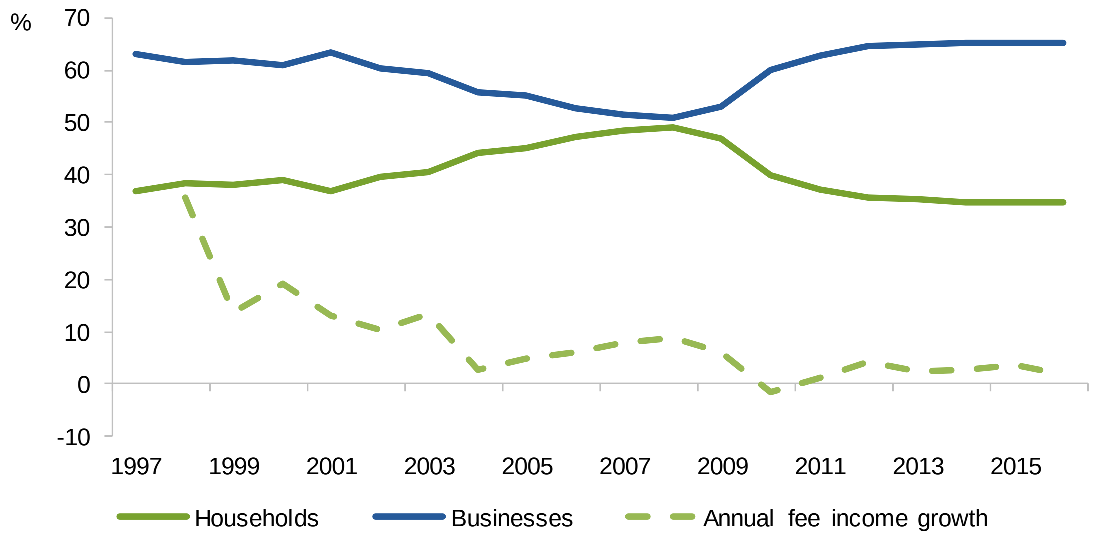
a Average interactions per respondent in the previous quarter, by channel. Digital channels exclude ATMs.

Source: du Toit and Burns (2016)

Bank fees

Figure C.11 **Most fee income is from businesses, and fee income growth has slowed[a]**

Share of total domestic bank fee income

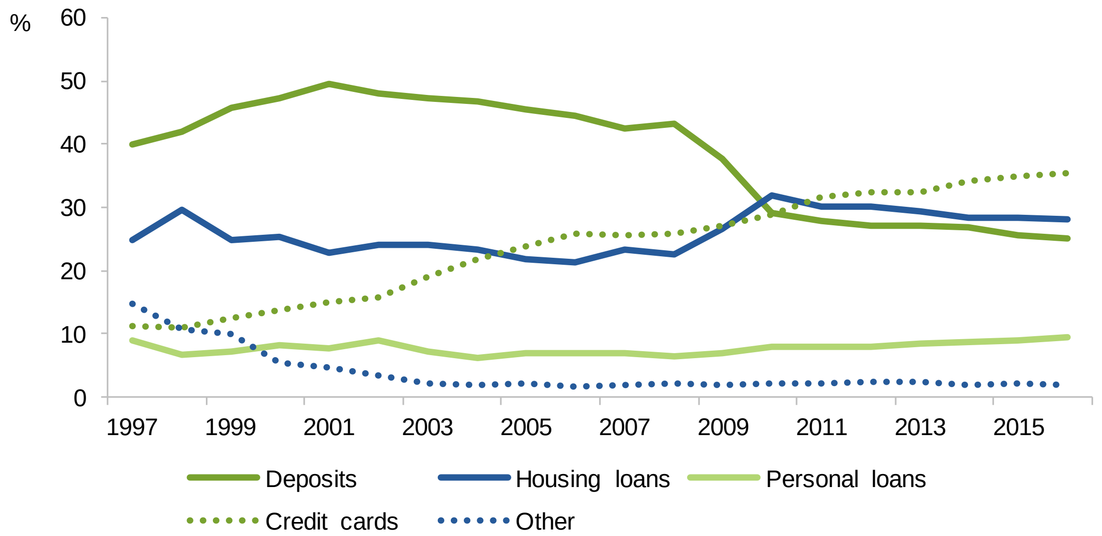


[a] Fee data are collected from 16 ADIs operating in Australia covering almost 90% of total ADI assets.

Source: RBA (2017o)

Figure C.12 **Credit card, housing loan and deposit fees account for most banking fees paid by households[a]**

Share of domestic banks' fee income from households

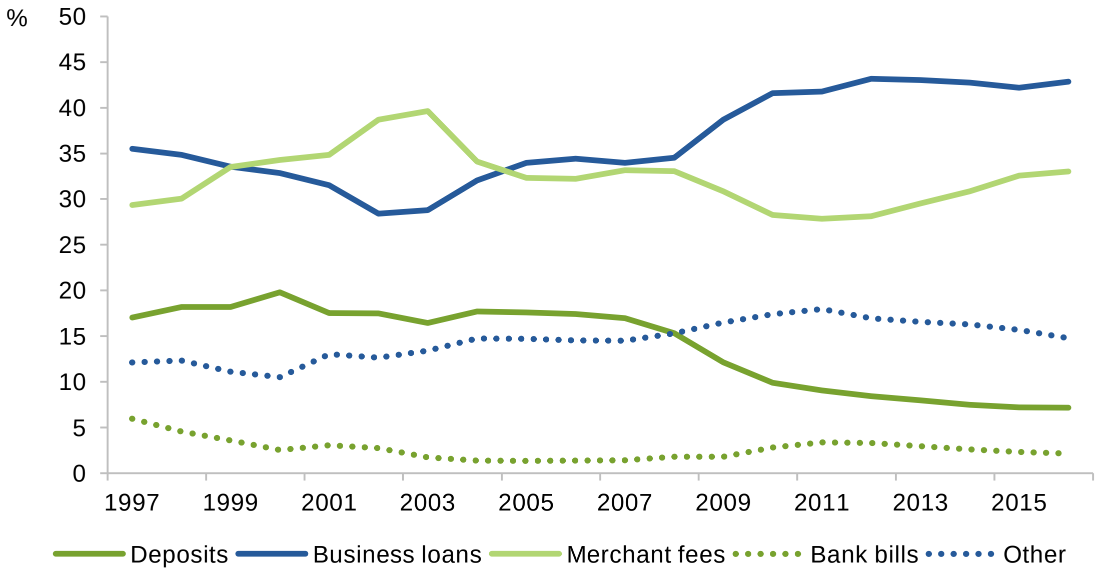


[a] Fee data are collected from 16 ADIs operating in Australia covering almost 90% of total ADI assets.

Source: RBA (2017o)

Figure C.13 **Loan and merchant fees account for most bank fees paid by businesses[a]**

Share of domestic banks' fee income from businesses



a Fee data are collected from 16 ADIs operating in Australia covering almost 90% of total ADI assets.

Source: RBA (2017o)

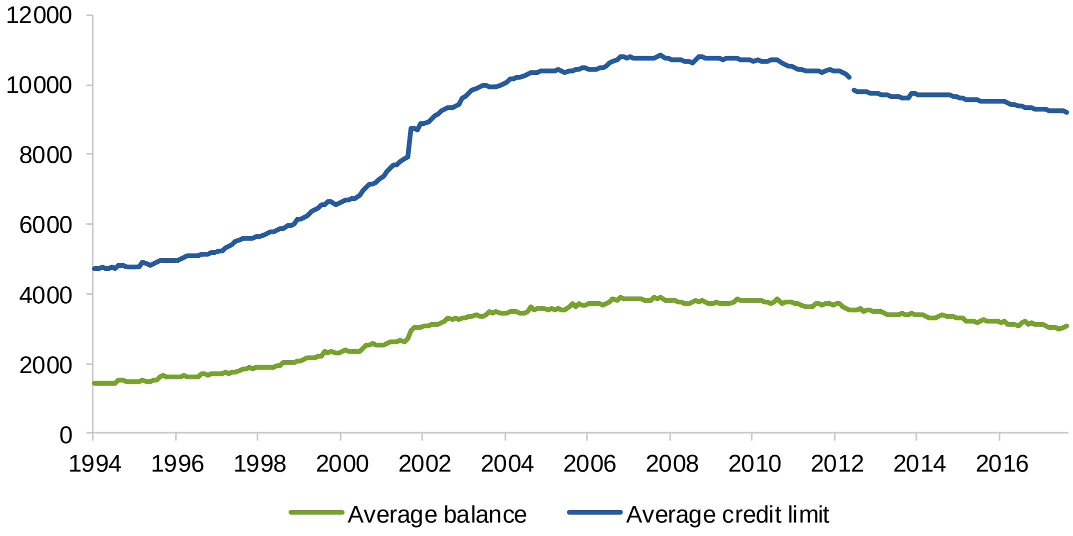
Credit cards and consumers

Figure C.14 **Key statistics on credit card use in Australia**

Source: ABS (2017a); CreditCard.com.au (2014); RBA (2017l)

Figure C.15 **Credit card balances have stabilised in real terms**[a]

2017 dollar terms

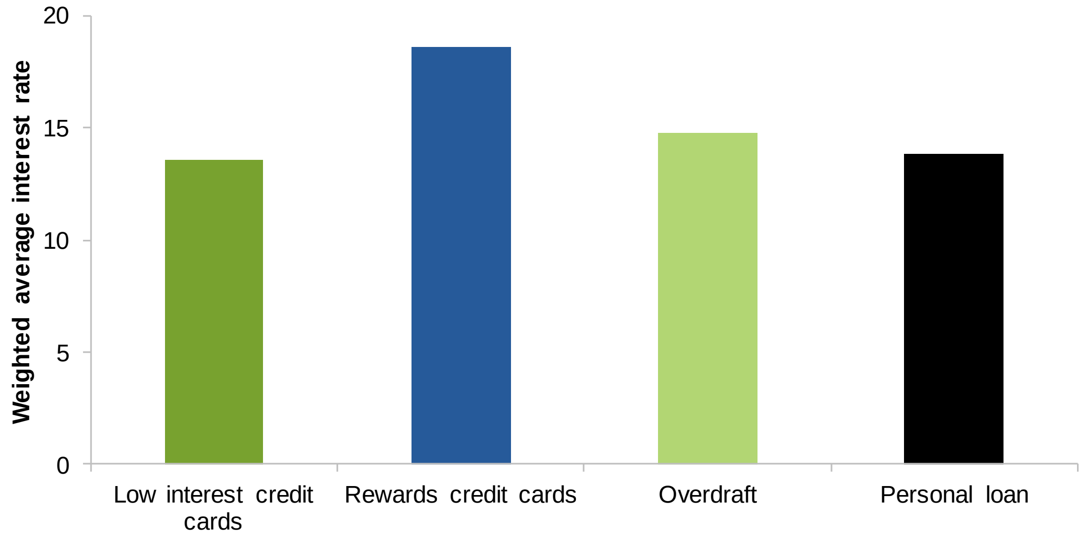


[a] Average outstanding monthly balance and credit card limit per credit card deflated by the all groups CPI index.

Source: Productivity Commission estimates based on ABS (*Consumer Price Index, Australia, Mar 2018*, Cat. no. 6401.0) and RBA (2017l)

Figure C.16 **Average interest rates on credit cards can be higher than for other personal credit products**[a]

2017

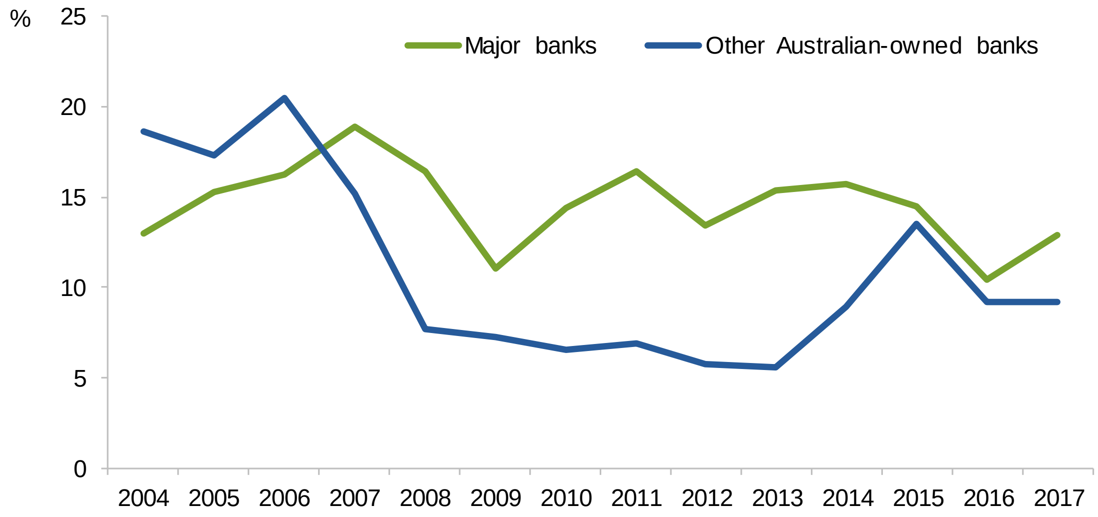


[a] Weighted by number of customers. Credit card interest rates are for interest charged on outstanding balances.

Source: Productivity Commission estimates based on unpublished ADI data

C.2 Performance of the banking system

Figure C.17 **The major banks' return on equity has been higher than that of other banks post-GFC, but the gap has narrowed[a]**

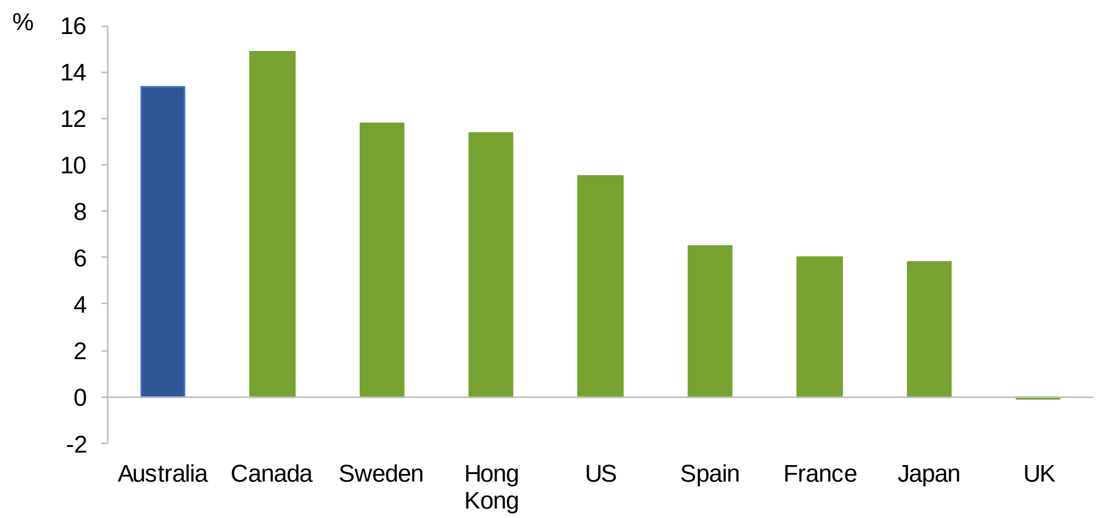


[a] Major banks are CBA, Westpac, NAB and ANZ. Others are the Australian owned ADIs.

Source: APRA (2018p)

Figure C.18 **Australian major banks' return on equity is higher than that of banks in most countries[a]**

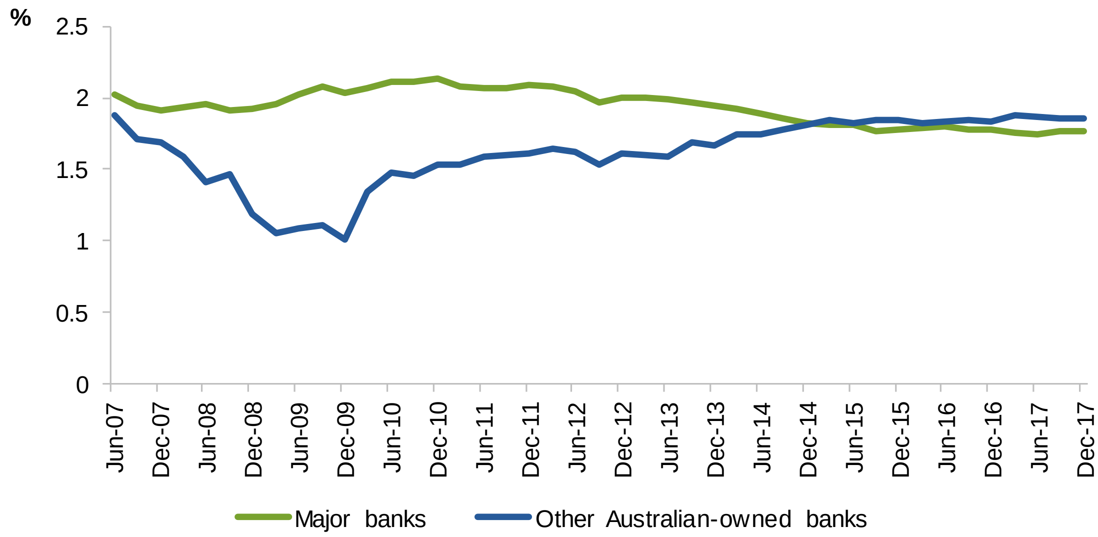
2016



[a] Australia's figure is based on the 4 major banks; Canada's is based on 5 banks; Sweden's on 4 banks; Hong Kong's on 2 banks; the US's on 6 banks; Spain's on 3 banks; France's on 4 banks; Japan's on 4 banks and the UK's on 5 banks.

Source: ABA (sub. 11)

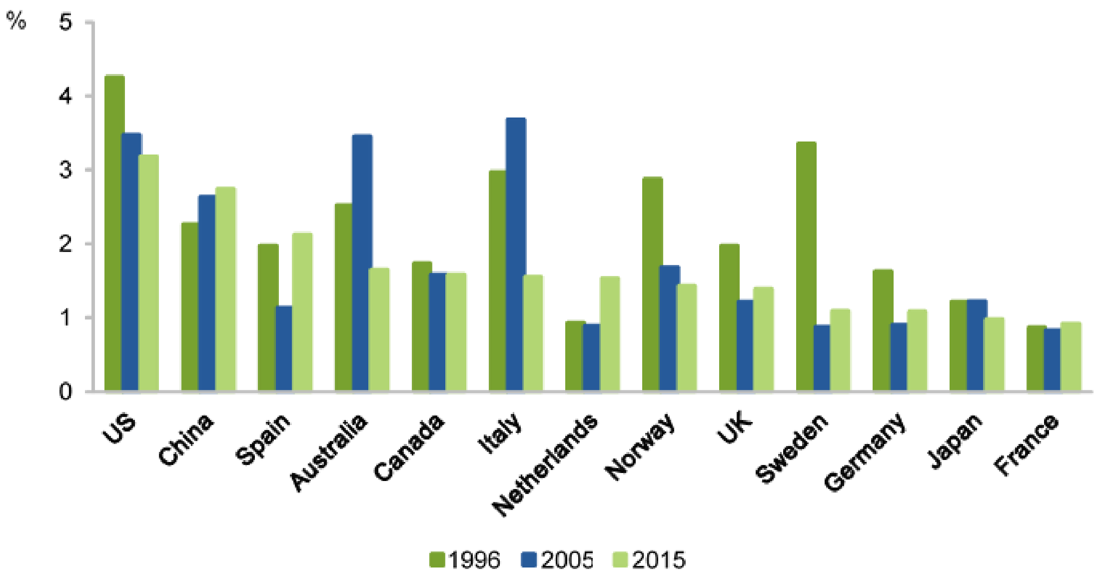
Figure C.19 Net interest margins have declined for the major banks and increased for other Australian-owned banks[a,b]



[a] Annual net interest income (interest income less interest expenses) as a share of interest-earning assets, weighted by share of assets (nonresident assets excluded). [b] Major banks are the CBA, Westpac, NAB and the ANZ.

Source: Unpublished APRA data

Figure C.20 The net interest margin of Australia's banks is consistently among the highest[a]

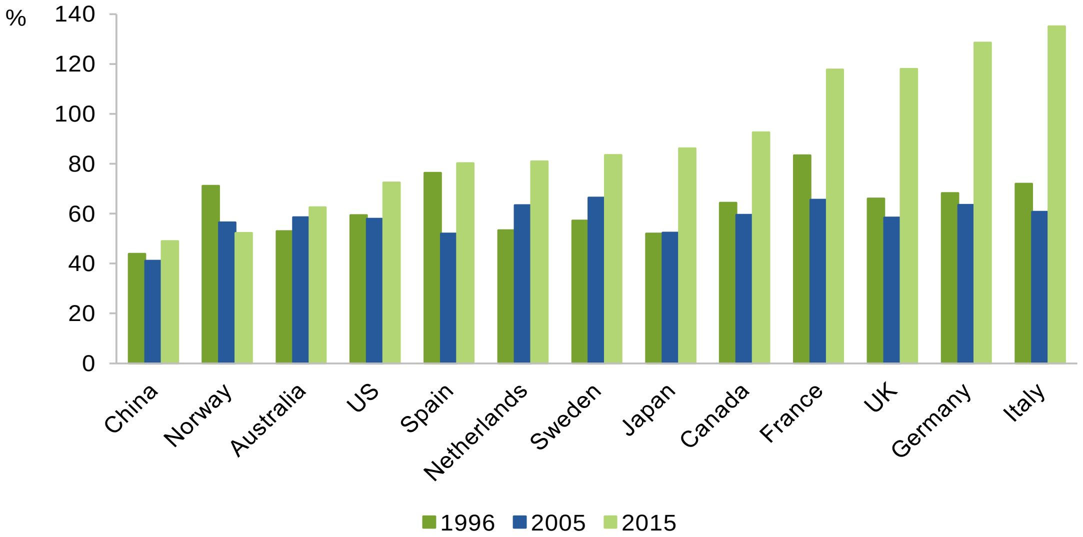


[a] Data for Australia is for all ADIs.

Source: World Bank (2017)

Figure C.21 **Australian banks have a low cost to income ratio relative to overseas banks[a]**

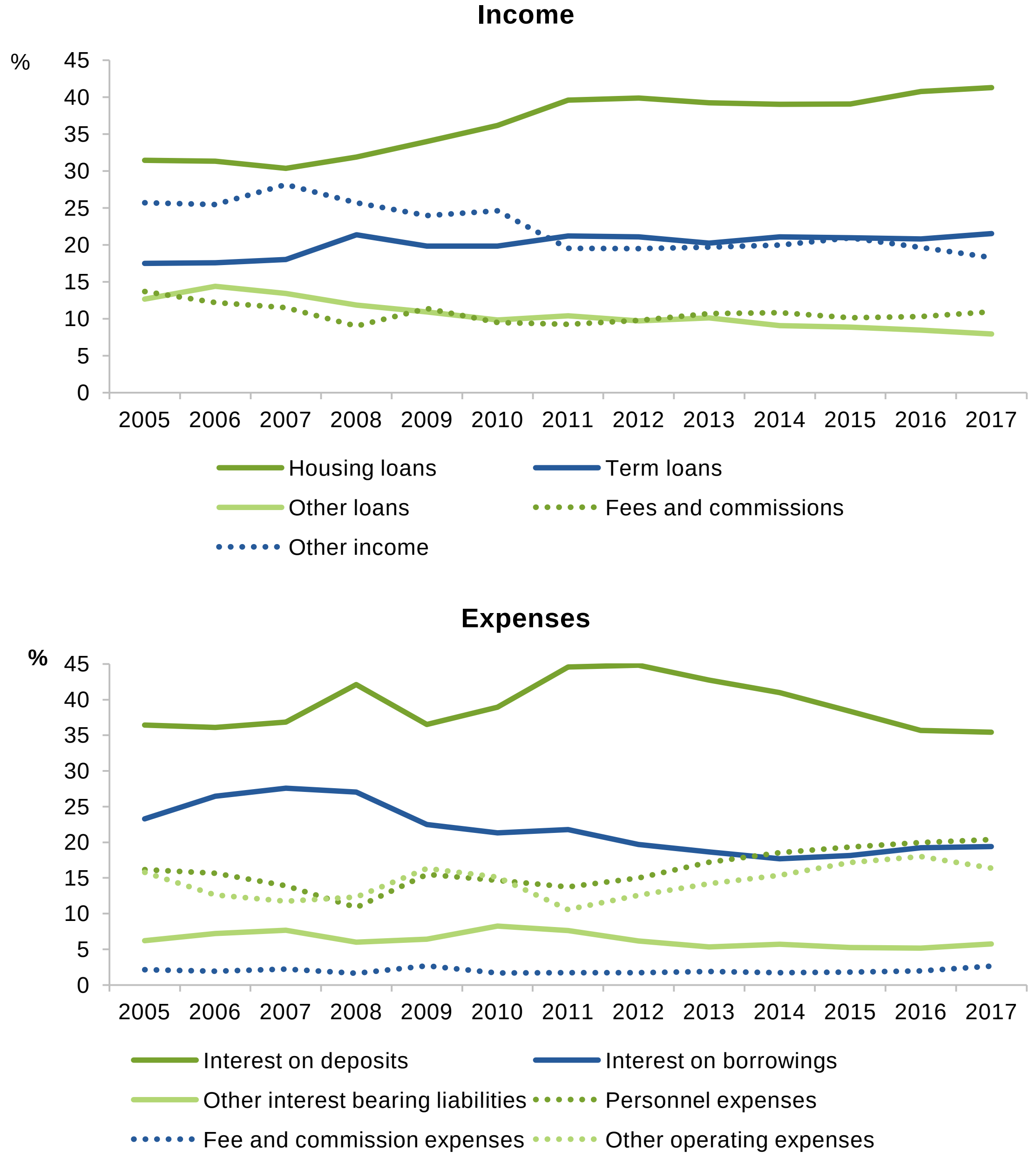
Banks' costs as a share of total income



a Data for Australia is for all ADIs.
Source: World Bank (2017)

Figure C.22 **Housing loans are the largest source of banks' income and deposits are their biggest expense**[a]

Share of total income and total expenses



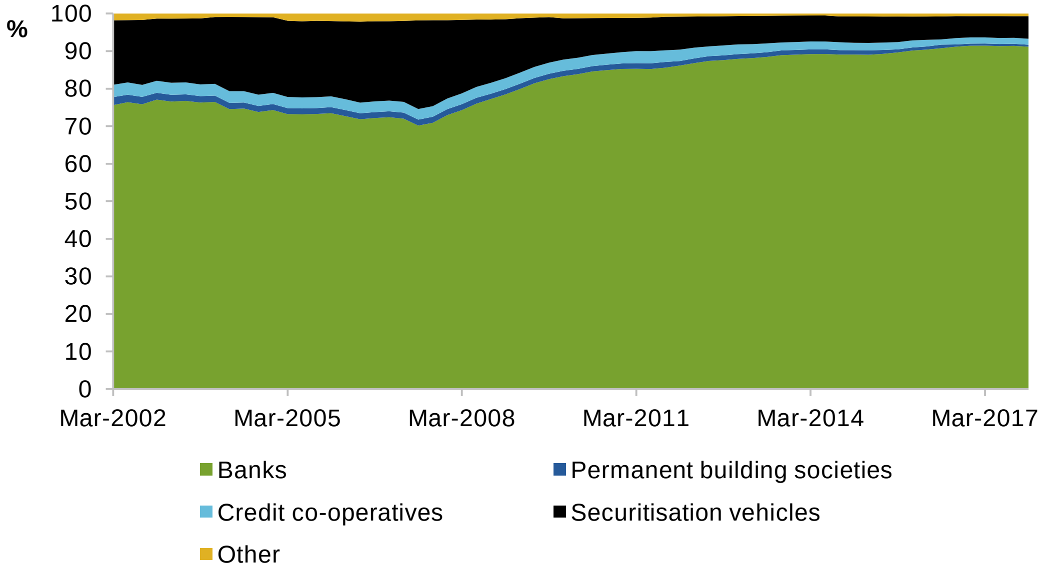
a Annual average shares for all ADIs. Other income includes cash and liquid assets, other interest earning assets and other operating income.

Source: Productivity Commission estimates based on APRA (2017s)

C.3 Residential mortgage lending

Figure C.23 **Banks provide the majority of home loans**

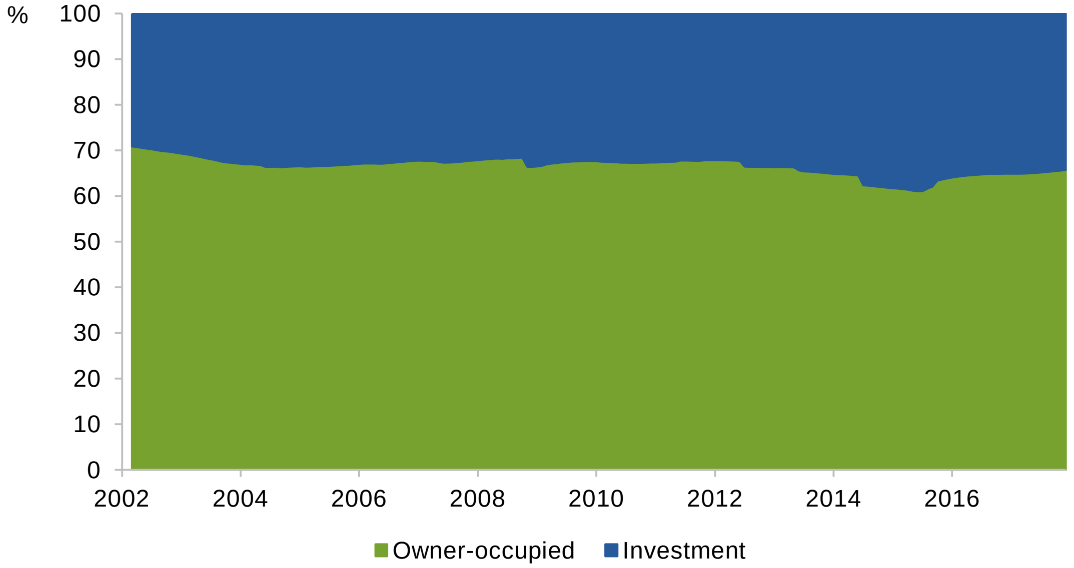
Lenders' shares of outstanding home loans by value of loan



Source: ABS (*Housing Finance, Australia*, *February 2018*, Cat. no. 5609.0)

Figure C.24 **Most home loans are for owner-occupied housing**

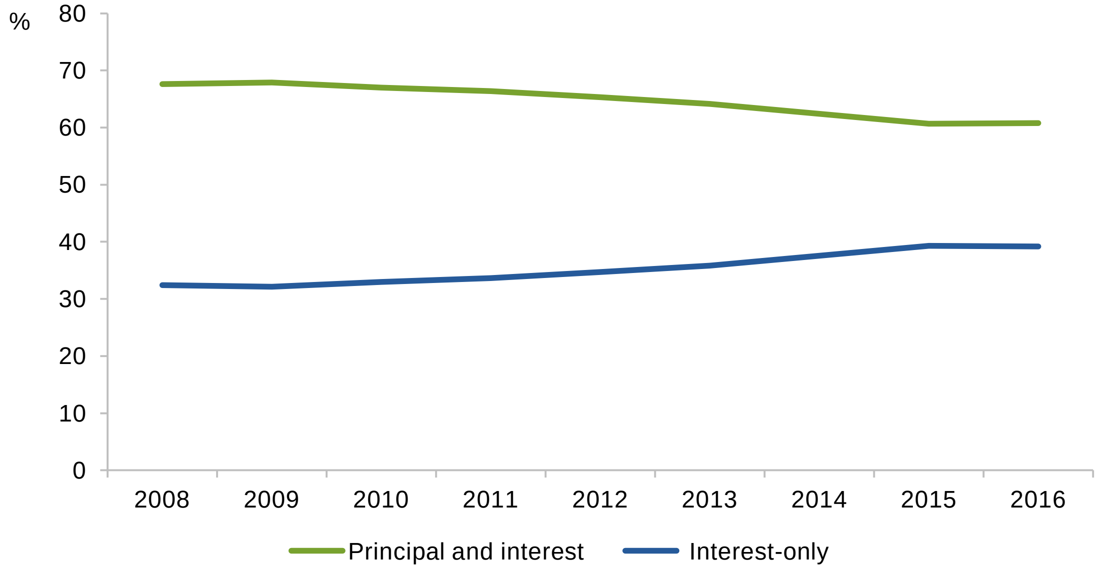
Share of total value of outstanding loans



Source: ABS (*Housing Finance, Australia*, *February 2018*, Cat. no. 5609.0)

Figure C.25 **Most outstanding credit is for principal and interest home loans**

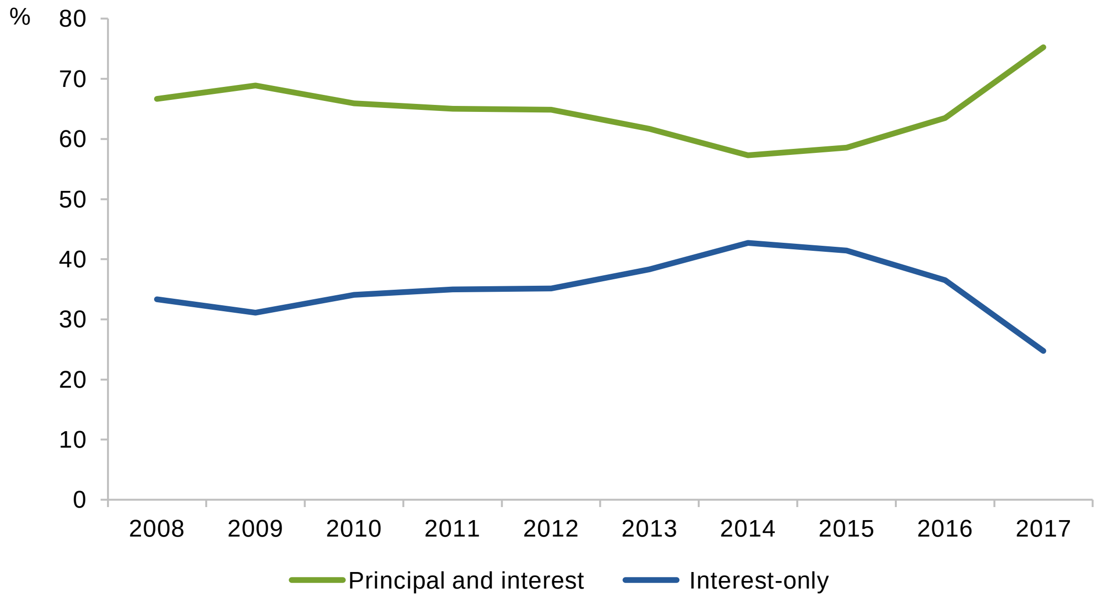
Annual average share of total outstanding credit



Source: RBA (2017p, graph B1)

Figure C.26 **Most home loan approvals are for principal and interest**

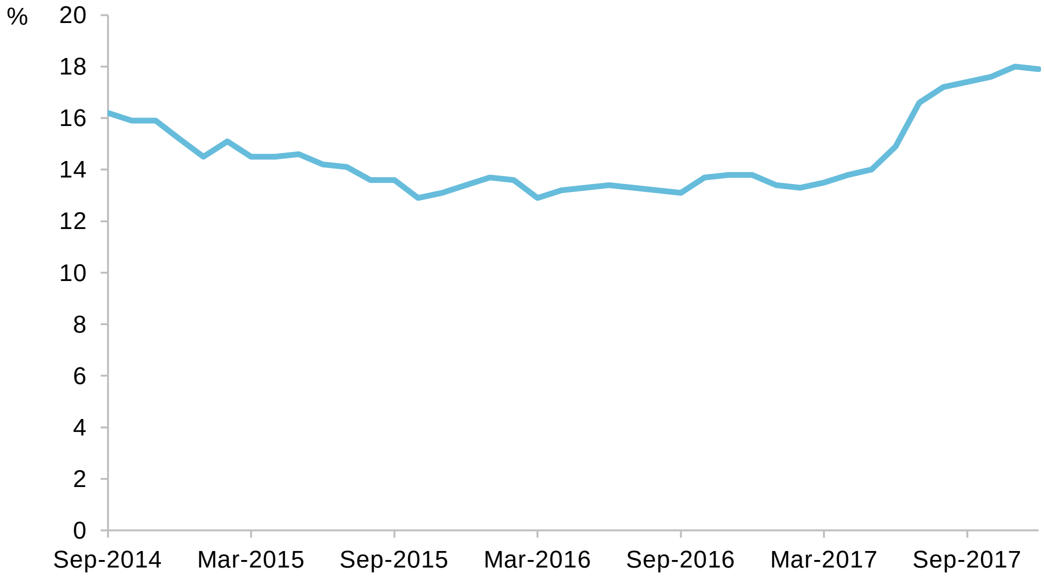
Annual average share of total loan approvals



Source: RBA (2017p, graph B1)

Figure C.27 **First home buyers are in the minority**

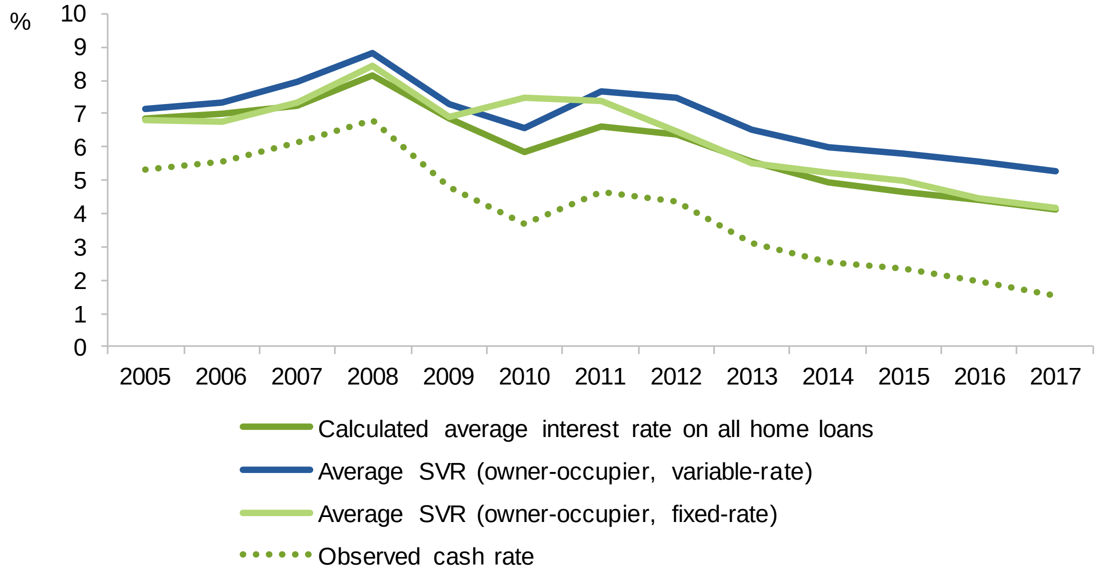
Share of new home loans



Source: ABS (*Housing Finance, Australia*, *February 2018*, Cat. no. 5609.0).

Figure C.28 **Housing interest rates of major banks have drifted lower[a]**

Weighted annual average rates

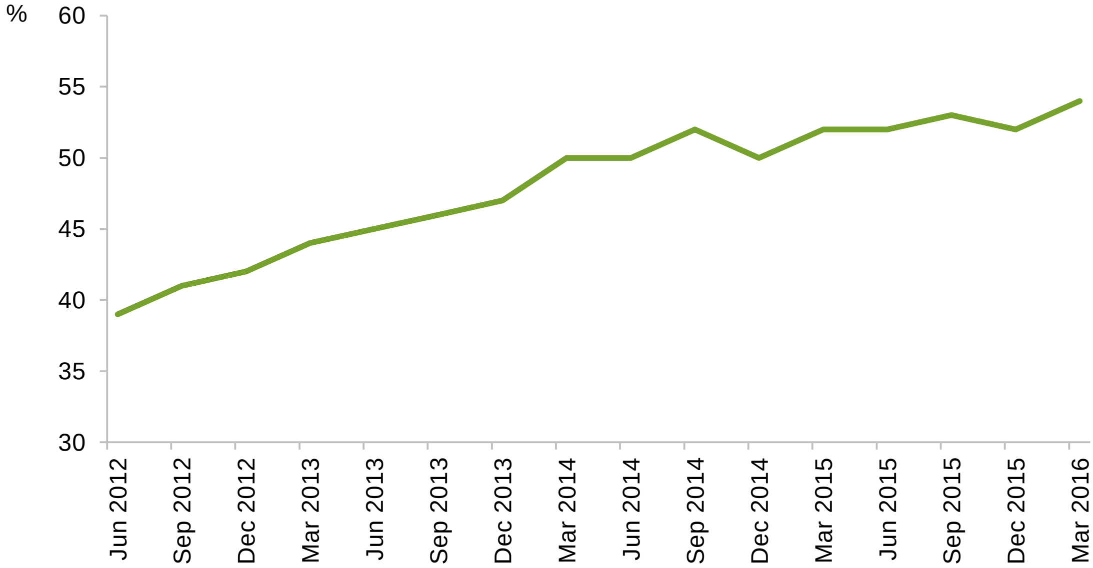


[a] SVR refers to the standard variable rate. Observed cash rate is the interbank overnight cash rate.

Source: APRA (2017s); RBA (2017r, 2017s)

Figure C.29 **Over half of home loans are originated by mortgage brokers**

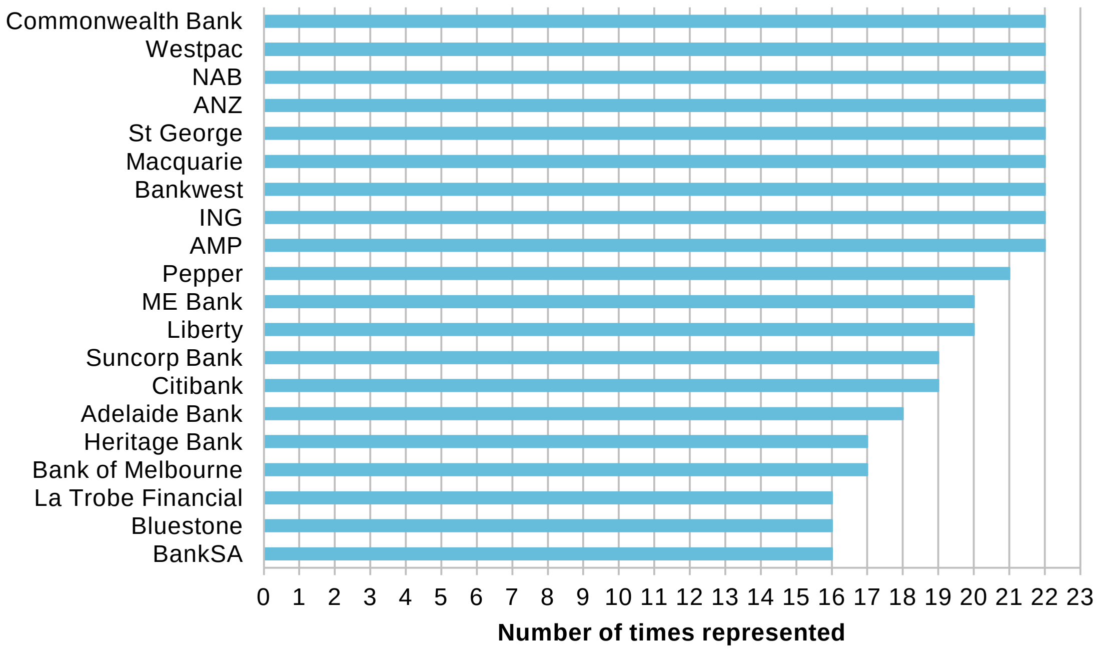
Share of total housing loan commitments



Source: ABA (sub. 11)

Figure C.30 **Which lenders appear most frequently on aggregators' panels?**

Number of times each lender appears within the 23 panels examined[a,b]

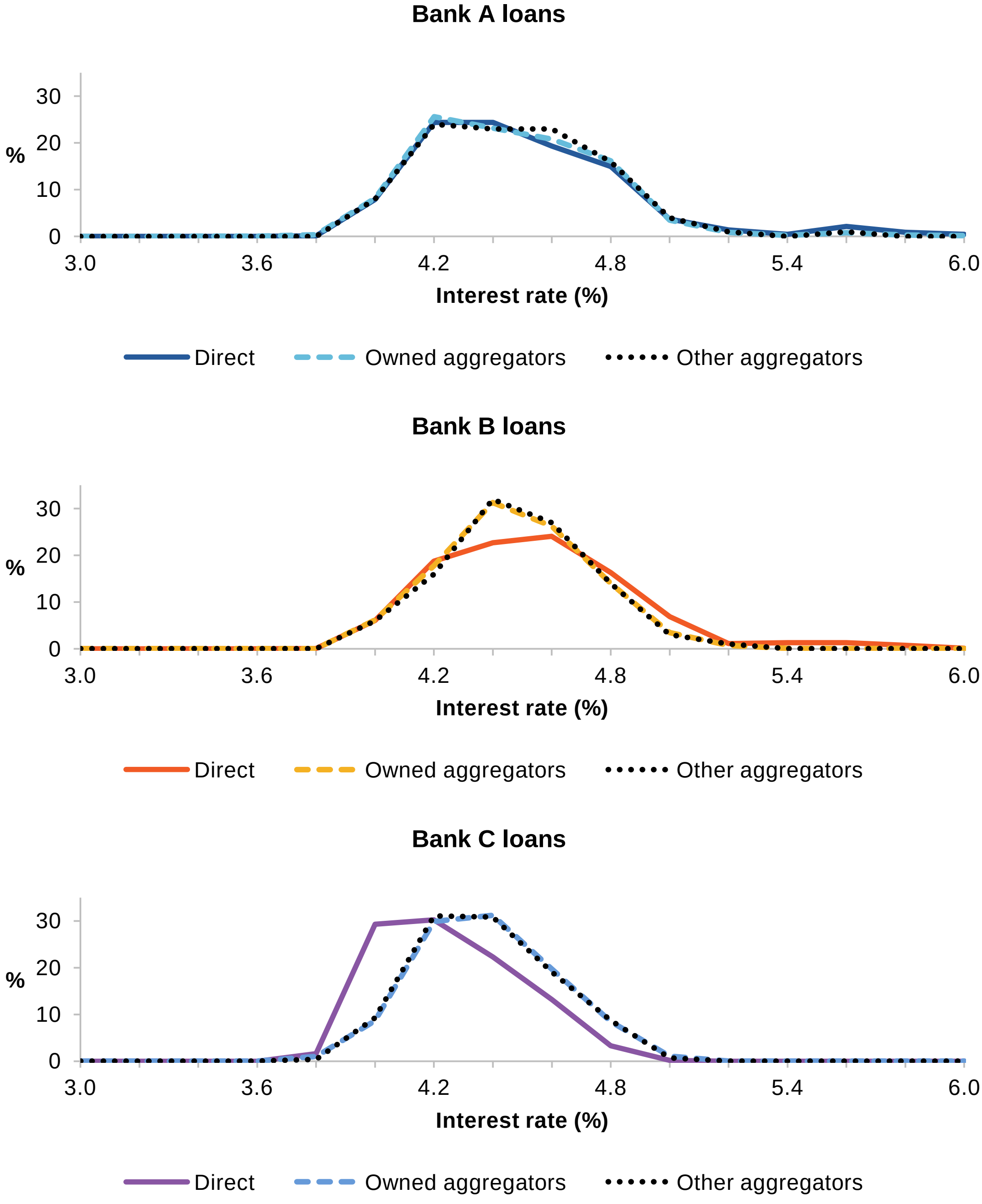


[a] The Commission examined the panels of 23 aggregators, which represented large and medium aggregators and a selection of smaller aggregators (listed below in the sources to this chart). As noted in section 11.1, the total number of aggregators in the market is unknown, but publicly available information suggests there are approximately 50. [b] Centrepoint Alliance's panel did not include ANZ or Westpac, and Citiwide's panel did not include the Commonwealth Bank or NAB.

Source: AAA Mortgage Solutions (2018); Aussie Home Loans (2018); Australian Finance Group (2018); Ballast (2018); Bernie Lewis Home Loans (2018); Centrepoint Alliance (2018); Choice Aggregation Services (2018); Citiwide (2018); Connective (2018); Custom Equity Group (2018); eChoice Pty. Ltd. (2018); Finance & Systems Technology Pty. Ltd. (2018); Finconnect (2018); Finsure (2018); Loan Market (2018); Mortgage Choice (2018); My Local Broker (2018); National Mortgage Brokers (2018); Outsource (2018); PLAN Australia (2018); Smartline (2018); Vow Financial Pty. Ltd. (2018); Yellow Brick Road (2018)

Figure C.31 **Rate distributions of home loan channels**[a,b,c]

2015



[a] x axis is interest rate charged in groupings of 20 basis points (for example, all loans with an interest rate from 3.0 to 3.2 make up the first data point). y axis is % of total loans made by the specific bank via that channel charged within the corresponding interest rate grouping. [b] Based on lenders' self-reporting of loans made through specific aggregators. Includes subsidiary lenders. [c] 'Direct' means loans made directly by the bank, such as through branches. 'Owned aggregators' means loans made through the specific bank's own aggregators. 'Other aggregators' means loans made through aggregators that are not owned by the specific bank.

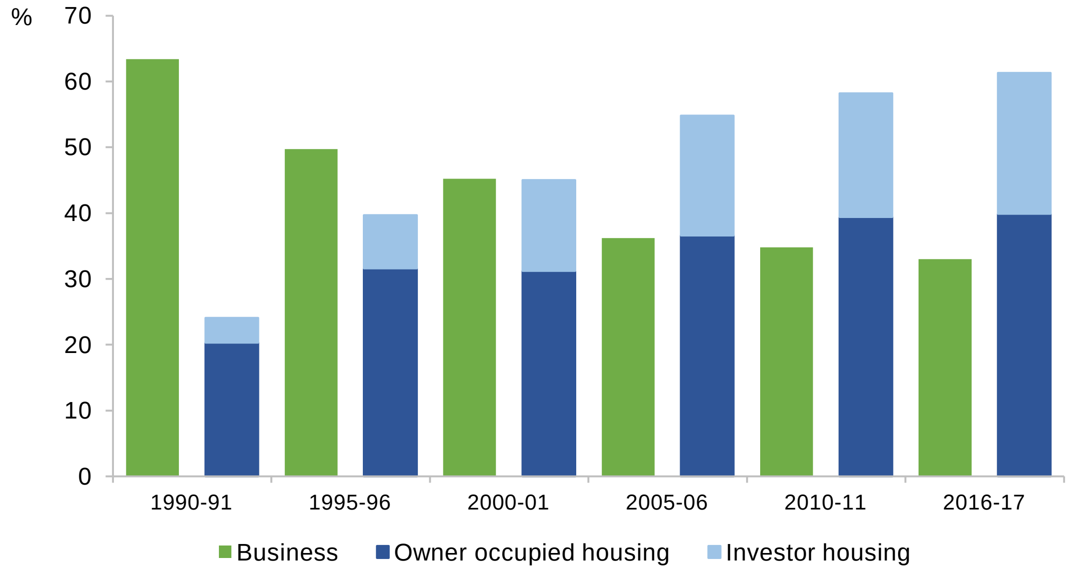
Source: Productivity Commission analysis based on unpublished ASIC data

C.4 Banking and the business sector

Business banking

Figure C.32 **Lending for business has declined while lending for housing has increased**[a]

Share of total lending by banks and non-bank financial institutions

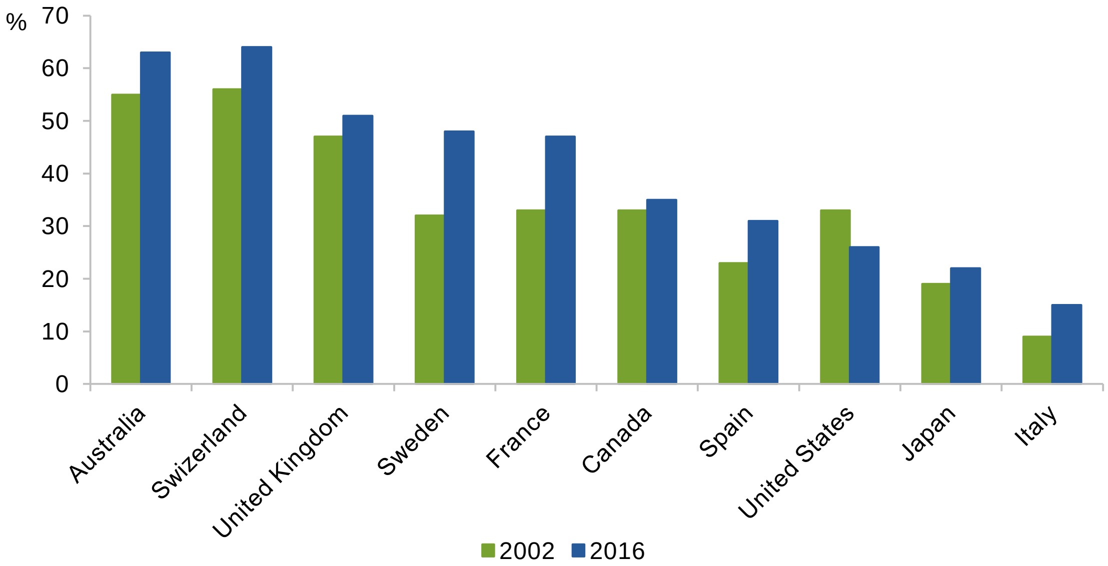


[a] Non-bank financial institutions are building societies, credit unions, specialist credit card institutions and registered financial corporations.

Source: RBA (2017t)

Figure C.33 **And the share of lending for housing is high by international standards**

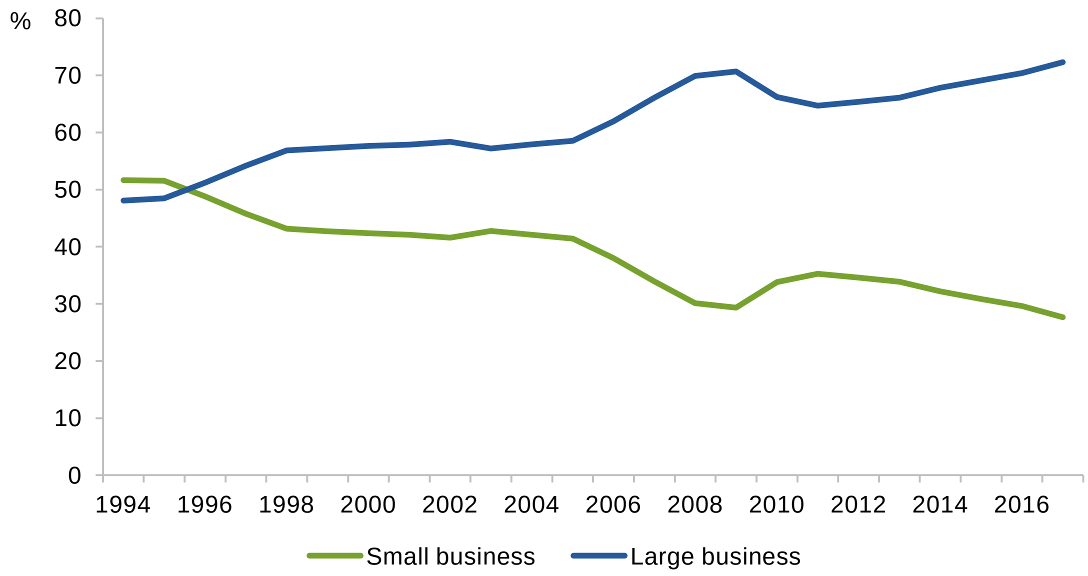
Residential mortgages as a share of total bank lending



Source: BIS (2017b)

Figure C.34 **Large businesses dominate business lending[a]**

Annual average share of total outstanding credit

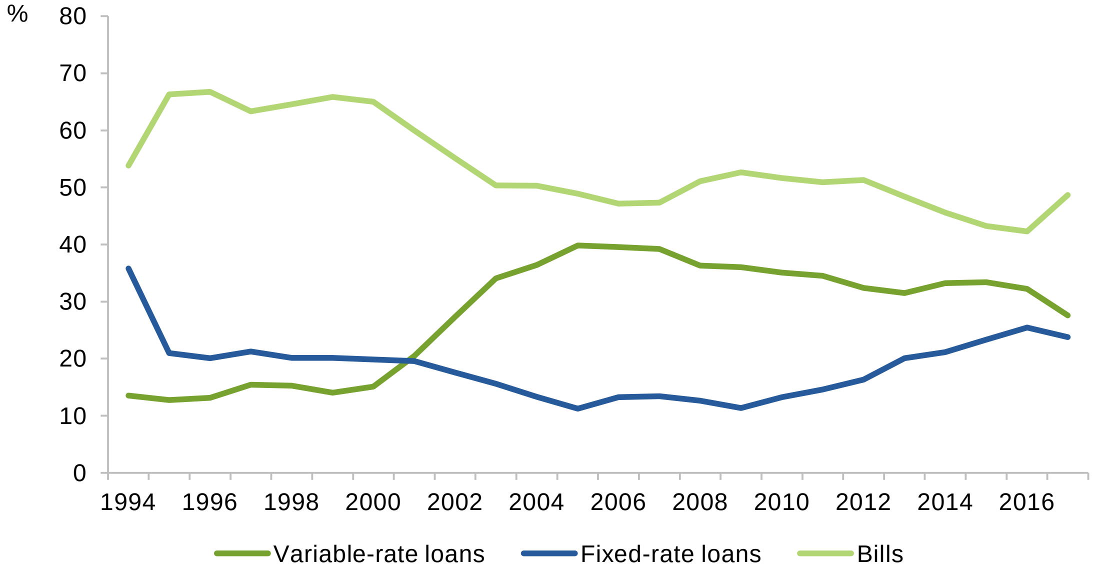


[a] Large business refers to credit of $2 million and over.

Source: RBA (2017i)

Figure C.35 **Most large business bank lending is via bills[a]**

Annual average share of total outstanding large business credit

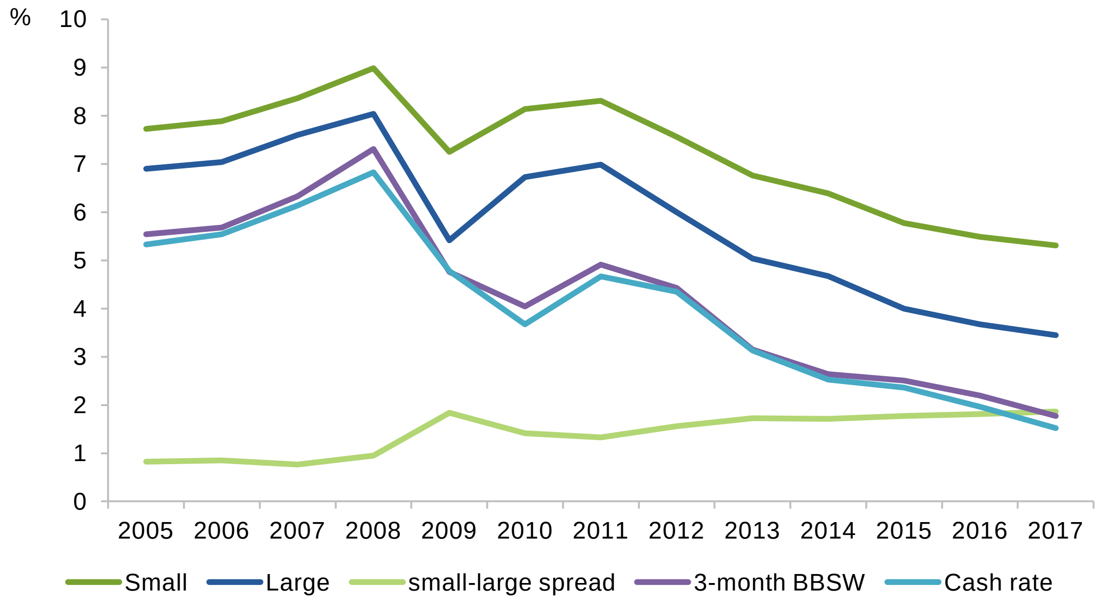


[a] Large business refers to credit of $2 million and over.

Source: RBA (2017i)

Figure C.36 **Interest rates are lower for large business lending[a]**

Weighted annual average interest rates on outstanding credit

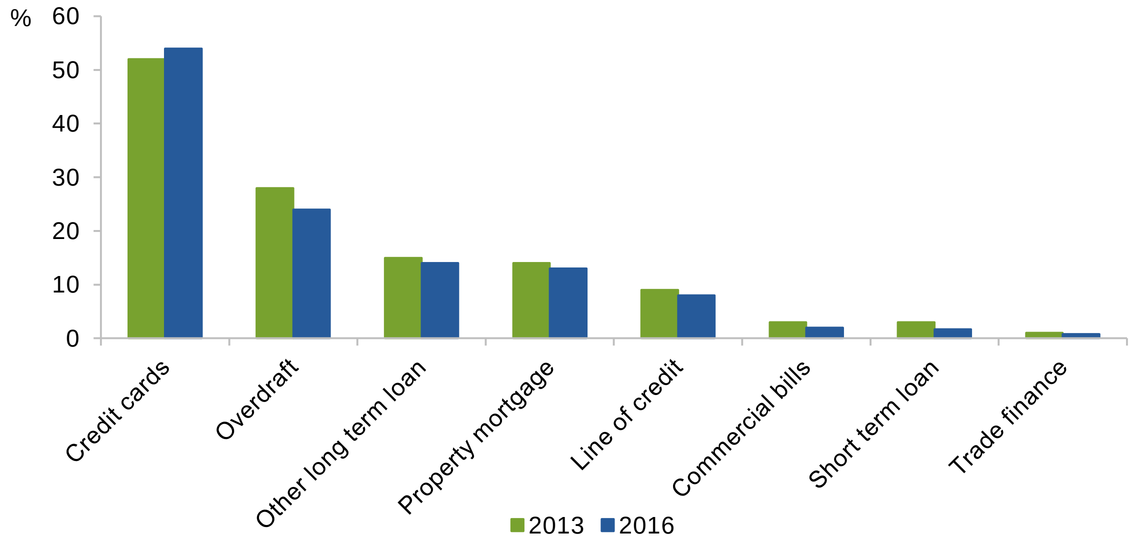


[a] Large business is for outstanding loans $2 million and over, and includes bill lending. The BBSW is the Bank Bill Swap Rate.

Source: RBA (2017i)

Figure C.37 **Small businesses typically use some form of debt finance**

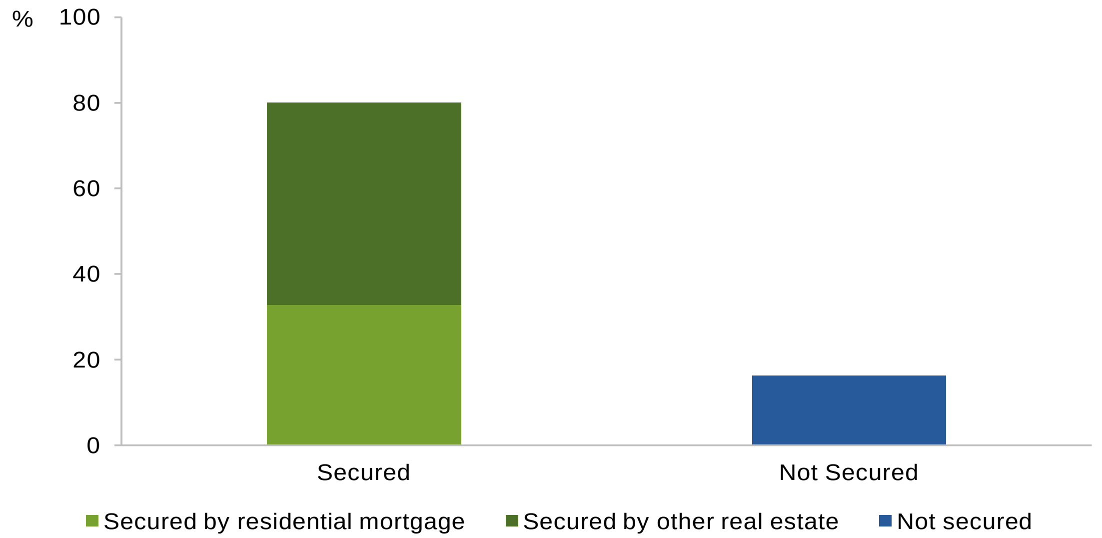
Share of small businesses using lending product



Source: ABA (2016)

Figure C.38 **Most small business term loans are secured by real estate[a]**

June 2017

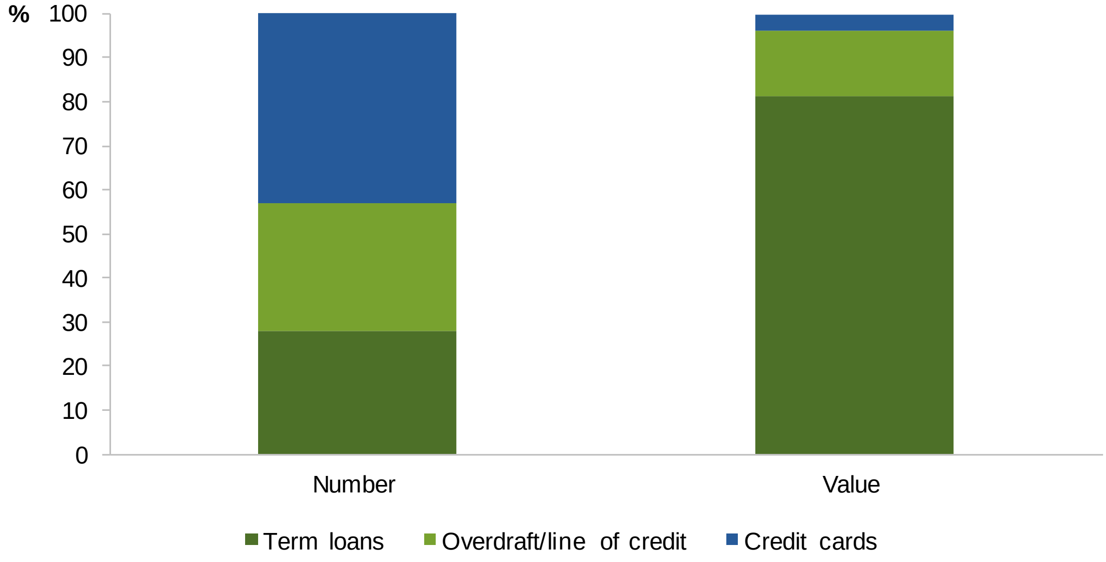


[a] Share of total value of small business lending by the major banks (CBA, Westpac, NAB and ANZ). The data for one of the major banks is at 30 September 2016. The classification of a small business loan is determined by each bank.

Source: Unpublished ADI data

Figure C.39 **Term loans dominate small business lending by value**[a]

June 2017



[a] One ADI's data is based on September 2017.

Source: Unpublished data provided by ADIs representing 84% of the market for SME lending.

Institutional banking

Box C.2 What is institutional banking?

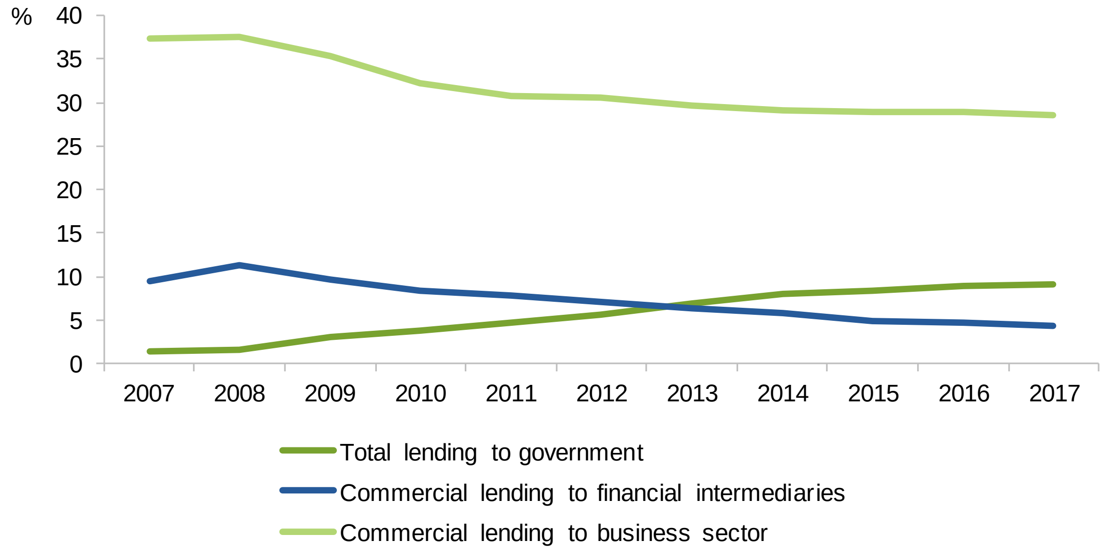
Institutional banking is typically a separate division within a bank. It provides financing and advisory functions for large corporations, governments, very high-net-worth households and investment managers with wholesale banking products and services. This includes financing and advisory functions relating to investments and divestments, transactional banking, capital restructuring and debt advice. Some banks include international operations in their institutional divisions

For the major banks in Australia, institutional banking accounted for between 12% and 28% of their net profits in the most recent reporting period. Returns from institutional banking tend to respond to financial market volatility, and are therefore more volatile than retail banking.

Source: ANZ (2017c); Citigroup (2017); CBA (2017a); NAB (2017a); WBC (2017); Yeates (2016).

Figure C.40 Bank lending to governments is increasing and lending to business is declining

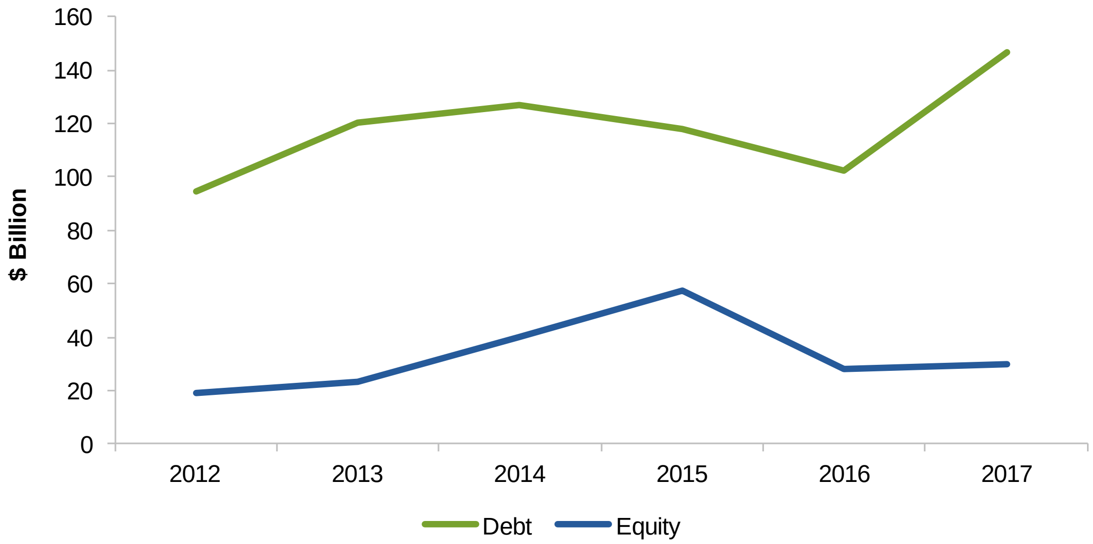
Share of total lending



Source: RBA (2017h)

Figure C.41 Debt is the main source of funds[a]

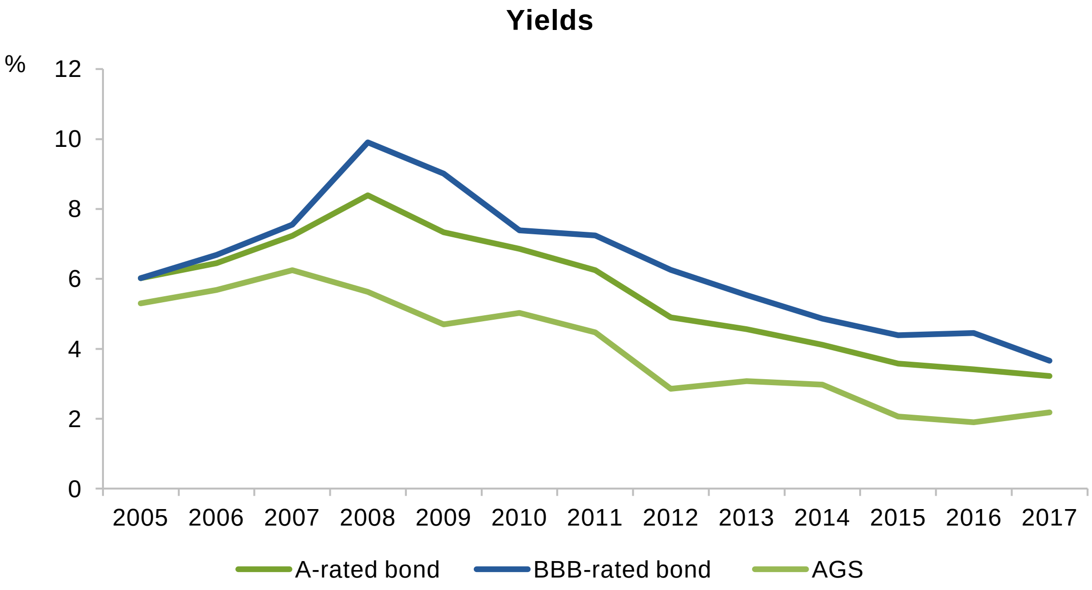
Sources of capital

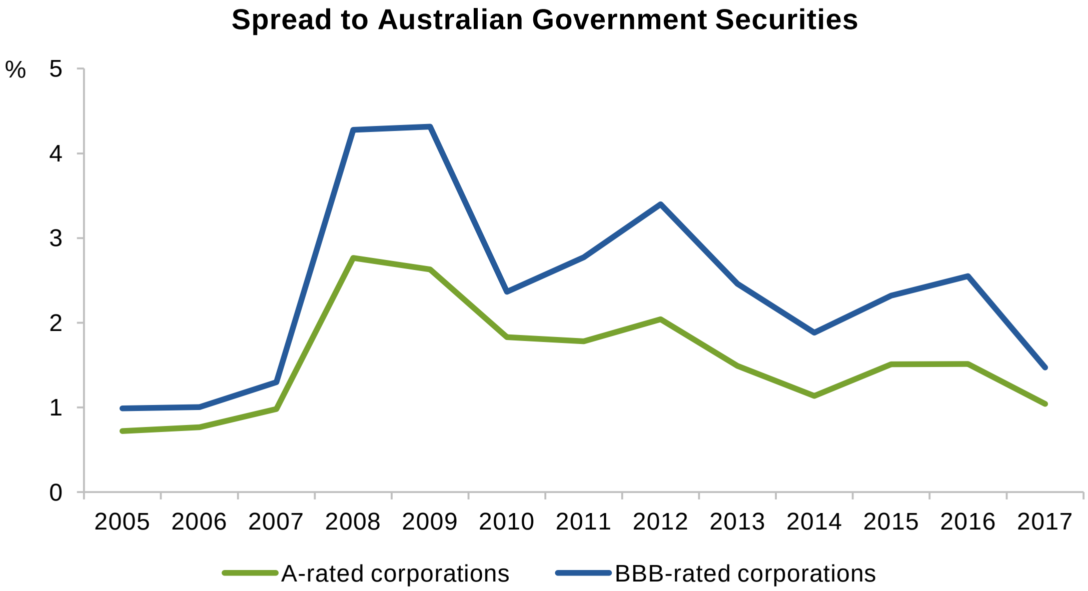


[a] All Australian bond offerings (excluding self-funded debt) and Australian equity & equity-related offerings with managing underwriters.

Source: Thomson Reuters Equity Capital Market and Global Debt Capital Market Reviews (various years)

Figure C.42 **Australian corporate bond yields have fallen and spreads have narrowed**[a]



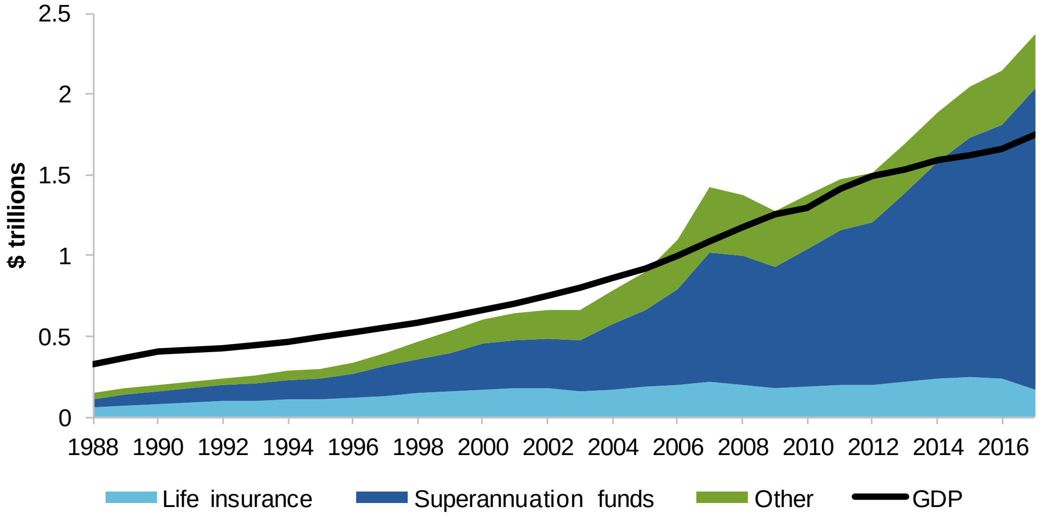


a 5-year target tenor (residual maturity of 5 years). Non-financial corporate bonds with an outstanding amount of at least $100 million. AGS refers to Australian Government Securities. Weighted annual averages.

Source: RBA (2017d)

C.5 Wealth management and platforms

Figure C.43 **Assets under management have grown at a faster rate than GDP[a]**

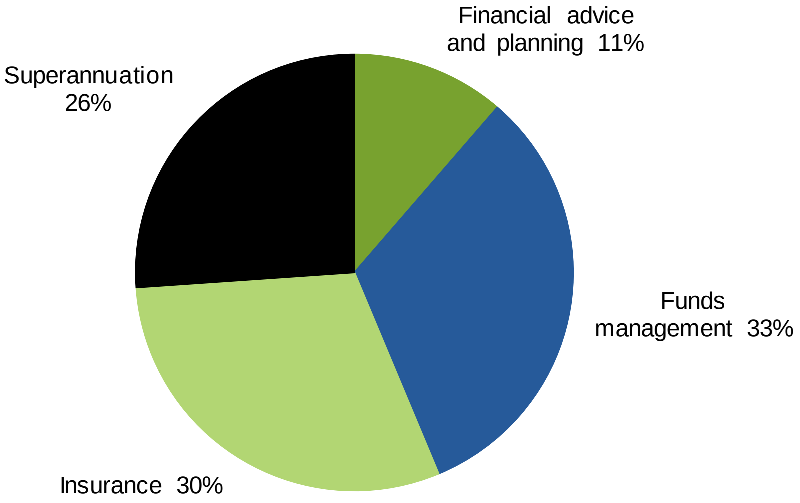


[a] Consolidated assets of managed funds institutions, as at 30 June each year. Excludes cross-investment between institutions. Includes overseas assets.

Source: ABS (*Managed Funds, Australia, Jun 2017*, Cat. no. 5655.0, table 1; *Australian System of National Accounts, 2016-17*, Cat. no. 5204.0, table 2)

Figure C.44 **Banks' income from wealth management[a]**

2016



[a] Average share of total wealth management income.

Source: Unpublished data from 9 ADIs

Box C.3 **What are platforms?**

Platforms — also known as 'investor directed portfolio services' — are typically online services, used by intermediaries and consumers, to allow investors to buy a range of funds from different asset managers, and to hold them together in one account or portfolio. They provide facilities for investments to be bought and sold, and to aggregate and arrange for customers' assets (including consolidated administration, tax, distribution and reporting).

There are two main types of platforms: master trusts (sometimes known as 'fund supermarkets') and wraps. At September 2016, most platform funds were invested in master trusts ($421.7 billion, or about 81%), with the remainder invested in wraps ($102 billion or 19%) (FSC and UBS 2017).

Key differences between master trusts and wraps

	Master Trust	*Wrap*
Trustee operator	Yes	Yes
Value of member's investment determined by value of …	Investment	Asset
Type of investments	Managed funds only	For example, managed funds and direct shares
Fees and taxes bundled into unit price[a]	Yes	No
Income distributed by	Master trust, then distributed to members	Member's cash account
Franking credits distributed by	Unit price	Member's cash account
Assets portable?	No — funds are specific to the master trust. Need to sell current investment.	Yes

[a] Platform fees may include administration fees (usually a percentage of funds under management, entry and exit fees, management fees for investment options, and service fees from a financial adviser.

Source: ASIC (2017t, 2017u); FCA (2015a); Stevens (2015)

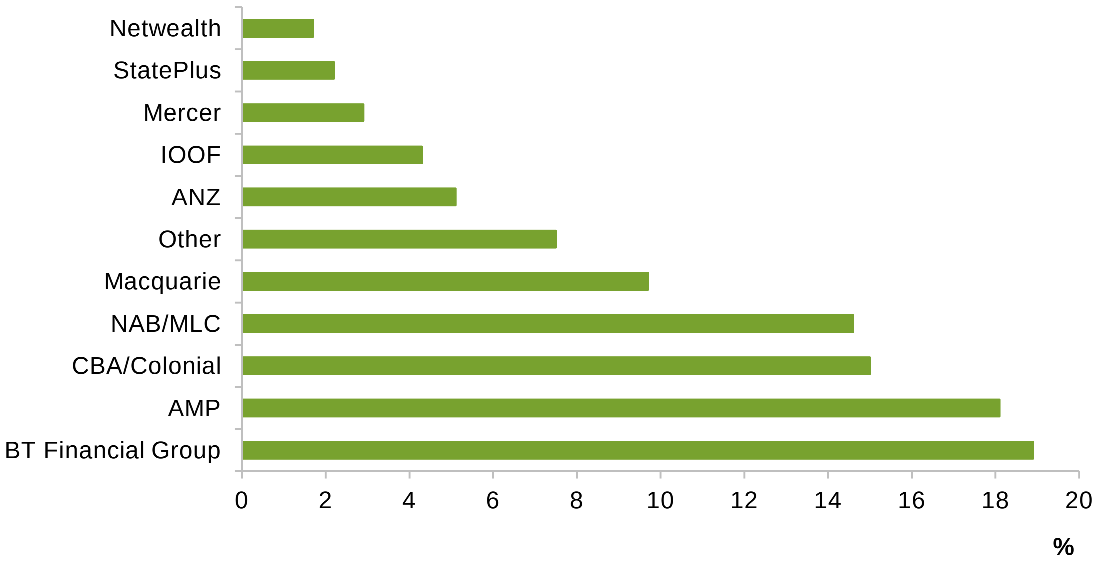
Figure C.45 **Annual net fund flows to platforms**

2005-06 to 2016-17

Source: Plan For Life (2015); Strategic Insight (2017)

Figure C.46 **Platform market share by funds under management**

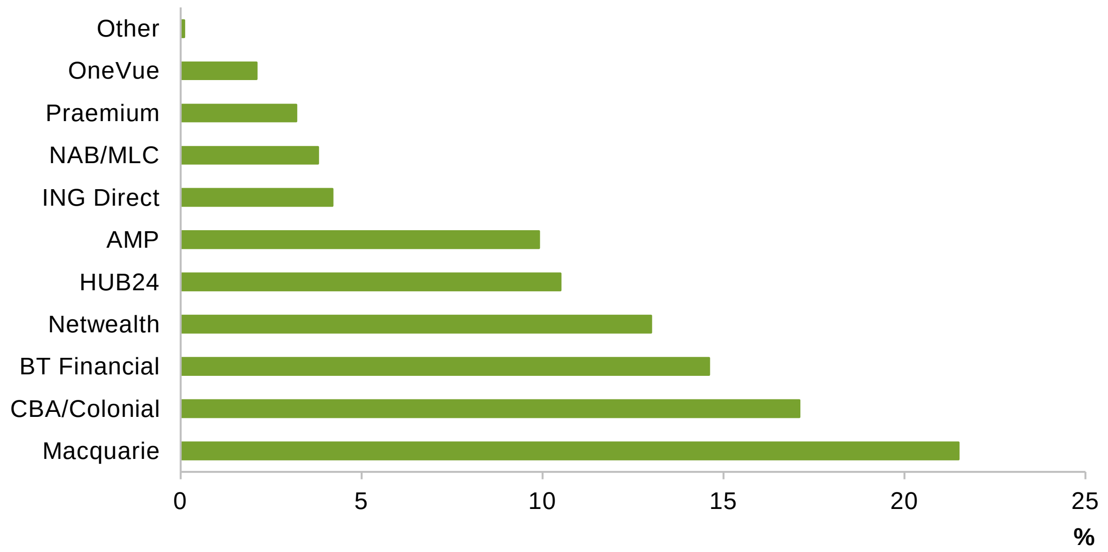
30 June 2017



Source: Strategic Insight (2017)

Figure C.47 **Platform market share by annual net fund flows[a]**

31 March 2017



a Macquarie includes transition from Oasis (ANZ) to Macquarie.

Source: Thompson et al. (2017)

D How do consumers make decisions?

D.1 Behavioural strategies in decision making

Consumers face difficulties in readily understanding the information presented to them, and/or finding financial and credit product information somewhat less enthralling than other consumer products.

When decisions are complex and overwhelming, consumers resort to strategies to help make the decision making process simpler (for example, Fletcher 2016; ASIC, sub. 40; COBA, sub. 21) (table D.1). ASIC noted the following observations about consumer decisions:

> Decisions themselves are often made using heuristics or 'shortcuts' — for example, unconscious rules of thumb, which may lead people to choose options that appear familiar or unambiguous without weighing up all the options. (ASIC 2014b, p. 172)

Table D.1 **Behavioural biases in financial markets**

Bias	*Example*
Decision-making shortcuts used when assessing available information	
Framing	Overestimating the value of a packaged bank account because it is presented in a particularly attractive way
Narrow framing	Investment decisions may be made asset-by-asset rather than considering the whole investment portfolio
Decision-making rules of thumb	Investments may be split equally across all funds in a pension scheme, rather than making a careful allocation decision
Social influence and trust	Following financial advice because an adviser is 'likeable'
Preferences that are influenced by emotions and psychological experiences	
Present bias	Spending on a credit card for immediate gratification
Reference dependence and loss aversion	Believing that insurance added on to a base product is cheap because the base price is much higher
Regret and other emotions	Buying insurance for peace of mind
Rules of thumb that can lead to incorrect beliefs	
Over-confidence	Excessive belief in one's ability to pick winning shares
Over-extrapolation	Extrapolating from just a few years of investment returns to the future
Projection bias	Taking out a payday loan without considering payment difficulties that may arise in the future

Source: adapted from ASIC (2014b)

While these behaviours can be useful in making decisions under constraint, they can also introduce significant and systematic biases into decision making (ASIC 2017y). These 'behavioural biases' mean that people do not take account of all relevant and available information, making it difficult for them to act in their own best interests.

This does not imply that consumers are incapable of understanding the important features of a product, or that they are apathetic. Rather, these actions are quite normal when faced with large costs (in terms of effort, time and fees) or when consumers are time constrained:

> Consumers will vary in the extent to which they exhibit these various biases, and the impact of these biases will also vary according to the context. However, it is important to remember that such biases do not imply stupidity or laziness, or even a special level of consumer vulnerability; all of us exhibit such cognitive limitations and biases, in one circumstance or another. … there is no such thing as a consumer who makes decisions in a careful, contemplative … way at all times. Life is too short. (Fletcher 2016, p. 17)

Consumers resort to making decisions based on trust

In some cases, consumers turn to trusted sources of information such as family and friends, using these to fill the gaps from their own experience and/or avoid the confusion presented by other channels of information and guidance. But when guidance from family and friends becomes the only source of information, this advice may perpetuate common misconceptions and lead to decisions that are not necessarily suitable (Consumer and Financial Literacy Taskforce 2004).

Equally, consumers' trust in expert financial advice has been found to be an important factor in consumer decision making processes. Research by ASIC found that consumers rated their financial advisers and the advice they received highly, with 86% indicating that they felt they had received good quality advice and 81% saying they trusted the advice received 'a lot'. However, an assessment of the quality of advice indicated only 3% of cases were 'good' with 58% of cases considered 'adequate' and 39% 'poor' (ASIC, sub. 40).

Too much choice leads to narrowing of information, default options or status quo bias

With some financial and credit products, there is a large array of options presented for individuals to choose from. For example, while the four major banks dominate the credit card market, there are about 100 different brands offering over 250 different credit cards (Consumer Action, FCA and Financial Rights, sub. 23). (Chapter 17 examines concentration in the debit and credit card markets.)

While variety and choice at some level are essential components of improved consumer outcomes, the need to decide between a large number of complex and poorly explained options can lead to choice overload. Around 40% of survey respondents agreed that there is often too much choice when making financial decisions (Fear 2008). When faced with a large number of products or services to choose from, consumers tend to look for one or two pieces of information to make decisions, rather than considering the wider range of benefits and costs. For example, consumers may assess the value of a credit card based on the rewards points and free travel insurance, ignoring the interest rate and other fees.

Product providers are aware that consumers make decisions using this narrowed framing, and advertise and market products in a way which highlights or downplays certain prices or features for commercial gain (ASIC, sub. 40; ACCC, sub. 17). Comparison websites, for example, can reduce complex insurance purchasing decisions to one based on solely on price, which has implications for the nature of competition:

> We are mostly concerned that the type of competition encouraged by price comparison websites, which oversimplify the consumer's options and magnify an existing bias towards choosing on price alone, will facilitate a race to the bottom on coverage, as insurers with superior cover and claims handling services are outcompeted by cheaper and inferior offerings. (Consumer Action, FCA and Financial Rights, sub. 23, p. 21)

Too much choice, particularly regarding complex products, can be so overwhelming that consumers take no action at all:

> According to psychologists, the more choosers perceive their choice-making task to necessitate expert information, the more they may be inclined not to choose, and further, they may even surrender the choice to someone else. (Fear 2008, p. 3)

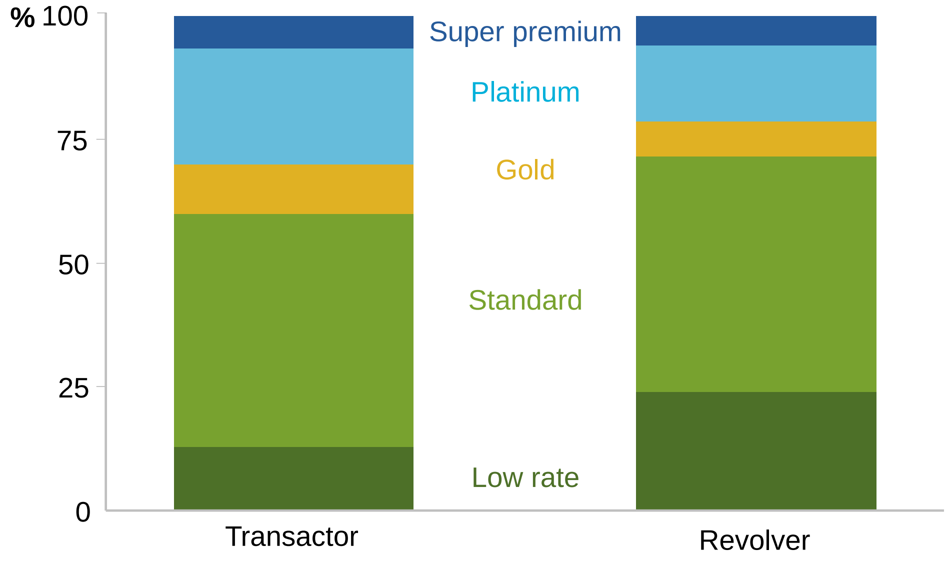
This may mean that consumers accept the default options when presented to them without assessing the value of those options. Consumers' preference for the status quo also has important implications for consumers changing from their current product or provider to a new one (chapter 5).

Furthermore, the existence of a large number of products and suppliers can often be an 'illusion' of choice, with consumers concluding that there is a greater degree of competition among providers than actually exists. For example, the pet insurance market has many brands but few insurers. While at least 25 brands offer pet insurance, 23 of these offered products are underwritten by a single insurer. (Despite this, the industry argues that competition does exist in this sector (chapter 14)).

Optimism, overconfidence, present bias

Consumers' ability to assess the information available is also influenced by general tendencies to focus on the present, while being overconfident about the future. In particular, consumers focus on costs that are incurred up front, downplay those incurred in the future, or miscalculate their future behaviour in a way that leads them to incur unexpected charges or penalties. A well-cited example is that consumers ignore credit card interest rates, believing they will always pay off their credit card balance in full by the end of each statement. They, therefore, consider the interest rate charge irrelevant (ASIC, sub. 40; Consumer Action, FCA and Financial Rights, sub. 23). Yet 40% of credit card holders are ‘revolvers’, meaning that they incur interest on their credit card balance. Three quarters of these use a standard, gold, platinum or super premium card that incurs a higher interest rate than low rate credit cards available in the market (figure D.1).

Figure D.1 **Many ignore credit card interest rates at great cost**



Source: RBA submission to SERC (2015) inquiry.

D.2 Financial literacy is important to assess information

Making information simpler and more reliable is only one part of the equation that results in effective demand-side competition in a market.

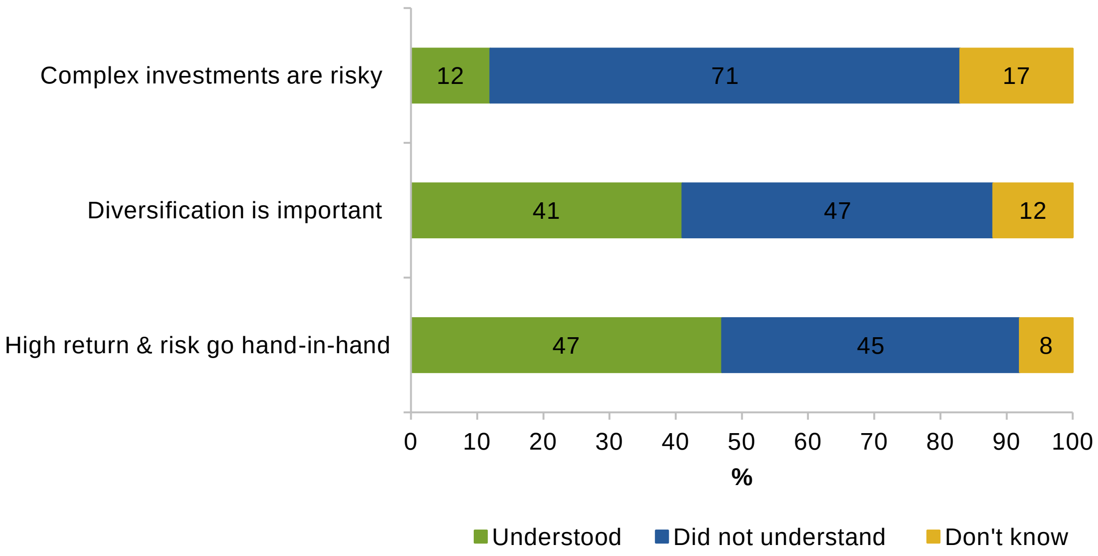
Consumers also need a reasonable level of financial literacy to be active agents in the competitive process: to be engaged and motivated to seek out information and to have the knowledge and skills to assess the information gathered.

Not surprisingly, some in the community do not fully understand certain financial and credit products.

- Many financial decisions, for example, require choices involving risk and uncertainty, but people are often not sure how to make such decisions. Findings from the Australian Financial Attitudes and Behaviour Tracker survey show that fewer than one in three Australians understand the risk and return trade-off (ASIC 2017i). ASIC also found that 45% of survey respondents, including industry participants and financial literacy specialists, believed consumers do not understand that higher reward often means higher risk, and 71% believed that consumers fail to fully understand the risk involved in complex products (figure D.2).

- The risks and extra costs of interest-only borrowing are not well understood by consumers. Typically, an interest-only loan will allow a consumer to make repayments that consist only of an interest component for the first five years. After that, they must pay principal and interest, which raises their monthly payments substantially. A 2015 ME Bank survey showed 38% survey respondents had ‘no understanding’ of interest-only repayments (Yeates 2017c).

Figure D.2 **Consumers have limited understanding of the role of risk**



Source: ASIC (2013a).

The infrequent purchase of some financial or credit products inhibits the development of financial literacy. It leaves consumers with limited opportunity to develop experience and subsequently draw upon in the decision making process (ASIC, sub 40). Not only do people make the smaller more frequent decisions better, the mistakes made on the larger and less frequent financial decisions are systematic and predictable:

> We are good at grocery shopping. We do it all the time. But only rarely do we buy a house, or enrol in a savings plan. It’s these decisions that we often get spectacularly wrong, in predictable ways. (Martin 2017)

There are notable differences in financial literacy between women and men, particularly around the financial aspiration of women. Survey evidence finds that women, on average, were more careful with money, that is, they keep track of their finances and fewer women than men were ‘impulsive’ in their attitudes. But, women were less likely to have considered what income they would require in retirement. The latter has implications for investment products and women seeking out information for these products (ANZ 2015).

ASIC is implementing the Australian Government’s National Financial Literacy Strategy, with the aim to improve the financial wellbeing of Australians by advancing their financial literacy. A number of core strategies include improving literacy of the next generation through the education system, increasing the use of free impartial tools and resources, and providing targeted guidance and support (ASIC 2014d). Some financial institutions also provide financial education — for example, ANZ undertakes research among, and provides financial education to those who are vulnerable and on lower incomes (ANZ 2015). Consumer advocacy groups undertake research and education to improve financial literacy of consumers more generally, and influence government policies (PC 2017b). In particular consumer groups have expressed concern about the role of banks in teaching children about financial literacy:

> The importance of financial literacy education for young children cannot be understated. CHOICE supports the ASIC MoneySmart Teaching program, which provides teachers with skills and independent resources to provide financial literacy education, and is accessed by 54% of Australian schools. Practical experience is an important component in this education, and a school banking program has a role to play in engaging young consumers.
>
> But letting banks teach primary students about money management is equivalent to letting Ronald McDonald lecture them about the importance of a balanced diet. (sub. 42, p. 27)

References

3 Delta Systems 2013, *Credit Card Tokenization 101 - And Why it's better than Encryption*, https://www.3dsi.com/blog/credit-card-tokenization-101 (accessed 22 November 2017).

AAA Mortgage Solutions 2018, *Adelaide Home Loan & Mortgage Brokers*, https://aaamortgagesolutions.com.au/ (accessed 16 May 2018).

AAI Limited 2015, *Essentials by AAI Product Disclosure Statement*.

ABA and COSBOA (Australian Bankers' Association and Council of Small Business) 2013, *Small Businesses - Access to Finance Report - Year to March 2013*.

ABA (Australian Bankers' Association) 2015, *ABA response to the Inquiry into credit card interest rates*, August.

—— 2016, *The small business sector in Australia*, May.

—— 2017a, *Code of Banking Practice - Response by Australian Bankers' Association to Review Final Recommendations*.

—— 2017b, *Small Business Loans Inquiry - Response by the Australian Bankers' Association*, 20 April.

—— 2017c, *Members*, https://www.ausbanking.org.au/about-us/members/ (accessed 20 April 2018).

—— 2018a, *Banking Code of Practice*, Final version - ASIC approval version - with changes.

—— 2018b, *Draft Code of Banking Practice*.

——, MFAA, FBAA, COBA and AFIA (Australian Bankers' Association, Mortgage & Finance Association of Australia, Finance Brokers Association of Australia, Customer Owned Banking Association and Australian Finance Industry Association) 2017, *Improving Customer Outcomes: The Combined Industry Forum Response to ASIC Report 516: Review of Mortgage Broker Remuneration*, December.

ABS (Australian Bureau of Statistics) 2017a, *2016 CensusQuickstats*.

—— 2017b, *Australian National Accounts: National Income, Expenditure and Product - Table 37. Industry Gross Value Added, Chain volume measures, Annual*, December, Cat. no. 5206.0.

—— 2017c, *Housing Finance, Australia, December 2017*, Cat no. 5609.0, Canberra.

—— 2017d, *Selected characteristics of Australian businesses 2015-16*, Cat. no. 8167.0.

—— 2018a, *2016 Census - Selected Family Characteristics*, Census TableBuilder Database.

—— 2018b, *Consumer Price Index, Australia*, March, Cat. no. 6401.1.

—— 2018c, *Counts of Australian Businesses Including Entries and Exits, June 2013 to June 2017*, February, Cat. no 8165.0.

—— 2018d, *Labour Force, Australia, Detailed, Quarterly - Table 04 Employed persons by Industry sub-division of main job (ANZSIC)*, 29 March, Cat. no. 6291.0.55.003.

—— 2018e, *Lending Finance, Australia, February 2018*, Cat. no. 5671.0, www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5671.0February%202018 (accessed 1 May 2018).

—— 2018f, *Managed Funds, Australia, Mar 2018*, 7 June, Cat. no. 5655.0.

ACCC and APRA (Australian Competition and Consumer Commission and Australian Prudential Regulation Authority) 1999, *Memorandum of Understanding*, 30 November.

—— nd, *About the ACCC*, https://www.accc.gov.au/about-us/australian-competition-consumer-commission/about-the-accc#related-publications (accessed 4 December 2017a).

—— 2008a, *Merger Guidelines*.

—— 2008b, *Public Competition Assessment: Commonwealth Bank of Australia - proposed acquisition of BankWest and St Andrew's Australia*.

—— 2008c, *Public Competition Assessment: Westpac Banking Corporation - proposed acquisition of St George Bank Limited*.

—— 2010, *ACCC maintains opposition to NAB acquiring AXA*, https://www.accc.gov.au/media-release/accc-maintains-opposition-to-nab-acquiring-axa (accessed 12 January 2018).

—— 2013a, *Commonwealth Bank of Australia - proposed acquisition of remaining issued capital of Aussie Home Loans*, http://registers.accc.gov.au/content/index.phtml/itemId/1106573 (accessed 24 November 2017).

—— 2013b, *Full Federal Court confirms false or misleading representations by Zamel's*, https://www.accc.gov.au/media-release/full-federal-court-confirms-false-or-misleading-representations-by-zamels (accessed 9 January 2018).

—— 2013c, *National access regime under Part IIIA*, www.accc.gov.au/regulated-infrastructure/about-regulated-infrastructure/acccs-role-in-regulated-infrastructure/national-access-regime-under-part-iiia (accessed 15 November 2017).

—— 2015a, *A guide for comparator website operators and suppliers*.

—— 2015b, *ACCC re-authorises Bulk Electronic Clearing System suspension & termination regulations*, https://www.accc.gov.au/update/accc-re-authorises-bulk-electronic-clearing-system-suspension-termination-regulations (accessed 23 November 2017).

—— 2016, *Credit, debit and prepaid card surcharges*, https://www.accc.gov.au/consumers/prices-surcharges-receipts/credit-debit-prepaid-card-surcharges (accessed 23 November 2017).

—— 2017a, *Applications for authorisation A91546 & A91547*, www.accc.gov.au/public-registers/authorisations-and-notifications-registers/authorisations-register/bendigo-and-adelaide-bank-ors-authorisation-a91546-a91547 (accessed 25 July 2017).

—— 2017b, *Applications for authorisation A91560 & A91562*, www.accc.gov.au/public-registers/authorisations-and-notifications-registers/authorisations-register/npp-australia-limited-authorisation-a91560-a91562 (accessed 15 November 2017).

—— 2017c, *Interim Guidelines on misuse of market power*, October.

—— 2017d, *Media Merger Guidelines*.

—— 2017e, *Northern Australia Insurance Inquiry*, Issues Paper, 24 October.

—— 2017f, *Opening Statement to Productivity Commission Public Hearing*, 29 June.

—— 2017g, *s.87B undertakings register*, https://www.accc.gov.au/public-registers/undertakings-registers/s87b-undertakings-register (accessed 20 June 2018).

—— 2018, *Residential mortgage price inquiry interim report*, Interim Report, March.

—— nd, *Misuse of market power*, https://www.accc.gov.au/business/anti-competitive-behaviour/misuse-of-market-power (accessed 15 November 2017b).

Accenture 2017, *Australian Banking Consumer Survey*.

ACFS (Australian Centre for Financial Studies) 2014, *Lending to small and medium enterprises. Submission to Financial System Inquiry*, September.

ACM (Netherlands Authority for Consumers and Markets) 2013, *Behavioural economics and its impact on competition policy - A practical assessment with illustrative examples from financial services*, May.

ACT Government 2017, *Economic Development*, https://apps.treasury.act.gov.au/budget/budget-2017-2018/media-releases/economic-development (accessed 4 December 2017).

Ahlfort, K. 2015, *Cashless future for Sweden?*, KTH, www.kth.se/en/forskning/artiklar/cashless-future-for-sweden-1.597792 (accessed 8 January 2018).

AIHW (Australian Institute of Health and Welfare) 2017, *Australia's Welfare 2017*, Australia's Welfare series 13.

Alipay 2017, *About Alipay*, https://intl.alipay.com/ (accessed 10 November 2017).

Allardice, D.R. and Erdevig, E. 1981, *The significance and measurement of concentration*, Federal Reserve Bank of Chicago.

ALRC (Australian Law Reform Commission) 2008, *For Your Information: Australian Privacy Law and Practice*, Report 108, Sydney.

AMP 2018, *Annual Report 2017*.

AMP Capital 2017, *Australian cash rate on hold - bank mortgage rates, home prices and implications for investors*, www.ampcapital.com.au/article-detail?alias=/olivers-insights/april-2017/australian-cash-rate-on-hold (accessed 8 August 2017).

ANAO (Australian National Audit Office) 2016, *Prudential Regulation of Superannuation Entities*, Report no. 26 2016–17.

Ant Financial 2017, *About Ant - Our History and Timeline*, www.antfin.com/history.htm (accessed 10 November 2017).

ANZ 2015, *ANZ Survey of Adult Financial Literacy in Australia 2014*, The Social Research Centre.

—— 2017a, *ANZ to abolish ATM fees for non-ANZ customers*, Media release, Melbourne.

—— 2017b, *Basel III Pillar 3: Disclosure*.

—— 2017c, *Annual Report 2017*, Annual Report Series.

AOFM (Australian Office of Financial Management) 2016a, *AOFM participation in RMBS transactions*, http://cdn.aofm.gov.au/uploads/sites/31/2013/07/rmbs_data_20150915.xls (accessed 21 October 2017).

—— 2016b, *Residential mortgage-backed securities*, http://aofm.gov.au/cash-management-and-investments/residential-mortgage-backed-securities/ (accessed 20 November 2017).

—— 2018, *AOFM participation in RMBS transactions*, 22 February.

APCA (Australian Payments Clearing Association) 2012, *Financial institutions ready to make switching easier*, Media release, 28 June, Sydney.

—— 2015a, *Cards and Accepting Devices*, www.apca.com.au/payment-systems/cards-accepting-devices (accessed 9 November 2017).

—— 2015b, *High Value*, www.apca.com.au/payment-systems/high-value (accessed 13 November 2017).

—— 2017a, *Regulations for Bulk Electronic Clearing System Framework*, Regulations, January.

—— 2017b, *Submission to Dual-Network Cards and Mobile Wallet Technology Consultation Paper*, February.

—— 2018, *The Community of Interest Network (COIN)*.

APNL (Australian Payments Network Limited) 2017, *Procedure for Bulk Electronic Clearing System Framework*.

APRA (Australian Prudential Regulation Authority) nd, *Regulator Performance Framework*, http://www.apra.gov.au/AboutAPRA/Publications/Pages/Regulator-Performance-Framework.aspx (accessed 8 September 2017).

—— 1999, *Annual Report 1999*.

—— 2005, *Prudential Standard APS 610 Providers of Purchased Payment Facilities*, November, http://www.apra.gov.au/adi/Documents/cfdocs/APS-610-PPF-1.pdf (accessed 26 April 2018).

—— 2006, *Authority to carry on banking business - PayPal*, October.

—— 2007, *Guidelines on Being Authorised as a Representative Office of a Foreign Bank*, March.

—— 2008a, *ADI authorisation guidelines*, April.

—— 2008b, *APG 117 - Interest Rate Risk in the Banking Book (Advanced ADIs)*, Prudential Practice Guide, http://www.apra.gov.au/adi/Documents/cfdocs/Final-APG-117-November-2007.pdf (accessed 11 December 2017).

—— 2008c, *APRA's Perspective on the Residential Mortgage Lending Market - Submission to the House of Representatives Standing Committee on Economics*, 18 July.

—— 2012a, *Prudential Standard APS 112 Capital Adequacy - Standardised Approach to Credit Risk*, 29 November.

—— 2012b, *Prudential Standard APS 113 Capital Adequacy - Internal Ratings-based Approach to Credit Risk*, 29 November.

—— 2012c, *Regulation Impact Statement - Implementing Basel III capital reforms in Australia*, OBPR ID: 2012/13813.

—— 2012d, *Regulation Impact Statement - Implementing Basel III liquidity reforms in Australia*, OBPR ID: 2012/14531.

—— 2013a, *APRA releases framework for domestic systemically important banks in Australia*, http://www.apra.gov.au/mediareleases/pages/13_40.aspx (accessed 21 October 2017).

—— 2013b, *Domestic systemically important banks in Australia*, Information Paper, December.

—— 2013c, *Prudential Practice Guide APG 113 Internal Ratings-based Approach to Credit Risk*, January.

—— 2013d, *Prudential Practice Guide SPG 220 Risk Management*.

—— 2014a, *Financial System Inquiry - Response to the interim report*, 26 August.

—— 2014b, *Financial System Inquiry submission*, 31 March.

—— 2014c, *Letter to all ADIs: Reinforcing sound residential mortgage lending practices*, 9 December.

—— 2015a, *About the Financial Claims Scheme*, https://www.fcs.gov.au/about-apra (accessed 11 October 2017).

—— 2015b, *APRA increases capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach*, www.apra.gov.au/MediaReleases/Pages/15_19.aspx (accessed 24 July 2017).

—— 2015c, *APRA releases updated guidelines on section 66 of Banking Act*, http://www.apra.gov.au/mediareleases/pages/15_22.aspx (accessed 25 September 2017).

—— 2015d, *APRA's enforcement activities*.

—— 2015e, *IRB Approach to Credit Risk Accreditation Process*, http://www.apra.gov.au /adi/Publications/Pages/IRB-Approach-to-Credit-Risk-Accreditation-Process.aspx (accessed 11 August 2017).

—— 2015f, *The APRA Supervision Blueprint*.

—— 2016a, *APRA confirms its definition of high-quality liquid assets for the Liquidity Coverage Ratio requirement*, http://www.apra.gov.au/MediaReleases/Pages/16_22.aspx (accessed 17 January 2018).

—— 2016b, *APRA reaffirms revised mortgage risk weight target*, http://www.apra.gov.au /MediaReleases/Pages/16_23.aspx (accessed 25 October 2017).

—— 2016c, *APRA Regulator Performance Framework Self-Assessment*.

—— 2016d, *APRA releases final revised prudential standard on liquidity for the Net Stable Funding Ratio*, http://www.apra.gov.au/MediaReleases/Pages/16_55.aspx (accessed 15 September 2017).

—— 2017a, *ADI points of presence*, June.

—— 2017b, *Annual Report 2016-17*.

—— 2017c, *APRA announces 'unquestionably strong' capital benchmarks*, http://www.apra.gov.au /MediaReleases/Pages/17_23.aspx (accessed 12 November 2017).

—— 2017d, *APRA releases changes to the capital framework for mutual ADIs*, https://www.apra.gov.au/media-centre/media-releases/apra-releases-changes-capital-framework-mutual-adis (accessed 15 June 2018).

—— 2017e, *ARF 395.0 Business Finance Statistics*, 21 December.

—— 2017f, *Competition in the Australian Financial System - Productivity Commission roundtable hearing opening statement*, June.

—— 2017g, *Foreign Banks with Consent to Maintain a Representative Office in Australia*, www.apra.gov.au/adi/Pages/what-is-a-representative-office.aspx (accessed 29 November 2017).

—— 2017h, *Further measures to reinforce sound residential mortgage lending practices*.

—— 2017i, *Intermediated General Insurance Statistics - June 2017*.

—— 2017j, *Letter to all ADIs: Aggregate results on the Committed Liquidity Facility for 2018*, http://www.apra.gov.au/adi/Publications/Documents/Aggregate-results-on-Committed-Liquidity-Facility-2017.pdf (accessed 23 May 2018).

—— 2017k, *Licensing - A phased approach to authorising new entrants to the banking industry*, Discussion Paper, 15 August.

—— 2017l, *List of Authorised Deposit-taking Institutions*, http://www.apra.gov.au/adi/Pages/adilist.aspx (accessed 13 November 2017).

—— 2017m, *Lloyd's in Australia*.

—— 2017n, *Monthly Banking Statistics*, September.

—— 2017o, *Prudential Practice Guide APG 223 – Residential Mortgage Lending*.

—— 2017p, *Prudential Standard APS 120 Securitisation - Regulation Impact Statement Updates*.

—— 2017q, *Prudential Standard APS 210 Liquidity*, 10 January.

—— 2017r, *Quarterly Authorised Deposit-Taking Institution Performance December 2017*, December, www.apra.gov.au/adi/Publications/Pages/adi-quarterly-performance-statistics.aspx (accessed 13 March 2018).

—— 2017s, *Quarterly Authorised Deposit-Taking Institution Performance June 2017*, 29 August.

—— 2017t, *Quarterly Authorised Deposit-Taking Institution Performance September 2017*, 5 December.

—— 2017u, *Statistics: Quarterly ADI property exposures June 2017*, 29 August.

—— 2017v, *Strengthening banking system resilience - establishing unquestionably strong capital ratios*, Information Paper, 19 July.

—— 2018a, *ADI licensing: Restricted ADI Framework*, Information Paper, 4 May.

—— 2018b, *Annual General Insurance Institution-level Statistics - December 2017*.

—— 2018c, *APRA authorises Restricted ADI*, www.apra.gov.au/MediaReleases/Pages/18_19.aspx (accessed 10 May 2018).

—— 2018d, *APRA's policy priorities*.

—— 2018e, *Changes to section 66 Banking Act*, Letter to all ADIs, 4 May.

—— 2018f, *Disqualification Register*, http://www.apra.gov.au/CrossIndustry/Pages/Disqualification-Register.aspx (accessed 22 May 2018).

—— 2018g, *Embedding Sound Residential Mortgage Lending Practices*, http://www.apra.gov.au/MediaReleases/Pages/18_16.aspx (accessed 26 April 2018).

—— 2018h, *Enabling Legislation*, http://www.apra.gov.au/AboutAPRA/Pages/APRA-Legislation.aspx (accessed 8 January 2018).

—— 2018i, *Enforceable Undertakings Register*, http://www.apra.gov.au/CrossIndustry/Pages/EnforceableUndertakings.aspx (accessed 22 May 2018).

—— 2018j, *Industry fees and levies*, http://www.apra.gov.au/AboutAPRA/Pages/Industry-fees-and-levies.aspx (accessed 24 April 2018).

—— 2018k, *Information on unauthorised foreign insurers (formerly DOFIs)*, http://www.apra.gov.au/GI/Pages/UFI-information.aspx (accessed 13 February 2018).

—— 2018l, *Intermediated General Insurance Statistics — December 2017*.

—— 2018m, *Monthly Banking Statistics*, April.

—— 2018n, *Monthly Banking Statistics Back Series - March 2018 Release*, March, www.apra.gov.au/adi/Publications/Pages/monthly-banking-statistics.aspx (accessed 18 May 2018).

—— 2018o, *Prudential Inquiry into the Commonwealth Bank of Australia*, April.

—— 2018p, *Quarterly Authorised Deposit-taking Institution Performance December 2017*.

—— 2018q, *Quarterly General Insurance Performance Statistics - December 2017*.

—— 2018r, *Revisions to the capital framework for authorised deposit-taking institutions*, Discussion Paper, 14 February.

ARA (Australian Retailers Association) 2014, *Submission to the Financial System Inquiry*.

—— 2017, *ARA Supportive of ANZ Dual Network Routing*, Media Release, 19 October.

Armour, J., Awrey, D., Davies, P., Enriques, L., Gordon, J.N., Mayer, C. and Payne, J. 2016, *Principles of Financial Regulation*, Oxford University Press.

Arora, R. 2017, *Another industry Amazon plans to crush is small-business lending*, https://www.cnbc.com/2017/06/16/amazon-plans-to-crush-small-business-lending.html (accessed 28 November 2017).

Arregui, N., Benes, J., Krznar, I., Mitra, S. and Oliveira Santos, A. 2013, *Evaluating the Net Benefits of Macroprudential Policy: A Cookbook*, IMF Working Paper WP/12/167.

ASBFEO (Australian Small Business and Family Enterprise Ombudsman) 2016, *Inquiry into small business loans*, 12 December.

—— 2018, *Fintech lending to small and medium-sized enterprises - Improving transparency and disclosure*, February.

ASIC (Australian Securities and Investments Commission) 2011a, *Consumer credit insurance: a review of sales practices by authorised deposit-taking institutions*, October, Report 256.

—— 2011b, *Disclosure: Product Disclosure Statements (and other disclosure obligations)*, October, Regulatory Guide 168.

—— 2011c, *Financial literacy and behavioural change*, March, Report 230.

—— 2013a, *ASIC Stakeholder Survey*.

—— 2013b, *ASIC's approach to enforcement*.

—— 2013c, *Consumer Credit Insurance Policies: Consumers' Claims Experiences*, Report 361.

—— 2013d, *Consumer testing of the MySuper product dashboard*, Report 378.

—— 2014a, *AFS licensees*, http://asic.gov.au/for-finance-professionals/afs-licensees/ (accessed 12 June 2018).

—— 2014b, *Financial System Inquiry - Submission by the Australian Securities and Investments Commission*, Media Release 14-071, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-071mr-asics-submission-to-the-2014-financial-system-inquiry/ (accessed 2 August 2017).

—— 2014c, *FoFA Background and implementation*, http://asic.gov.au/regulatory-resources/financial-services/future-of-financial-advice-reforms/fofa-background-and-implementation/ (accessed 12 June 2018).

—— 2014d, *National Financial Literacy Strategy 2014–17*, Report 403.

—— 2014e, *Regulating complex products*, January, Report 384.

—— 2015, *Westpac to refund premiums for unwanted insurance cover*, 15-318MR, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2015-releases/15-318mr-westpac-to-refund-premiums-for-unwanted-insurance-cover/ (accessed 23 November 2017).

—— 2016a, *A market that is failing consumers - The sale of add-on insurance through car dealers*, September, Report 492.

—— 2016b, *Briefing on Competition and Tracker Mortgages received from Mr Greg Medcraft, Chair, Australian Securities and Investments Commission*, Supplementary Budget Estimates 2016-17.

—— 2016c, *Buying add-on insurance in car yards: Why it can be hard to say no*, February, Report 470.

—— 2016d, *Financial advice - Fees for no service*, 27 October, Report 499.

—— 2016e, *Fintech - ASIC's Approach and Regulatory Issues*.

—— 2016f, *National Credit Code*, http://asic.gov.au/regulatory-resources/credit/credit-general-conduct-obligations/national-credit-code/ (accessed 13 October 2017).

—— 2016g, *North Queensland home insurance*.

—— 2016h, *Regulator Performance Framework*, http://asic.gov.au/about-asic/what-we-do/how-we-operate/performance-and-review/regulator-performance-framework/ (accessed 8 September 2017).

—— 2016i, *Submission to PC inquiry into Data Availability and Use*, August.

—— 2016j, *The sale of life insurance through car dealers: Taking consumers for a ride*, February, Report 471.

—— 2017a, *Annual Report 2016-17*.

—— 2017b, *Answers to Questions on Notice - ASIC capability review and the implementation plan*, March.

—— 2017c, *ASIC accepts enforceable undertaking from Macquarie Bank to address inadequacies within their wholesale FX businesses*, Media Release 17-144, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-144mr-asic-accepts-enforceable-undertaking-from-macquarie-bank-to-address-inadequacies-within-their-wholesale-fx-businesses/ (accessed 27 December 2017).

—— 2017d, *ASIC accepts enforceable undertakings from ANZ and NAB to address conduct relating to BBSW*, Media Release 17-393, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-393mr-asic-accepts-enforceable-undertakings-from-anz-and-nab-to-address-conduct-relating-to-bbsw/ (accessed 25 December 2017).

—— 2017e, *ASIC enforcement outcomes: January to June 2017*, Report 536.

—— 2017f, *ASIC Financial Advisers Dataset*.

—— 2017g, *ASIC's Corporate Plan 2017–18 to 2020–21*.

—— 2017h, *ASIC's Innovation Hub and our approach to regulatory technology*, May, Report 523.

—— 2017i, *Australian Financial Attitudes and Behaviour Tracker*, Report 541, Sydney.

—— 2017j, *Big four banks change loan contracts to eliminate unfair terms*, 24 August, Media Release 17-278.

—— 2017k, *Commonwealth Bank to refund over $10 million for mis-sold consumer credit insurance*, Media Release 17-268, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-268mr-commonwealth-bank-to-refund-over-10-million-for-mis-sold-consumer-credit-insurance/ (accessed 23 November 2017).

—— 2017l, *Do I Need a Credit Licence?*, Regulatory Guide 203, Sydney.

—— 2017m, *Enhanced regulatory sandbox proposal – ASIC submission*, Submission to Treasury, November.

—— 2017n, *ePayments Code*, http://asic.gov.au/regulatory-resources/financial-services/epayments-code/ (accessed 10 November 2017).

—— 2017o, *Fees*, https://www.moneysmart.gov.au/borrowing-and-credit/home-loans/fees (accessed 21 November 2017).

—— 2017p, *Financial advice costs*, https://www.moneysmart.gov.au/investing/financial-advice/financial-advice-costs (accessed 9 August 2017).

—— 2017q, *Latitude Insurance refunds almost $1.1 million for poor consumer credit insurance sales and claims handling*, Media Release 17-457, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-457mr-latitude-insurance-refunds-almost-11-million-for-poor-consumer-credit-insurance-sales-and-claims-handling/ (accessed 9 January 2018).

—— 2017r, *Licensing exemption for fintech testing*.

—— 2017s, *Licensing: Financial product advisers - Conduct and disclosure*, November, Regulatory Guide 175.

—— 2017t, *Master trusts & wraps*.

—— 2017u, *Platforms that are managed investment schemes and nominee and custody services*, September, Regulatory Guide 148.

—— 2017v, *QBE refunds $15.9 million in add-on insurance premiums*, Media Release 17-258.

—— 2017w, *Retaining ASIC's fintech licensing exemption*, Consultation Paper, December.

—— 2017x, *Review of Mortgage Broker Remuneration*, Report 516.

—— 2017y, *Submission to Senate Economics References Committee Inquiry into Australia's General Insurance Industry*, March.

—— 2017z, *Swann Insurance refunds $39 million in add-on insurance premiums*, Media Release 17-446, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-446mr-swann-insurance-refunds-39-million-in-add-on-insurance-premiums/ (accessed 9 January 2018).

—— 2017aa, *Testing fintech products and services without holding an AFS or credit licence*, August, Regulatory Guide 257.

—— 2017ab, *The sale of add-on insurance and warranties through caryard intermediaries*, August, Consultation Paper 294.

—— 2017ac, *Your AFS licence obligations explained*, http://asic.gov.au/for-finance-professionals/afs-licensees/your-ongoing-afs-licence-obligations/your-afs-licence-obligations-explained/ (accessed 10 August 2017).

—— 2018a, *Allianz refunds $45.6 million in add-on insurance premiums*, Media Release 18-008, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-008mr-allianz-refunds-456-million-in-add-on-insurance-premiums/ (accessed 18 January 2018).

—— 2018b, *ASIC enforcement outcomes: July to December 2017*, Report 568.

—— 2018c, *ASIC Financial Advisers Dataset*, https://data.gov.au/dataset/asic-financial-adviser (accessed 6 June 2018).

—— 2018d, *ASIC industry funding*, http://asic.gov.au/about-asic/what-we-do/how-we-operate/asic-industry-funding/ (accessed 3 April 2018).

—— 2018e, *ASIC industry funding*, http://asic.gov.au/about-asic/what-we-do/how-we-operate/asic-industry-funding/ (accessed 23 April 2018).

—— 2018f, *ASIC licenses first crowd-sourced funding intermediaries*, Media Release 18-004MR, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-004mr-asic-licenses-first-crowd-sourced-funding-intermediaries/ (accessed 15 January 2018).

—— 2018g, *ASIC Reports on changes to small business loan contracts by big four banks*, http://www.asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-073mr-asic-reports-on-changes-to-small-business-loan-contracts-by-big-four-banks/ (accessed 21 March 2018).

—— 2018h, *ASIC's Innovation Hub*, http://asic.gov.au/for-business/your-business/innovation-hub/ (accessed 23 April 2018).

—— 2018i, *ASIC's Innovation Hub - Results*, http://asic.gov.au/for-business/your-business/innovation-hub/results/ (accessed 23 April 2018).

—— 2018j, *Entities using the fintech licensing exemption*, http://asic.gov.au/for-business/your-business/innovation-hub/regulatory-sandbox/entities-using-the-fintech-licensing-exemption/ (accessed 23 April 2018).

—— 2018k, *Financial advice: Vertically integrated institutions and conflicts of interest*, January, Report 562.

—— 2018l, *Professional standards for financial advisers – reforms,* https://asic.gov.au/regulatory-resources/financial-services/professional-standards-for-financial-advisers-reforms/ (accessed 7 June 2018).

—— 2018m, *Regulatory sandbox*, http://asic.gov.au/for-business/your-business/innovation-hub/regulatory-sandbox/ (accessed 23 April 2018).

—— 2018n, *Submissions of the Australian Securities and Investments Commission: Consumer Finance*, Submission to the Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry, Sydney.

—— 2018o, *Suncorp refunds $17.2 million in add-on insurance premiums*, Media Release 18-009, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-009mr-suncorp-refunds-172-million-in-add-on-insurance-premiums/ (accessed 18 January 2018).

ASIC Capability Review Panel 2015, *ASIC Capability Review*, December.

ASX Group (Australian Securities Exchange) 2018, *Types of bonds*, https://www.asx.com.au/products/bonds/types-of-bonds.htm (accessed 24 April 2018).

Atkin, T. and Cheung, B. 2017, 'How have Australian banks responded to tighter capital and liquidity requirements', *RBA Bulletin*, June Quarter, pp. 41–50.

—— and La Cava, G. 2017, 'The Transmission of Monetary Policy: How Does It Work?', *RBA Bulletin*, September Quarter, pp. 1–8.

ATO (Australian Taxation Office) 2017, *Tax incentives for early stage investors*, www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?default (accessed 28 November 2017).

Auditor General's Department of South Australia 1993, *Auditor General's Investigation into the State Bank of South Australia*.

Aussie Home Loans 2017, *Want to know more about Aussie?*, https://www.aussie.com.au/corporate-careers/our-history.html (accessed 1 September 2018).

—— 2018, *Home loans - Aussie*, https://www.aussie.com.au/home-loans.html (accessed 16 May 2018).

AUSTRAC (Australian Transaction Reports and Analysis Centre) 2011, *Verification of identity: The use and disclosure of personal information by reporting entities and credit reporting agencies for the purposes of verifying an individual's identity – natural persons (e-verification)*, Guidance note 11/2, Canberra.

—— 2016, *About AUSTRAC*, www.austrac.gov.au/about-us/austrac (accessed 8 January 2018).

—— 2017, *AUSTRAC seeks civil penalty orders against CBA*, www.austrac.gov.au/media/media-releases/austrac-seeks-civil-penalty-orders-against-cba+&cd=1&hl=en&ct=clnk&gl=au (accessed 4 August 2017).

Australian Finance Group 2018, *Our Lender Panel*, https://www.afgonline.com.au/get-a-loan/lenders/ (accessed 16 May 2018).

Australian Government 2012, *Questions & Answers about the Guarantee on Deposits*, https://www.guaranteescheme.gov.au/qa/deposits.html (accessed 21 October 2017).

—— 2014, *The Aviation Safety Regulation Review Report: Government Response*.

—— 2015, *Improving Australia's Financial System: Government Response to the Financial System Inquiry*.

—— 2017a, *ASIC Enforcement Review Taskforce Report*.

—— 2017b, *Australian Government Guarantee Scheme: Guaranteed Liabilities*, https://www.guaranteescheme.gov.au/guaranteed-liabilities/ (accessed 6 November 2017).

—— 2017c, *Australian Government response to the Senate Economics References Committee report: Australia's general insurance industry: sapping consumers of the will to compare*, December.

—— 2017d, *Enhanced Regulatory Sandbox,* https://treasury.gov.au/consultation/c2017-t230052/ (accessed 27 October 2017).

—— 2017e, *Exposure Draft Explanatory Statement - Enhanced Regulatory Sandbox*, treasury.gov.au/consultation/c2017-t230052/ (accessed 27 October 2017).

—— 2017f, *Letters Patent - Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.

—— 2017g, *Major Bank Levy Bill 2017 Explanatory Memorandum*, 30 May.

—— 2017h, *Major Bank Levy Bill 2017 Treasury Laws Amendment (Major Bank Levy) Bill 2017 Explanatory Memorandum*.

—— 2017i, *Treasury Laws Amendment (Banking Measures No. 1) Bill 2017 Explanatory Memorandum,* www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5990 (accessed 28 November 2017).

—— 2017j, *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 Exposure Draft Explanatory Memorandum*.

—— 2018a, *Budget Measures Budget Paper No. 1 2018-19*, 8 May.

—— 2018b, *Government Response to Review into Open Banking*.

—— 2018c, *Treasury Laws Amendment (2018 Measures No. 2) Bill 2018*, www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r6023 (accessed 9 April 2018).

—— 2018d, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018 Explanatory Memorandum*, http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r6092_ems_a4fc66c2-e247-40f6-b3e5-e3a5838d1d41/upload_pdf/668040.pdf;fileType=application%2Fpdf (accessed 28 November 2017).

Australian Government Actuary 2014a, *Report on Home and Contents Insurance Prices in North Queensland*.

—— 2014b, *Second Report on Investigation into Strata Title Insurance Price Rises in North Queensland*.

Auto & General Insurance Company 2017, *About us*, http://www.autogeneral.com.au/about-us/ (accessed 21 August 2017).

Aviva 2016, *Take the Aviva Drive challenge*, https://www.aviva.co.uk/car-insurance/drive/ (accessed 12 April 2017).

Aylmer, C. 2016, 'Towards a more Transparent Securitisation Market', Australian Securitisation Conference, Sydney.

BACS 2017, *The Current Account Switch Service*, www.currentaccountswitch.co.uk/ (accessed 27 November 2017).

—— 2018, *Current Account Switch Service dashboard - Issue 18: Covering the period 1 January 2018 to 31 March 2018*, United Kingdom.

Bain and Company 2017, *Evolving the Customer Experience in Banking*.

Bain, J. 1956, *Barriers to New Competition, Their Character and Consequences in Manufacturing Industries*, Harvard University Press, Berlin, Boston, https://www.degruyter.com/view/product/251898 (accessed 20 June 2018).

Ballast 2018, *Ballast*, http://www.ballast.com.au/ (accessed 16 May 2018).

Bank Negara Malaysia 2014, *Payment Card Reform Framework*, December.

Bank of England 2017, *Bank of England extends direct access to RTGS accounts to non-bank Payment Service Providers*, Media Release, July.

Bank of England - Prudential Regulation Authority 2017, *Annual Competition Report 2017*.

Bank of England Independent Evaluation Office 2016, *Evaluating the PRA's approach to its Secondary Competition Objective*, March.

Bankgirot 2017, *Bankgiro Number (Bg Bankgironummer)*, www.bankgirot.se/en/services/incoming-payments/bankgiro-number/ (accessed 26 November 2017).

Barbeler, D. 2016, *Inside the insurance innovation lab*, https://www.insuranceandrisk.com.au/article/the-insurance-lab/ (accessed 18 December 2017).

Barr, N. and Diamond, P. 2017, *Designing a default structure - Submission to the Inquiry into Superannuation: Assessing Efficiency and Competitiveness*, September.

BCBS (Basel Committee on Banking Supervision) 2010, *Basel III A global regulatory framework for more resilient banks and banking systems*, December, Bank for International Settlements.

—— 2015, *Revisions to the Standardised Approach for credit risk - Consultative document*, 27 March, Bank for International Settlements.

—— 2017, *Basel III Finalising post-crisis reforms*, December, Bank for International Settlements, pp. 21–22.

Bech, M. and Monnet, C. 2013, *The Impact of Unconventional Monetary Policy on the Overnight Interbank Market*.

Behn, M., Gross, M. and Peltonen, T. 2016, *Assessing the costs and benefits of capital-based macroprudential policy*, European Central Bank Working Paper Series no. 1935, July.

Ben-David, R. 2018, 'Competition, Neo-paternalism and the Nonsumer uprising', Consumer Law Conference, Sydney.

Bendel, N. 2017, 'White label special', *The Adviser*.

Bennet, M. 2016, 'PayPal takes $85m slice of SME lending pie', *The Australian*, 8 July.

Berger, A., Klapper, L. and Turk-Ariss, R. 2009, 'Bank competition and financial stability', *Journal of Financial Services Research*, vol. 35, no. 2, pp. 99–118.

Bergmann, M. and Tran, M. 2018, 'The distribution of mortgage rates', *RBA Bulletin*, pp. 117–131.

Bernie Lewis Home Loans 2018, *Home loan advice from Bernie Lewis*, https://www.bernielewis.com.au/home-loans/ (accessed 16 May 2018).

Bikker, J.A. and Haaf, K. 2000, *Measures of competition and concentration in the banking industry: a review of the literature*, September, Research Series Supervision no. 27, Central Bank of the Netherlands.

——, Spierdijk, L. and Finnie, P. 2006, *The Impact of Bank Size on Market Power*, DNB Working Paper 120, Netherlands Central Bank, Research Department.

Bird, J. 2017, *Review of insurance comparison sites*, httpss://www.choice.com.au/money/insurance/insurance-advice/articles/insurance-comparison-sites (accessed 30 November 2017).

BIS (Bank for International Settlements) 2015, *Basel Committee on Banking Supervision - Second Consultative Document - Standards - Revision to the Standardised Approach to Credit Risk*, December.

—— 2017a, *Sound Practices - Implications of fintech developments for banks and bank supervisors*, Basel Committee on Banking Supervision Consultative Document.

—— 2017b, *Statistical tables (to update)*.

—— 2018, *Structural changes in banking after the crisis*, January, CGFS Papers No. 60.

BIT (Behavioural Insights Team) 2018, *The impact of improved transparency of foreign money transfers for consumers and SMEs*, Final Report, March.

—— and BIU (The Behavioural Insights Team and Behavioural Insights Unit) 2014, *Understanding People Better Outcomes*, Sydney.

Blackmarket Research 2017, *Project: Switch - Financial/Banking Institution Survey*, Sydney.

Blight, D., Field, M. and Henriquez, E. 2012, 'The first home buyer grant and house prices in Australia', *Deakin Papers on International Business Economics*, vol. 5, pp. 1–11.

Blood, R. 2009, 'Regulation of mortgage default insurance: principles and issues', *Housing Finance International*, vol. 23, no. 3, p. 20.

BoE (Bank of England) 2017, *Stress testing the UK banking system: 2017 results*, November.

Bolt, W., Jonker, N. and Van Renselaar, C. 2008, *Incentives at the Counter: An Empirical Analysis of Surcharging Card Payments and Payment Behaviour in the Netherlands*, Working Paper 196, December, De Nederlandsche Bank, Amsterdam.

Börestam, A. and Schmiede, H. 2011, *Interchange Fees in Card Payments,* Occasional Paper Series, September, 131, European Central Bank.

Bowen, C. 2009, *National Consumer Credit Protection Reform Package*, Media Release 002, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/002.htm&min=ceba&DocType= (accessed 23 May 2018).

BPAY (BPAY Pty Ltd) 2017a, *About BPAY - Overview*, www.bpay.com.au/About-BPAY/Overview.aspx (accessed 9 November 2017).

—— 2017b, *Memberships*, www.bpay.com.au/Member-Financial-Institutions/Memberships.aspx (accessed 9 November 2017).

—— 2017c, *Osko by BPAY,* https://www.osko.com.au/ (accessed 14 November 2017).

Bradney-George, A. 2016, *What is Dynamic Currency Conversion?*, *finder.com.au*, 6 January, www.finder.com.au/dynamic-currency-conversion (accessed 20 April 2018).

Brunet, E. 2017, *Swish, the secret Swedish FinTech payment company created by Nordic banks and used by 50% of Swedes is challenging Swedish unicorns*, *Medium*, 8 January, https://medium.com/@etiennebr/swish-the-secret-swedish-fintech-payment-company-created-by-nordic-banks-and-used-by-50-of-swedes-cfcf06f59d6f (accessed 8 January 2018).

BSP (The Bangko Sentral ng Pilipinas) 2017, *Manual of Regulations for Banks*, September, Volume 1, The Bangko Sentral ng Pilipinas.

BTCA (Better Than Cash Alliance) 2017, *Social Networks, e-Commerce Platforms, and the Growth of Digital Payment Ecosystems in China: What It Means for Other Countries*, April.

Bullock, M. 2017, 'Big Banks and Financial Stability', Address by Assistant Governor (Financial System) Reserve Bank of Australia to Economic and Social Outlook Conference, Melbourne.

Burnham, T., Frels, J. and Mahajan, V. 2003, 'Consumer switching costs: A typology antecedents and consequences', *Journal of the Academy of Marketing Science*, vol. 31, no. 2, pp. 109–126.

Byres, W. 2014, 'Seeking strength in adversity: Lessons from APRA's 2014 stress test on Australia's largest banks', Address by APRA Chairman to AB+F Randstad Leaders Lecture Series 2014, Sydney.

—— 2017a, 'Individual challenges and mutual opportunities', Keynote address, COBA 2017 — Customer Owned Banking Convention, Brisbane.

—— 2017b, *Review of Australian Prudential Regulation Authority annual report 2016*, Official Committee Hansard, Canberra.

Cabral, J. 2018, *Credit cards with no international fees*, *finder.com.au*, 15 January, www.finder.com.au/foreign-currency-international-fees-for-credit-cards (accessed 15 January 2018).

Cai, P. 2012, 'China's biggest bank ICBC moves on Australian expansion plans', *The Sydney Morning Herald*, 13 November.

CALC (Consumer Action Law Centre) 2016, *DemandARefund.com*, http://demandarefund.consumeraction.org.au/ (accessed 23 November 2017).

—— 2017, *Penalised for poverty - consumer groups say Morrison announcement will make the poor pay more*, Media Release.

CALC et al. (Consumer Action Law Centre, Financial Rights Legal Centre, Consumer Credit Law Centre (SA), Consumer Credit Legal Service (WA) and CHOICE) 2017, *Joint submission: Options to reform the sale of add-on insurance and warranties in car yards*, Submission to the Australian Securities and Investments Commission in response to CP 294.

Campbell, J., McCrossin, R., Coates, A., Mallyon, J., Halkerston, K. and Argy, F. 1981, *Australian Financial System Final Report of the Committee of Inquiry*, 29 September.

Canstar 2017a, *Package Home Loans - Benefits, Interest Rates, & Fees*, https://www.canstar.com.au /home-loans/what-is-a-package/ (accessed 4 December 2017).

—— 2017b, *What Is Comprehensive Credit Reporting?*, https://www.canstar.com.au/credit-score/what-is-positive-credit-reporting/ (accessed 21 November 2017).

Capgemini and Efma 2016, *World Retail Banking Report 2016*.

—— 2017, *World Retail Banking Report 2017*.

Capgemini and The University of Sydney Business School 2017, *The Fintech Advantage: Harnessing digital technology, keeping the customer in focus*.

Carey, S. 2017, *15 UK Insurtech Startups to Watch*, https://www.techworld.com/picture-gallery/startups/uk-insurtech-startups-watch-3645315/ (accessed 17 November 2017).

CB Insights 2017, *Insurance Tech Startups Raise $1.7B Across 173 Deals in 2016*, www.cbinsights.com/research/2016-insurance-tech-funding/ (accessed 6 December 2017).

CBA (Commonwealth Bank of Australia) 2015, *Long-term strategy delivers continuing customer satisfaction and profit growth*, https://www.commbank.com.au/content/shared/newsroom/2015/ 08/long-term-strategy-customer-satisfaction.html (accessed 27 December 2017).

—— 2016, *Keeping your online banking secure is very important to us*, www.commbank.com.au/content/shared/newsroom/2016/08/keeping-online-banking-secure.html (accessed 10 November 2017).

—— 2017a, *Annual Report 2017*.

—— 2017b, *Basel III Pillar 3: Capital Adequacy and Risks Disclosures*, 30 June.

—— 2017c, *Commonwealth Bank cuts ATM withdrawal fees*, 24 September, Media release, Sydney.

—— 2017d, *Consumer Mortgage Lending Products - Terms and conditions*, https://www.commbank.com.au/content/dam/commbank/personal/apply-online/download-printed-forms/utc-home-loan.pdf (accessed 17 May 2018).

—— 2017e, *Lenders' Mortgage Insurance and Low Deposit Premium Fact Sheet*.

—— 2018a, *Commbank to no longer offer credit card plus and personal loan protection insurance; loan insurance refund program to be implemented*, Media Release, 7 March, Sydney.

—— 2018b, *Investment Home Loan Interest Rates*, https://www.commbank.com.au /content/dam/commbank/personal/apply-online/download-printed-forms/home-loan-update-002842.pdf (accessed 17 May 2018).

CCAF et al (Cambridge Centre for Alternative Finance, Australian Centre for Financial Studies, KPMG, HNA Capital and CME Group Foundation) 2017, *Cultivating Growth - The 2nd Asia Pacific Region Alternative Finance Industry Report*, September.

Cecchetti, S. and Schoenholtz, K. 2015, *Money, banking and financial markets*, Fourth edition, McGraw-Hill Education.

Centrepoint Alliance 2018, *Mortgage Lending Services for Financial Services*, https://www.centrepointalliance.com.au/lending-solutions/mortgage-lending/ (accessed 16 May 2018).

CFR (Council of Financial Regulators) nd, *Charter*, https://www.cfr.gov.au/about-cfr/charter.html (accessed 6 September 2017a).

—— nd, *Memoranda of Understanding*, http://www.cfr.gov.au/about-cfr/memoranda.html (accessed 7 September 2017b).

—— 2002, *Annual Report 2002*.

CHOICE 2015a, *Cutting Credit Card Confusion Submission to Senate Economics References Committee Matters Related to Credit Card Interest Rates*, Sydney.

—— 2015b, *Foreign transaction fees when shopping online - Online shopping*, www.choice.com.au /shopping/online-shopping/buying-online/articles/foreign-transaction-fees-when-shopping-online (accessed 20 April 2018).

—— 2017a, *Big banks abolish ATM withdrawal fees*, Media Release, 25 September, Sydney.

—— 2017b, *How to Switch Bank Accounts*, https://www.choice.com.au/money/banking/switching-accounts/articles/how-to-switch-banks (accessed 6 September 2017).

Choice Aggregation Services 2018, *Lender Products*, https://www.choiceaggregation services.com.au/member-benefits/lender-products (accessed 16 May 2018).

Chong, B. 2018, 'Super funds can learn the power of choice from SMSFs', *Investment Magazine*.

CIO (Credit and Investments Ombudsman) 2017, *Annual Report 2017*.

Cipriani, J. 2017, *Apple Pay Cash: How to use your iPhone's new Venmo-like feature*, www.cnet.com/how-to/apple-pay-cash-is-now-available-what-you-need-to-know/ (accessed 7 December 2017).

Citigroup 2017, *Institutional Business*.

Citiwide 2018, *Citiwide Home Loans*, http://www.citiwide.com.au/ (accessed 16 May 2018).

Claessens, S. 2009, 'Competition in the financial sector: Overview of competition policies', *The World Bank Research Observer*, vol. 24, no. 1, pp. 83–118.

Clark, J.M. 1940, 'Toward a concept of workable competition', *American Economic Review*, vol. 30, no. 2, pp. 241–256.

CMA (Competition & Markets Authority (UK)) 2014, *Private motor insurance market investigation*, Final Report, 24 September, London.

COAG (Council of Australian Governments) 1995, *Competition Principles Agreement*, https://www.coag.gov.au/about-coag/agreements/competition-principles-agreement (accessed 13 November 2017).

Commonwealth Consumer Affairs Advisory Council 2013, *Credit card surcharges and non‑transparent transaction fees: A study*, July.

Commonwealth Parliament 2018, *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2018*.

Competition Commission 2009, *Market investigation into payment protection insurance*.

Connective 2018, *Our Lender Panel*, https://www.connective.com.au/our-lender-panel/ (accessed 16 May 2018).

Connolly, E. and Jackman, B. 2017, ‘The availability of business finance’, *RBA Bulletin*, December Quarter, pp. 55–66.

Connolly, E., La Cava, G. and Read, M. 2015, ‘Housing Prices and Entrepreneurship: Evidence for the Housing Collateral Channel in Australia’, *Small Business Conditions and Finance,* Reserve Bank of Australia, pp. 115–144.

Consumer and Financial Literacy Taskforce 2004, *Australian Consumers and Money*.

Cooper, J. 2006, ‘The integration of financial regulatory authorities – the Australian experience’, presented at Securities and Exchange Commission of Brazil Conference, Rio de Janeiro, September.

Coorey, P. 2017, *Scott Morrison warns banks to absorb cost of dumping ATM fees*, Financial Review, www.afr.com/news/scomo-warns-banks-to-absorb-atm-fee-costs-20170924-gynlxs (accessed 16 April 2018).

Corderoy, J. 2016, *Mortgages linked to Reserve Bank cash rate are here, despite risk concerns*, http://www.news.com.au/finance/real-estate/buying/mortgages-linked-to-reserve-bank-cash-rate-are-here-despite-risk-concerns/news-story/a7e3df07f00b312fd270316d61c470e2 (accessed 18 September 2017).

Costello, P. (Treasurer) 1997, *Release of the Report of the Financial System Inquiry and Initial Government Response on Mergers Policy*, Press Release no. 28, 9 April.

Council of the European Union 2017, *Remarks by Jeroen Dijsselbloem following the Eurogroup meeting of 15 June 2017*, http://www.consilium.europa.eu/en/press/press-releases /2017/06/15/eurogroup-jd-remarks/ (accessed 15 June 2018).

CreditCard.com.au 2014, *The Australian Credit Card Industry Survey*, https://www.creditcard.com.au/australian-credit-card-industry-survey-2014-b/ (accessed 16 November 2017).

Creighton, A. 2018, *Credit card foreign transaction fees ‘a form of gouging’*, The Australian, www.theaustralian.com.au/business/financial-services/credit-card-foreign-transaction-fees-a-form-of-gouging/news-story/cc41a1d86e6491035a65532356a691b2 (accessed 20 April 2018).

Crowe, D. 2014, ‘Four-pillars policy to stay: Hockey’, *The Australian*, 20 June.

Custom Equity Group 2018, *Custom*, https://www.customequitygroup.com.au/ (accessed 16 May 2018).

Damiani, C., Bourne, N. and Foo, M. 2015, ‘The HIH Claims Support Scheme’, *Economic Roundup*, no. 1.

Davis, K. 2007, ‘Banking Concentration, Financial Stability and Public Policy’, presented at The Structure and Resilience of the Financial System, Sydney, Reserve Bank of Australia, 20 August.

Davis, K. and Jenkinson, M. 2013, *The Financial Claims Scheme: an Assessment of the scheme’s broader economic impact*, August, Australian Centre for Financial Studies.

—— and Lawrence, K. 2015, ‘Basel 3 and 4 and Australian Banking’, presented at 20th Melbourne Money and Finance Conference, Brighton, Victoria, 13 July.

Debelle, G. 2012, ‘Enhancing Information on Securitisation’, Address delivered by Assistant Governor (Financial Markets) Reserve Bank of Australia to the Australian Securitisation Forum, Sydney.

—— 2015, ‘Some Effects of the New Liquidity Regime’, Speech by Assistant Governor (Financial Markets) Reserve Bank of Australia to 28th Australasian Finance and Banking Conference, Sydney.

—— 2018, ‘Twenty-five Years of Inflation Targeting in Australia’.

Dell’Ariccia, G. 1998, *Asymmetric Information and the Market Structure of the Banking Industry*, IMF Working Paper, 98/92.

Deloitte 2012, *Competition in Banking*, June.

—— 2016a, *Customer Experiences of Using Mortgage Brokers*, Market Research Report Prepared for the Mortgage & Finance Association of Australia, October.

—— 2016b, *Mobile Consumer Survey 2016: The Australian Cut*.

—— 2017, *Mortgages 2017: Finding Focus in a Complex Market*, Sydney.

Demirguc-Kunt, A., Peria, M. and Soledad, M. 2010, *A framework for analyzing competition in the banking sector : an application to the case of Jordan*, 1 December, WPS5499, The World Bank, pp. 1–26.

Denk, O., Schich, S. and Cournede, B. 2015, ‘Why implicit bank debt guarantees matter: Some empirical evidence’, *OECD Journal: Financial Market Trends*, vol. 2014/2, pp. 63–88.

Desai, P. 2011, *From Financial Crisis to Global Recovery*, Columbia University Press.

Di Natale, R. 2018, *The Trickle down hoax and the need for government to step in*, https://greens.org.au/npc-2018 (accessed 11 April 2018).

Djankov, S., McLiesh, C. and Shliefer, A. 2007, ‘Private credit in 129 countries’, *Journal of Financial Economics*, vol. 84, pp. 299–329.

Doepel, M. 2017, *Australia slow on the cyber insurance uptake*, http://www.sparke.com.au /insights/australia-slow-on-cyber-insurance-uptake/ (accessed 6 December 2017).

DoF (CA) (Department of Finance (Canada)) 2016, *Technical Backgrounder: Mortgage Insurance Rules and Income Tax Proposals*, https://www.fin.gc.ca/n16/data/16-117_2-eng.asp (accessed 25 May 2018).

Doyle, M.-A., Fisher, C., Tellez, E. and Yadav, A. 2017, *How Australians Pay: Evidence from the 2016 Consumer Payments Survey*, Research Discussion Paper, July, Reserve Bank of Australia.

Dun and Bradstreet 2016, *Comprehensive Credit Reporting*, New Zealand.

Dunkley, E. 2017, ‘New-generation UK banks challenge with technology’, *The Financial Times*, 10 March.

Dutch Payments Association 2017, *Switching Service*, https://www.betaalvereniging.nl/en/payment-products-services/switching-service/ (accessed 26 November 2017).

eChoice Pty Ltd 2018, *eChoice Award Winning Mortgage Brokers*, https://www.echoice.com.au/ (accessed 16 May 2018).

Effective Disclosure Taskforce 2015, *Too Long - Didn’t Read Enhancing General Insurance Disclosure*, Report of the Effective Disclosure Taskforce to Insurance Council Board, 29 October.

eftpos (eftpos Payments Australia Limited) 2016, *Annual Report 2016*.

Elliott, S. 2017, *Review of Australia’s Four Major Banks*.

Ellis, L. 2009, ‘The Global Financial Crisis: Causes, Consequences and Countermeasures’, Emerging from the Global Storm: Growth and Climate Change Policies in Australia Conference, Victoria University, Melbourne.

—— and Littrell, C. 2017, ‘Financial Stability in a Low Interest Rate Environment: An Australian Case Study’, presented at Monetary Policy and Financial Stability in a World of Low Interest Rates, Sydney, Reserve Bank of Australia, 16 March.

Emmerton, K. 2017, *Credit card rewards schemes devalued as interchange fee changes come into effect*, https://mozo.com.au/credit-cards/articles/credit-card-rewards-schemes-devalued-as-interchange-fee-changes-come-into-effect (accessed 14 November 2017).

Eslake, S. 2011, ‘Billions in handouts but nothing gained’, *The Sydney Morning Herald*, 16 March.

European Commission 2013, *Impact Assessment accompanying the Commission’s proposal for a Regulation on Interchange Fees and a revised Payment Services Directive*, Commission staff working document, July, Brussels.

—— 2015, *Survey on merchants’ costs of processing cash and card payments - Final results*, March.

—— 2018, *Proposal for a Regulation - Review of Regulation on cross-border payments*, March, Brussels.

EY (Ernst & Young Global Limited) 2015, *Observations on the value of mortgage broking: prepared for the Mortgage & Finance Association of Australia*, May.

—— 2016, *EY FinTech Australia Census 2016*.

—— 2017a, *EY FinTech Australia Census 2017*.

—— 2017b, *FinTech Adoption Index 2017*.

Eyers, J. 2018a, *Banks launch Beem It to take on their own Osko*, Australian Financial Review, www.afr.com/technology/banks-launch-beem-it-to-take-on-their-own-osko-20180601-h10udy (accessed 4 June 2018).

—— 2018b, ‘NAB to allow payments through Xero’, *Australian Financial Review*, 31 January.

—— 2018c, ‘Westpac invests $25m more in Uno mortgage broking play’, *Australian Financial Review*, 4 February.

Farrell, J. and Klemperer, P. 2007, ‘Coordination and lock-in: competition with switching costs and network effects’, in Armstrong, M. and Porter, R. (eds), *Handbook of Industrial Organization*, vol 3, Elsevier, pp. 1967–2072.

Farrell, S. 2017, *Review into Open Banking: giving customers choice, convenience and confidence*, December, Australian Government.

FCA (Financial Conduct Authority) 2017a, *Applying to the regulatory sandbox*, FCA, www.fca.org.uk/firms/regulatory-sandbox/prepare-application (accessed 29 March 2018).

—— 2017b, *Regulatory sandbox lessons learned report*, October.

—— 2014, *Guaranteed Asset Protection insurance: a competition remedy*, Consultation paper, December, CP14/29.

—— 2015a, *Asset management market study Terms of Reference*, Market Study, November, MS15/2.1.

—— 2015b, *Encouraging consumers to act at renewal: Evidence from field trials in the home and motor insurance markets*, December, Occasional Paper No. 12.

—— 2015c, *General Insurance Add-ons Market Study – Proposed Remedies: Banning opt-out selling across financial services and supporting informed decision-making for add-on buyers*, Consultation Paper, March, CP15/13.

—— 2016, *Increasing transparency and engagement at renewal in general insurance markets – feedback on CP15/41 and final rules and guidance*, Policy Statement, August.

—— 2017c, *Prudential sourcebook for banks, building societies and investment firms. Chapter 3 Standardised credit risk*.

—— 2018, *Business Plan 2018/19*.

FDIC (Federal Deposit Insurance Corporation (US)) 2015, *Compliance Examination Manual*.

Fear, J. 2008, *Choice Overload - Australians coping with financial decisions*, Discussion Paper no. 99, The Australia Institute.

——, Richard, D. and Richardson, D. 2010, *Money and power - The case for better regulation in banking*, Institute Paper no. 4, August, The Australia Institute.

Fels, A. and Cousins, D. 2017, *Submission to the Senate Economics References Committee inquiry into Australia's General Insurance Industry*, May.

Ferguson, A. and Epstein, R. 2011, 'Bendigo's community spirit has a hefty price', *The Sydney Morning Herald*, 13 May.

Finance & Systems Technology Pty Ltd 2018, *Lender Panel*, https://www.fastgroup.com.au /benefits/lender-panel (accessed 16 May 2018).

Finconnect 2018, *Finconnect - Lending Panel*, https://www.finconnect.com.au/lending-panel.html (accessed 16 May 2018).

Finsure 2018, *Finsure*, https://www.finsure.com.au/ (accessed 16 May 2018).

First Data (First Data Corporation) 2011, *How Merchants Can Maximise Cost Savings in the Post-Durbin Era of Debit Payments*, White Paper.

Firstmac 2017, *Firstmac Extends Two Week Settlement Guarantee*, https://www.firstmac.com.au/media/press-releases/firstmac-extends-two-week-settlement-guarantee (accessed 27 November 2017).

Fisher, P. and Grout, P. 2017, *Competition and prudential regulation*, September, Staff Working Paper 675, Bank of England.

Fitzpatrick, R. and White, G. 2017, 'Banking fees in Australia', *RBA Bulletin*, June Quarter, pp. 35-39.

Fletcher, A. 2011, *Competition in the microscope*, 11 January.

—— 2016, *The Role of Demand-Side Remedies in Driving Effective Competition - A Review for Which?*, 7 November, Centre for Competition Policy University of East Anglia.

Flood, D. and Mitchell, S. 2016, 'The ATM System since the 2009 Reforms', *RBA Bulletin*, December Quarter, pp. 33–42.

FOS (Financial Ombudsman Service Australia) 2017a, *Annual Review 2016-17*.

—— 2017b, *Comparative Tables 2016-17*, Final Report.

—— 2015, *Overview of the Year 2013–2014*, 2012 General Insurance Code of Practice Aggregated Industry Data Report.

Fraser, B. 2011, *Banking Services Switching Arrangements*, Canberra.

Fraser, S. and Gatty, A. 2014, 'The Introduction of Same-day Settlement of Direct Entry Obligations in Australia', *RBA Bulletin*, June Quarter, pp. 55–64.

FRB of Kansas City (Federal Reserve Bank of Kansas City) 2017, *Credit and Debit Card Interchange Fees in Various Countries August 2017 Update*, August.

Freixas, X. and Rochet, J.-C. 2008, *Microeconomics of Banking*, 2nd edn, MIT Press.

FSB (Financial Stability Board) 2017a, *Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms*, http://www.fsb.org/2017/07/framework-for-post-implementation-evaluation-of-the-effects-of-the-g20-financial-regulatory-reforms/ (accessed 13 November 2017).

—— 2017b, *Policy Development and Coordination*, http://www.fsb.org/what-we-do/policy-development/ (accessed 31 October 2017).

FSC and UBS (Financial Services Council and UBS Asset Management) 2017, *State of the Industry 2017*, Sydney.

Galaxy Research 2017, *Bank Switching*, Sydney.

Gambacorta, L. and Murcia, A. 2017, *The impact of macroprudential policies and their interaction with monetary policy: an empirical analysis using credit registry data*, BIS Working Papers 636, May.

Gans, J.S. and King, S.P. 2003, 'The Neutrality of Interchange Fees in Payment Systems', *The B.E. Journal of Economic Analysis & Policy*, vol. 3, no. 1.

Geithner, T. 2009, *Hearing before the Joint Economic Committee, 'Financial Regulatory Reform: Protecting Taxpayers and the Economy'*, Washington DC.

General Insurance Code Governance Committee 2017, *General Insurance Code of Practice Industry Data Report 2015-16*, March.

—— 2018, *General Insurance in Australia 2016-17*, March.

Genworth 2017a, *Cancellations*, https://www.genworth.com.au/about-genworth-and-lmi/about-lmi/lenders-mortgage-insurance-faqs/ (accessed 13 December 2017).

—— 2017b, *Lenders Mortgage Insurance FAQs*, https://www.genworth.com.au/about-genworth-and-lmi/about-lmi/lenders-mortgage-insurance-faqs/ (accessed 13 December 2017).

Genworth Financial 2009, *The Genworth Financial Mortgage Trends Report*.

Gishkariany et al. (Gishkariany, Norman and Rosewall) 2017, 'Shadow bank lending to the residential property market', *RBA Bulletin*, September Quarter, pp. 45–52.

Gizmodo (Gizmodo Australia) 2017, *Apple Pay Is Now Available for Macquarie Bank and ING Direct Customers*, www.gizmodo.com.au/2017/02/apple-pay-is-now-available-for-macquarie-bank-and-ing-direct-customers/ (accessed 10 November 2017).

Golat, T. 2016, 'Banks' wealth management activities in Australia', *RBA Bulletin*, September Quarter, pp. 53–60.

Goodman, L. and Kaul, K. 2017, *Sixty years of private mortgage insurance in the United States*, Research Report, Urban Institute, Washington DC.

Government of Canada 2016, *Competition Bureau submission to the OECD Competition Committee roundtable on Public Interest Considerations in Merger Control*, http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/04101.html (accessed 5 June 2018).

Government of Western Australia 2017, *Insurance duty*, https://www.finance.wa.gov.au/cms/State_Revenue/Duties/Insurance_Duty.aspx (accessed 4 December 2017).

Grattan Institute 2017, *Competition in Australia - Too little of a good thing?*

Groenfeldt, T. 2017, *First Data Acquisition Expands Online Debit Capability*, www.forbes.com/sites/tomgroenfeldt/2017/03/22/first-data-acquisition-expands-online-debit-capability/ (accessed 4 December 2017).

Hanson, R., Reeson, A. and Staples, M. 2017, *Distributed Ledgers: Scenarios for the Australian economy over the coming decades*, May, CSIRO.

Harper, I. 2012, *Is competition crucial to the health of the financial sector? You can bank on it*, http://theconversation.com/is-competition-crucial-to-the-health-of-the-financial-sector-you-can-bank-on-it-8713 (accessed 20 October 2017).

—— 2016, 'Competition policy as a driver of productivity growth', presented at Where to from here? Improving Australia's Productivity Performance conference, Canberra, 13 December.

——, Anderson, P., McCluskey, S. and O'Bryan, M. 2014, *Competition Policy Review*, Issues Paper, April.

——, ——, —— and —— 2015, *Competition Policy Review*, Final Report, March.

Healey, D. and Nicholls, R. 2017, 'Enhancing competition: challenges for Australian retail banking', *Journal of Banking and Finance Law and Practice*, vol. 28, pp. 48–71.

Henry, K., Harmer, J., Piggott, J., Ridout, H. and Smith, G. 2010, *Australia's Future Tax System*, Final Report Overview, Department of the Treasury.

Heritage Bank 2017a, *Heritage Bank to temporarily halt investor lending*, https://www.heritage.com.au/news/2017/august/heritage-bank-to-temporarily-halt-investor-lending (accessed 19 September 2017).

—— 2017b, *Submission: Removing restrictions on the use of the term 'Bank'*, Submission to Treasury Reducing barriers to new entrants to the banking sector – removing restrictions on the use of the term 'bank', August.

HIH Royal Commission 2003, *Volume I: A corporate collapse and its lessons*, http://pandora.nla.gov.au/pan/23212/20030418-0000/www.hihroyalcom.gov.au/finalreport/Front%20Matter,%20critical%20assessment%20and%20summary.html#_Toc37086538 (accessed 19 December 2017).

Hilmer, F., Rayner, M. and Taperell, G. 1993, *National Competition Policy Review*.

Hing, A., Kelly, G. and Olivan, D. 2016, 'The Cash Market', *RBA Bulletin*, December Quarter, pp. 33–41.

Hirschman, A.O. 1970, *Exit Voice and Loyalty: Responses to Decline in Firms Organizations and States*, Harvard University Press, United States.

HKMC (Hong Kong Mortgage Corporation Ltd) 2018, *Mortgage Insurance Programme Introduction*, http://www.hkmc.com.hk/eng/our_business/mortgage_insurance_programme.html (accessed 10 May 2018).

HMT (UK) (HM Treasury (UK)) 2017, *Help to Buy: mortgage guarantee scheme Quarterly Statistics - September 2017*, London, United Kingdom.

Hollard 2017, *About Hollard Insurance*, http://www.hollard.com.au/about.aspx (accessed 20 December 2017).

Hollard Insurance 2018, *Retail Brands and Partners - Insurance Partners*, http://www.hollard.com.au/insurance-partners/retail-brands-and-partners.aspx (accessed 19 January 2018).

HoRSCE (House of Representatives Standing Committee on Economics) 2016a, *Proof Committee Hansard - Review of Australian Prudential Regulation Authority annual report 2015*, Hansard Transcript, 14 October, Parliament of the Commonwealth of Australia, Canberra.

—— 2016b, *Public Hearings - Review of the Four Major Banks*, https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Four_Major_Banks_Review/Public_Hearings (accessed 28 March 2018).

—— 2016c, *Review of the Australian Prudential Regulation Authority Annual Report 2015 - First Report*, April, Parliament of the Commonwealth of Australia, Canberra.

—— 2016d, *Review of the Australian Prudential Regulation Authority Annual Report 2015 - Second Report*, November, Parliament of the Commonwealth of Australia, Canberra.

—— 2016e, *Review of the Four Major Banks - First Report*, Parliament of the Commonwealth of Australia, Canberra.

—— 2017, *Review of the Four Major Banks - Third Report*, December, Parliament of the Commonwealth of Australia, Canberra.

House of Representatives 1998, *Financial Sector (Shareholdings) Bill 1998 Explanatory Memorandum*.

Hsieh, M.-F., Chen, C. and Yang, S.-J. 2013, ‘How does diversification impact bank stability? The role of globalization regulations and governance environments’, *Asia Pacific Journal of Financial Studies*, vol. 42, no. 5, pp. 813–844.

IAG (IAG Limited) 2014, *Our history*, https://www.iag.com.au/about-us/who-we-are/our-history (accessed 11 February 2017).

—— 2016, *InsureLite*, https://www.insurelite.com.au/#/product (accessed 17 November 2017).

—— 2017a, *IAG Profile*, 3 January.

—— 2017b, *Insurance 4 That Product Disclosure Statement*, https://edge-uploads.s3-ap-southeast-2.amazonaws.com/i4t-production/distributors/c181f060-e967-40e0-9354-fec95dbf6618.pdf (accessed 17 November 2017).

IBISWorld 2018, *Financial Planning and Investment Advice in Australia*, January.

ICA (Insurance Council of Australia) 2017a, *Consultation Paper 294 - The Sale of Add-on Insurance and Warranties through Caryard Intermediaries*, Submission to the Australian Securities and Investments Commission in response to CP 294.

—— 2017b, *Lenders Mortgage Insurance*, Fact sheet, understandinsurance.com.au/types-of-insurance/lenders-mortgage-insurance (accessed 9 May 2017).

—— 2017c, *Review of the General Insurance Code of Practice Interim Report*, Interim Report, November.

IMF, FSB and BIS 2016, *Elements of Effective Macroprudential Policies - Lessons from International Experience*.

—— 2012, *Australia: Financial System Stability Assessment*, IMF Staff Country Report 12/308.

—— 2013, *Key aspects of macroprudential policy*.

ING 2017, *LMI Fact sheet*, August.

—— 2018, *Ways to bank*, https://www.ing.com.au/ways-to-bank.html (accessed 7 May 2018).

Insurance News 2009, *Two more foreign insurers get the tick from APRA*, http://www.insurancenews.com.au/corporate/two-more-foreign-insurers-get-the-tick-from-apra (accessed 20 December 2017).

—— 2016, *Tesla's electric cars in Australia get unique insurance*, http://www.insurancenews.com.au/corporate/teslas-electric-cars-in-australia-get-unique-insurance (accessed 6 December 2017).

Investment Trends 2016, *Investment Trends Report: Robo-advice can be a game changer for many Australians*, 30 November, AdviserVoice.

—— 2017, *Demand for advice from financial planners is at a record high: Investment Trends*, 2 November, AdviserVoice.

iSelect 2017, *Submission to the Senate Economics References Committee Inquiry into Australia's General Insurance Industry*, 10 February.

Ivaldi, M., Jullien, B., Rey, P., Seabright, P. and Tirole, J. 2003, *The Economics of Unilateral Effects*, Interim Report for DG Competition European Commission, November.

Jorda, O., Moritz, S. and Taylor, A. 2016, 'The great mortgaging: housing finance crisies and buisness cycles', *Economic Policy*, vol. 31, no. 85, pp. 107–152.

Joye, C. 2017, 'Major banks still benefit from taxpayer subsidy, making levy fair', *Australian Financial Review*, 11 May.

Kalayci, K. 2016, 'Confusopoly: competition and obfuscation in markets', *Experimental Economics*, vol. 19, no. 2, pp. 299–316.

Keating, P. (Acting Prime Minister and Treasurer) 1990, *Proposal for Merger of ANZ Banking Group (ANZ) and National Mutual Life Association (NM)*, Press Release no. 42, 23 May.

Kell, P. 2016, *Regulatory update to general insurance industry 2016*, Speech, 4 March.

—— 2017a, 'A better toolkit for ASIC', Speech by Deputy Chairman, ASIC to Thomson Reuters Regulatory Summit.

—— 2017b, *ASIC Transcript of Proceedings - Productivity Commission Inquiry into Competition in the Australian Financial System*, Transcript, 29 June.

—— 2017c, *Productivity Commission Inquiry into the State of Competition in the Australian Financial System: Roundtable - ASIC Opening Statement*, Melbourne.

—— 2018a, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Witness Statement of Deputy Chair of ASIC*, Exhibit 2.1.

—— 2018b, 'What kind of company sells a dud like this to its customers?', *The Sydney Morning Herald*, 18 January.

Kendell, S. 2017, *Australian robo yet to reach critical mass*, http://www.financialobserver.com.au /articles/australian-robo-yet-to-reach-critical-mass (accessed 16 May 2018).

Kent, C. 2017, 'The availability of business finance', 30th Australasian Finance and Banking Conference, University of New South Wales, Sydney.

—— 2018, 'Some Features of the Australian Fixed Income Market', Speech delivered by Christopher Kent, Assistant Governor (Financial Markets), to the Australian Government Fixed Income Forum 2018, Tokyo, https://www.rba.gov.au/speeches/2018/sp-ag-2018-06-06.html (accessed 15 June 2018).

Keppo, J. and Korte, J. 2016, ‘Risk targeting and policy illusions: evidence from the announcement of the Volcker Rule’.

Khoury, P. 2017, *Independent Review of the Code of Banking Practice*.

King, S. 2013, *Why did our banks survive the GFC?*, 22 July, http://economicstudents.com /2013/07/why-did-our-banks-survive-the-gfc/ (accessed 28 December 2017).

King, S.P. 2009, ‘The 2008 ACCC Merger Guidelines: How and why have they changed?’, *UNSW Law Journal*, vol. 32, no. 1, pp. 263–274.

Klemperer, P. 1995, ‘Competition when consumers have switching costs: an overview with applications to industrial organization, macroeconomics, and international trade’, *The Review of Economic Studies*, vol. 62, no. 4, pp. 515–539.

Kohler, M. 2017, ‘Mortgage Insights from Securitisation Data’, presented at Australian Securitisation Forum, Sydney, 20 November.

KPMG 2015, *Marketplace of change: Automobile insurance in the era of autonomous vehicles*, White Paper.

—— 2016, *A new landscape: Challenger banking annual results*, May.

—— 2017a, *KPMG Australian Fintech Landscape*.

—— 2017b, *US$656M invested in Australia's Fintech sector in 2016*, https://home.kpmg.com/au/en /home/media/press-releases/2017/02/fintech-pulse-q4-2016-23-feb-2017.html (accessed 28 March 2018).

—— 2018, *The Pulse of Fintech Q4 2017*, February.

Lam, T. and Ossolinski, C. 2015, *The Value of Payment Instruments: Estimating Willingness to Pay and Consumer Surplus*, Research Discussion Paper 2015-03, March, Reserve Bank of Australia.

Lea, D.M. 2010, *International Comparison of Mortgage Product Offerings*, September, Research Institute for Housing America.

Lel, U. and Miller, D.P. 2014, *Does Takeover Activity Cause Managerial Discipline? Evidence from International M&A Laws*, SSRN Scholarly Paper ID 1730316, 24 October.

Littrell, C. 2003, ‘Mortgage lending practices: The APRA View’.

Liu, S. 2016, *The Honeymoon Rate Versus the Real Rate*, https://www.finder.com.au/honeymoon-versus-real-rate (accessed 28 November 2017).

—— 2018, *Compare debit cards with no foreign transaction fees*, *finder.com.au*, 16 January, www.finder.com.au/debit-cards-low-foreign-transaction-fees (accessed 15 January 2018).

Lloyd's 2017, *About us*, https://www.lloyds.com/lloyds/offices/australasia/australia/about-us (accessed 9 November 2017).

Loan Market 2018, *Loan Market*, https://www.loanmarket.com.au/ (accessed 16 May 2018).

Lochner, M., Duenser, A. and Reeson, A. 2017, *Automated Financial Advice for Superannuation: A Randomised Controlled Experimental Test of Engagement and Motivation Impacts*, 10 May.

Lowe, P. 1995, *The link between the cash rate and market interest rates*, Research Discussion Paper 9504, May, Reserve Bank of Australia.

Lumpkin, S.A. 2009, ‘Regulatory issues related to financial innovation’, *Financial Market Trends*, vol. 2009/2.

Macfarlane, I. 2009, ‘The crisis: causes, consequences and lessons for the future - The Australian perspective’, *ASIC Summer School 2009*, ASIC, pp. 41–46.

—— 2014, *Submission to the Financial System Inquiry,* 31 March.

Macquarie Group 2018, *Annual Report 2018,* March.

Maddock, R. 2014, *Is the Australian financial sector too big?*, https://bluenotes.anz.com /posts/2014/04/is-the-australian-financial-sector-too-big (accessed 7 December 2017).

Madrian, B. and Shea, D.F. 2001, ‘The power of suggestion: inertia in 401(k) participation and savings behavior’, *The Quarterly Journal of Economics*, vol. 116, no. 4, pp. 1149–1187.

Martin, P. 2017, ‘Why Richard Thaler thinks we’ve two brains, in one body’, *The Canberra Times*, 12 October.

Mason, M. 2017, ‘Facebook’s Messenger payments looms over Australia’s big banks’, *Australian Financial Review,* 19 November.

Mas-Ruiz, F., Ruiz-Moreno, F. and Ladron de Guevara Martinez, A. 2014, ‘Asymmetric rivalry within and between strategic groups’, *Strategic Management Journal*, vol. 35, no. 3, pp. 419-439.

MasterCard 2017, *Understanding Interchange*, www.MasterCard.com.au/en-au/about-MasterCard/what-we-do/interchange.html (accessed 14 November 2017).

Mather, J. 2017, ‘Big four banks scrap ATM fees’, *Australian Financial Review*, 24 September.

McKinnon, T. 2018, ‘Developments in Banks’ Funding Costs and Lending Rates’, *RBA Bulletin*, March Quarter, pp. 1–13.

McKinsey (McKinsey and Company) 2013, *Driving merchant services and digital commerce: Findings from McKinsey’s 2012 U.S. Small Business Acquiring Panel*, March.

—— 2017, *Global reinsurance: Fit for the future?*, September.

McMullen, S. 2018a, *Breaking: New Amex Westpac credit cards revealed*, finder.com.au, www.finder.com.au/new-westpac-american-express-credit-cards-revealed (accessed 10 April 2018).

—— 2018b, *CBA ditches American Express dual credit cards*, finder.com.au, www.finder.com.au/cba-ditches-american-express-dual-credit-cards (accessed 7 June 2018).

ME Bank (Members Equity Bank) 2017, *ME Savvy Savers Survey*, Melbourne.

MFAA (Mortgage & Finance Association of Australia) 2017a, *Broker market share rises to a record 55.7% in September quarter*, https://www.mfaa.com.au/news/broker-market-share-rises-to-a-record-55.7-percent-in-september-quarter (accessed 22 February 2018).

—— 2017b, *MFAA Industry Intelligence Service Fourth Edition*.

—— 2018, *MFAA Aggregators and Franchise Groups*, https://www.mfaa.com.au/our-industry/mfaa-aggregators-franchise-groups (accessed 4 June 2018).

MFS (Monitor Financial Sector) 2014, *Barriers to entry into the Dutch retail banking sector*, The Netherlands.

Moneysoft 2017, *Moneysoft - A personal finance software and money management tool.*, www.moneysoft.com.au/moneysoft-for-individuals/ (accessed 5 January 2018).

Moody’s (Moody’s Investors Service) 2017, *Financial Institutions*, June.

Morgan Stanley 2015, *Global Marketplace Lending - Disruptive Innovation in Financials*, Morgan Stanley Blue Paper.

Morningstar 2016, *Australian Managed Funds Industry*, Prepared for the Financial Services Council.

Morrison, S. (Treasurer) 2017a, *Australia to join in IMF Financial Sector Assessment in 2018*, Media Release, http://sjm.ministers.treasury.gov.au/media-release/125-2017/ (accessed 6 December 2017).

—— 2017b, *Budget Speech*, http://www.budget.gov.au/2017-18/content/speech/html/speech.htm (accessed 9 April 2018).

—— 2017c, *Building an accountable and competitive banking system*, Media Release, http://sjm.ministers.treasury.gov.au/media-release/044-2017/ (accessed 18 July 2017).

—— 2017d, *Mandating comprehensive credit reporting*, Media Release no. 110, http://sjm.ministers.treasury.gov.au/media-release/110-2017/ (accessed 13 December 2017).

—— 2017e, *Ministerial direction on ACCC review of residential mortgage products pricing*, Media Release, www.accc.gov.au/system/files/Ministerial%20Direction.pdf (accessed 4 August 2017).

—— 2017f, *Royal Commission - Banks and Financial Services*, Media Release, http://sjm.ministers.treasury.gov.au/media-release/124-2017/ (accessed 30 November 2017).

—— 2018a, *Boosting penalties to protect Australian consumers from corporate and financial misconduct*, http://sjm.ministers.treasury.gov.au/media-release/boosting-penalties-to-protect-australian-consumers-from-corporate-and-financial-misconduct/ (accessed 24 April 2018).

—— 2018b, *Financial Sector (Shareholdings) Amendment (Relaxing Ownership Restrictions) Bill 2018 Exposure Draft*.

—— 2018c, *Getting Australians better deals on their loans*, Media rrelease, http://sjm.ministers.treasury.gov.au/media-release/027-2018/?utm_source=wysija&utm_ =email&utm_campaign=Media+Release+-+Getting+Australian%27s+better+deals+on+ their+loans (accessed 29 March 2018).

—— 2018d, *Review into Open Banking - giving consumers choice*, Media Release, http://sjm.ministers.treasury.gov.au/media-release/010-2018/ (accessed 13 February 2018).

Mortgage Choice 2018, *Mortgage Choice*, https://www.mortgagechoice.com.au/ (accessed 16 May 2018).

MPA (Mortgage Professional Australia) 2017, '2017 Consumers on Brokers', *Mortgage Professional Australia*, iss. 17.5, pp. 36–41.

Muoio, D. 2017, *Tesla strikes another deal that shows it's about to turn the car insurance world upside down*, https://www.businessinsider.com.au/tesla-liberty-mutual-create-customize-insurance-package-2017-10 (accessed 4 December 2017).

Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, B. 2014a, *Financial System Inquiry - Final Report*, Canberra.

——, ——, ——, —— and —— 2014b, *Financial System Inquiry - Interim Report*, Canberra.

My Local Broker 2018, *Our Lender Panel*, https://www.mylocalbroker.com.au/lenders/ (accessed 16 May 2018).

NAB (National Australia Bank) 2016, *Lenders Mortgage Insurance*, https://www.nab.com.au:443 /personal/learn/buying-your-first-home/lenders-mortgage-insurance (accessed 1 November 2017).

—— 2017a, *Annual Financial Report 2017*.

—— 2017b, *Full year results 2017*, Investor Presentation.

—— 2017c, *NAB removes ATM withdrawal fees*, Media Release, 24 September, Melbourne.

—— 2017d, *Pillar 3 report 2017*.

National Mortgage Brokers 2018, *Our Suppliers*, /broker-services/lending-panel/ (accessed 16 May 2018).

Netwealth 2018, *Platforms - the original fintech*, https://www.netwealth.com.au/web/resources/insights/platforms-the-original-fintech/ (accessed 18 June 2018).

Newgate Research 2017, *Consumer Research for the Australian Energy Market Commission's 2017 Retail Competition Review*, Sydney.

NHG (NL) (Nationale Hypotheek Garantie (Netherlands)) 2017, *Conditions and Norms 2017-4*.

Nicholls, R. 2017, *If scandals don't make us switch banks, financial technology might*, http://theconversation.com/if-scandals-dont-make-us-switch-banks-financial-technology-might-72361 (accessed 18 November 2017).

Norman, D. 2017, 'Returns on equity, cost of equity and the implications for banks', *RBA Bulletin*, March Quarter, pp. 51–58.

Northern Territory Department of Treasury and Finance 2016, *Duty Type and Rates*, www.treasury.nt.gov.au/TaxesRoyaltiesAndGrants/StampDuty/Pages/Duty-Types-and-Rates.aspx#gen_insurance (accessed 18 January 2018).

NPPA (New Payments Platform Australia Limited) 2016, *Constitution*, Constitution, October.

—— 2017a, *Architecture overview*, www.nppa.com.au/what-is-the-new-payments-platform/architecture-overview/ (accessed 15 November 2017).

—— 2017b, *Introduction to the New Payments Platform: NPPA Webinar*, 18 July.

—— 2017c, *New Payments Platform: An Introductory Guide*, June.

—— 2017d, *New Payments Platform Board*, www.nppa.com.au/our-company/new-payments-platform-board/ (accessed 15 November 2017).

—— 2017e, *Regulations for New Payments Platform*, July.

—— 2017f, *What is the New Payments Platform?*, www.nppa.com.au/what-is-the-new-payments-platform/ (accessed 14 November 2017).

NSW Government 2017a, *2017 State Budget*, http://www.revenue.nsw.gov.au/info/legislation/budget/201706 (accessed 12 May 2017).

—— 2017b, *Insurance duty*, http://www.revenue.nsw.gov.au/taxes/insurance (accessed 12 May 2017).

O'Dowd, C. 2017, 'CUA urges APRA over lending limits as it seesaws on investor loans', *The Australian*, 19 September.

O'Dwyer, K. (Minister for Revenue and Financial Services) 2018a, 'Address to the ASIC Annual Forum', Sydney.

—— 2018b, *Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018*, Second Reading Speech, 28 March, House of Representatives Debates.

O'Dwyer, K. (Minister for Small Business and Assistant Treasurer) 2016, *Financial Sector Advisory Council*, Media Release, http://kmo.ministers.treasury.gov.au/media-release/067-2016/ (accessed 9 August 2017).

OECD (Organisation for Economic Co-operation and Development) 2009, *Competition and Financial Markets*.

—— 2012, *Competitive Neutrality: Maintaining a level playing field between public and private business*, 30 August.

—— 2016a, *Being an Independent Regulator - The Governance of Regulators*, OECD Publishing, Paris.

—— 2016b, *Competition Assessment Toolkit Volume 1: Principles*, Competition Assessment Toolkit, Version 3.0.

—— 2016c, *Structural separation in regulated industries - Report on implementing the OECD Recommendation*.

—— 2018, *Value added by activity (indicator)*, http://data.oecd.org/natincome/value-added-by-activity.htm (accessed 30 May 2018).

OFT (Office of Fair Trading (UK)) 2010, *What Does Behavioural Economics Mean for Competition Policy?*, March, OFT 1224.

Optus (Singtel Optus Pty Limited) 2016, *Optus expands the Optus Pay accessories range*, https://media.optus.com.au/media-releases/2016/optus-expands-the-optus-pay-accessories-range/ (accessed 10 November 2017).

Oracle Group 2017, *How workers compensation in Australia works*, https://www.oraclegroup.com.au/news/business-insurance/workers-compensation-in-australia/ (accessed 10 April 2018).

OSFI (Office of the Superintendent of Financial Institutions - Canada) 2017, *Capital adequacy requirements: Chapter 3 - Credit Risk Standardized Approach*, http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR17_chpt3.aspx#3115 (accessed 20 December 2017).

Outsource 2018, *Lending Panel*, http://www.outsourcefinancial.com.au/join-us/lending-panel/ (accessed 16 May 2018).

OUTsurance 2017, *OUTsurance company information*, https://www.outsurance.co.za/about-outsurance/general-information/ (accessed 20 December 2017).

Oxera 2016, *The contribution of asset management to the UK economy*, July.

Pacific International 2017, *About us*, https://www.pacificintins.com.au/ (accessed 20 December 2017).

Padgett, S. 2013, 'The negative impact of Basel III on small business financing', *Ohio State Entrepreneurial Business Law Journal*, vol. 8, no. 1, pp. 183–208.

Panagiotis, A., Cabolis, C. and Konstantinos, S. 2016, *Does One Bank Size Fit All? The Role of Diversification and Monitoring*, September.

Parliament IRS (Parliament of Australia Information and Research Services) 2006, *Bills Digest No. 29 2006–07 Housing Loans Insurance Corporation (Transfer of Pre-transfer Contracts) Bill 2006*, 10 October.

Parliament of the Commonwealth of Australia 2006, *Housing Loans Insurance Corporation (Transfer of Pre-Transfer Contracts) Bill 2006; Housing Loans Insurance Corporation (Transfer of Assets and Abolition) Repeal Bill 2006 Explanatory Memorandum*.

Pash, C. 2017, 'The 10 most valuable Australian brands for 2017', *Business Insider Australia*, 1 February.

Paterson, J.M. and Howell, N. 2018, *Everyday consumer credit: overview of Australian law regulating consumer home loans credit cards and car loans*, Background Paper 4 to the Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry, Melbourne Law School, Melbourne.

Paul, S. and Kourouche, K. 2008, 'Regulatory policy and the efficiency of the banking sector in Australia', *Australian Economic Review*, vol. 41, no. 3, pp. 260–271.

Payments UK 2016, *The Second Payment Services Directive (PSD2): A briefing from Payments UK*, July.

PayPal (PayPal Australia Pty Limited) 2017, *Who we are*, www.paypal.com/au/webapps/mpp/about (accessed 10 November 2017).

PC (Productivity Commission) 2008, *Review of Australia's Consumer Policy Framework*, Report no. 45, Canberra.

—— 2014a, *Natural Disaster Funding Arrangements*, Report no. 74, Canberra.

—— 2014b, *Public Infrastructure*, Report no. 71, Canberra.

—— 2015a, *Business Set-up, Transfer and Closure*, Inquiry Report no. 75, 30 September, Canberra.

—— 2015b, *Business Set-up, Transfer and Closure*, Report no. 75, Canberra.

—— 2017a, *About the survey and the results*, Superannuation: Alternative Default Models - Supplement to the Draft Report, July, Canberra.

—— 2017b, *Consumer Law Enforcement and Administration*, Research Report, March, Canberra.

—— 2017c, *Data Availability and Use*, Report no. 82, Canberra.

—— 2018, *Superannuation: Assessing Efficiency and Competitiveness*, Draft Report, Canberra.

Pedersen-McKinnon, N. 2017a, 'Families worst hit by Christmas travel insurance mark-ups', *The Sydney Morning Herald*, 20 November.

—— 2017b, 'Peace of mind at lower prices', *The Sydney Morning Herald*, 22 November.

Pepper Group 2016, *Lending*, https://www.pepper.com.au/lending/ (accessed 27 November 2017).

Perry, E. and Maruthiah, C. 2018, 'Banking Fees in Australia', *RBA Bulletin*.

Petplan 2018, *Pet Insurance Australia - Cat, Kitten, Dog & Puppy Plans*, https://www.petplan.com.au/ (accessed 19 January 2018).

PHIAC (Private Health Insurance Administration Council) 2015, *Portability, Switching and Competition in the Australian Private Health Insurance Market*, Research Paper 2, Canberra.

PJC CFS (Parliamentary Joint Committee on Corporations and Financial Services) 2011, *Access for small and medium business to finance*, April.

—— 2016, *Impairment of customer loans*, May.

PLAN Australia 2018, *Our Lender Panel*, https://www.planaustralia.com.au/what-we-do/our-lender-panel (accessed 16 May 2018).

Plan For Life 2015, *Analysis of Wrap, Platform and Master Trust Managed Funds at June 2015*, 29 September, Mount Waverley.

PM&C (Department of the Prime Minister and Cabinet) 2016, *BETA starts work in the Department of the Prime Minister and Cabinet*, Media release, 22 April.

—— 2018, *The Australian Government's response to the Productivity Commission Data Availability and Use Inquiry*, 1 May.

Pocketbook (Pocketbook Australia Pty Ltd) 2017, *Security*, Pocketbook, https://getpocketbook.com/security/ (accessed 5 January 2018).

Popper, N. 2017, 'Banks and Tech Firms Battle over Something Akin to Gold: Your Data', *The New York Times*, 23 March.

Porter, M.E. 1976, *Interbrand Choice, Strategy and Bilateral Market Power*, Harvard Economic Studies, Harvard University Press, Cambridge, Massachusetts.

PRA (Prudential Regulation Authority) 2018, *New Bank Start-up Unit What you need to know from the UK's financial regulators*, March, Bank of England.

Price, J. 2017, *The role of the regulator in the cyber insurance market*, Speech to the Cyber Insurance Forum, 21 September, Australian Securities and Investments Commission, Sydney.

Price, S. 2018, *Mobile wallet spending surges over holiday period*, Blog, *bluenotes*, January, https://bluenotes.anz.com/posts/2018/01/Mobile-wallet-spending-surges-over-holiday-period (accessed 3 May 2018).

PSB and APC (Payments System Board and Australian Payments Council) 2015, *Memorandum of Understanding - Payments System Board and Australian Payments Council*.

PwC (PricewaterhouseCoopers) 2016a, *Escaping the commodity trap - The future of banking in Australia*.

—— 2016b, *Opportunities await: How InsurTech is reshaping insurance*, Global FinTech Survey, June.

QBE 2017, *Our history*, https://www.qbe.com.au/about/our-company/history (accessed 11 February 2017).

QBE LMI 2017, *What is Lenders Mortgage Insurance?*, http://www.qbelmi.com/pg-what-is-LMI.seo#Is-LMI-refundable (accessed 13 December 2017).

—— 2018, *LMI Guide Australia*.

Quantum Market Research 2016, *Survey of Australians' Travel Insurance Behaviour*, Prepared for the Insurance Council of Australia and the Department of Foreign Affairs and Trade, August.

Queensland Government 2017, *Insurance duty rates*, https://www.business.qld.gov.au /industries/service-industries-professionals/professional-financial-services/insurance-duty/calculating/rates (accessed 12 May 2017).

Rabobank 2014, *The Rabobank Story - From 19th Century Rural Cooperative to 21st Century Global Leader*, December.

RACQ 2018, *Pet Insurance*, https://www.racq.com.au/insurance/get-insurance/pet-insurance (accessed 19 January 2018).

Raiz (Raiz Invest Australia Limited) 2018, *Registration Guide*, https://raizinvest.com.au /registration-guide/ (accessed 8 March 2018).

Ramsay, P.I., Abramson, J. and Kirkland, A. 2017, *Review of the financial system external dispute resolution and complaints framework*, Final Report, April.

Rappeport, A. and Flitter, E. 2018, ‘Congress approves first big Dodd-Frank rollback’, *New York Times*, 22 May.

Ratnovski, L. 2013, *Competition Policy for Modern Banks*, IMF Working Paper, WP/13/126.

RBA and ACCC (Reserve Bank of Australia and Australian Competition and Consumer Commission) 1998, *Memorandum of Understanding - The Australian Competition and Consumer Commission and the Reserve Bank of Australia*.

—— and APRA (Reserve Bank of Australia and Australian Prudential Regulation Authority) 2009, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees - Joint Submission from the RBA and APRA*.

—— and —— 2012, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework*.

—— 2016a, *Statement on the Conduct of Monetary Policy*, https://rba.gov.au/monetary-policy/framework/stmt-conduct-mp-7-2016-09-19.html (accessed 16 April 2018).

—— nd, *Council of Financial Regulators Annual Reports*, http://www.rba.gov.au /publications/annual-reports/cfr/ (accessed 9 June 2017a).

—— nd, *Glossary*, https://www.rba.gov.au/glossary/ (accessed 25 October 2017b).

—— 2003, *Interchange Fees for the Bankcard, MasterCard and Visa Credit Card Schemes*, Reserve Bank of Australia, www.rba.gov.au/media-releases/2003/mr-03-14.html (accessed 10 April 2018).

—— 2004, *Financial Stability Review - September 2004*.

—— 2005, *Banking Fees in Australia*, Bulletin, May.

—— 2006, *Interchange Fees for the MasterCard and Visa Schemes*, Media Release 2006-08, www.rba.gov.au/media-releases/2006/mr-06-08.html (accessed 14 November 2017).

—— 2011, *Media Release - The RBA Committed Liquidity Facility*, Media Release 2011-25, www.rba.gov.au/media-releases/2011/mr-11-25.html (accessed 21 July 2017).

—— 2012a, *Exchange Settlement Account Policy*, www.rba.gov.au/payments-and-infrastructure/esa/ (accessed 9 November 2017).

—— 2012b, ‘Foreign-owned Bank Activity in Australia’, *Financial Stability Review*.

—— 2012c, *Parliamentary briefing, 24 February 2012 - implicit guarantees for banks*.

—— 2012d, *Strategic Review of Innovation in the Payments System: Conclusions*.

—— 2013a, *Dual-network Debit Cards*, Media Release 2013-16, 21 August.

—— 2013b, *Financial Stability Review - September 2013*.

—— 2013c, *Financial Stability Review - September 2013 - Box C: Lenders Mortgage Insurance*, https://www.rba.gov.au/publications/fsr/2013/sep/box-c.html (accessed 2 November 2017).

—— 2013d, *Supplementary Statistics from the Survey of Consumers’ Use of Payments 2013*, Statistical Appendix to the Research Discussion Paper, ‘The Changing Way We Pay: Trends in Consumer Payments’.

—— 2014a, *Submission to the Financial System Inquiry*, www.rba.gov.au/publications /submissions/financial-sector/financial-system-inquiry-2014-03/competition-efficiency-and-innovation.html (accessed 12 January 2017).

—— 2014b, *The Regulatory Response to the Global Financial Crisis - Submission to the Financial System Inquiry*, https://www.rba.gov.au/publications/submissions/financial-sector/financial-system-inquiry-2014-03/regulatory-response-to-the-global-financial-crisis.html (accessed 28 December 2017).

—— 2015a, *About New Payments Platform*, www.rba.gov.au/payments-and-infrastructure/new-payments-platform/ (accessed 17 November 2017).

—— 2015b, *Approach to Regulation*, www.rba.gov.au/payments-and-infrastructure/payments-system-regulation/approach-to-regulation.html (accessed 8 August 2017).

—— 2015c, *Declarations and Exemptions for Purchased Payment Facilities*, www.rba.gov.au/payments-and-infrastructure/payments-system-regulation/declarations-and-exemptions-for-purchased-payment-facilities/ (accessed 10 November 2017).

—— 2015d, *Do large Australian banks receive an implicit public subsidy?*, 1 May.

—— 2015e, *Financial Stability Review - March 2015*, March.

—— 2015f, *Payments System Board - Responsibilities and Powers*, www.rba.gov.au/about-rba/boards/psb-board.html (accessed 10 December 2017).

—— 2015g, *Review of Card Payments Regulation - Consultation Paper*, December.

—— 2015h, *Review of Card Payments Regulation - Issues Paper*, March.

—— 2015i, *Statement on Monetary Policy*, August.

—— 2016b, *Dual-Network Cards and Mobile Wallet Technology*, Consultation Paper, December.

—— 2016c, *Freedom of Information Disclosure Log RBAFOI-151609*, 25 May.

—— 2016d, *Review of Card Payments Regulation - Conclusions Paper*.

—— 2016e, *Supplementary Statistics from the Consumer Payments Survey 2016*, Statistical Appendix to the Research Discussion Paper, 'How Australians Pay: Evidence from the 2016 Consumer Payments Survey'.

—— 2017a, *About Card Payments Regulation – Questions & Answers*, www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/q-and-a/card-payments-regulation-qa-conclusions-paper.html (accessed 26 July 2017).

—— 2017b, *About RITS*, www.rba.gov.au/payments-and-infrastructure/rits/about.html (accessed 14 November 2017).

—— 2017c, *About the CFR*.

—— 2017d, *Aggregate Measures of Australian Corporate Bond Spreads and Yields - F3*, Statistical Tables.

—— 2017e, *Annual Report 2017*.

—— 2017f, *Annual Report 2017 - Financial Statements*, 16 August.

—— 2017g, *ATM Cash Withdrawals - C4*, Statistical Tables, June.

—— 2017h, *Bank Lending Classified by Sector - D5*, Statistical Tables.

—— 2017i, *Bank Lending to Business - Selected Statistics - D8*, Statistical Tables.

—— 2017j, *Bulletin - June Quarter 2017*, http://www.rba.gov.au/publications/bulletin/2017/jun/ (accessed 9 August 2017).

—— 2017k, *Cheques and Direct Entry Payments - C6*, Statistical Tables, June.

—— 2017l, *Credit and Charge Card Statistics - Additional Credit Card Statistics - C1.1*, Statistical Tables.

—— 2017m, *Credit and Charge Card Statistics - C1*, Statistical Tables, June.

—— 2017n, *Debit Card Statistics - C5*, Statistical Tables, June.

—— 2017o, *Domestic Banking Fee Income - C9*, Statistical Tables.

—— 2017p, *Financial Stability Review - April 2017*.

—— 2017q, *Financial Stability Review - October 2017*.

—— 2017r, *Indicator Lending Rates - F5*, Statistical Tables.

—— 2017s, *Interest Rates and Yields - Money Market - Monthly - F1.1*, Statistical Tables.

—— 2017t, *Lending and Credit Aggregates - D2*, Statistical Tables.

—— 2017u, *Payments System Board Update: November 2017 Meeting*, www.rba.gov.au/media-releases/2017/mr-17-24.html (accessed 20 November 2017).

—— 2017v, *RBA Data on securitisation*, October.

—— 2017w, *Regulations - Payments System*, www.rba.gov.au/payments-and-infrastructure /payments-system-regulation/regulations.html (accessed 7 July 2017).

—— 2017x, *Statement on Monetary Policy*, August.

—— 2018a, *Assets of Financial Institutions - B1*, Statistical Tables.

—— 2018b, *Cash rate*, https://www.rba.gov.au/statistics/cash-rate/ (accessed 22 January 2018).

—— 2018c, *Exchange rates - F11 - Exchange Rates – Monthly – January 2010 to latest complete month of current year*, Statistical Tables, May.

—— 2018d, *Financial Stability Review*, April.

—— 2018e, *Financial Stability Review - April 2018*.

—— 2018f, *Indicator Lending Rates - F5*, Statistical Tables, April.

—— 2018g, *Interest Rates and Yields – Money Market – Monthly F1.1; Indicator Lending Rates F5*, Statistical Tables.

—— 2018h, *Lending and Credit Aggregates - D2*, Statistical Tables, April.

RBI (Reserve Bank of India) 2015, *RBI grants 'in-principle' approval to 11 Applicants for Payments Banks*, www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=34754 (accessed 10 November 2017).

RBNZ (Reserve Bank of New Zealand) nd, *Loan-to-valuation ratio restrictions*, https://www.rbnz.govt.nz/financial-stability/loan-to-valuation-ratio-restrictions (accessed 1 November 2017).

—— 2017, *Response to submissions on the Consultation Paper: Serviceability Restrictions as a Potential Macroprudential Tool in New Zealand*, November.

Read, M., Stewart, C. and La Cava, G. 2014, *Mortgage-related Financial Difficulties: Evidence from Australian Micro-level Data*, Research Discussion Paper, RDP 2014-13, Reserve Bank of Australia.

RevenueSA 2016, *Stamp Duty on Insurance*, https://www.revenuesa.sa.gov.au/taxes-and-duties/stamp-duties/insurance#_General_Insurance (accessed 12 May 2017).

RFI (Retail Finance Intelligence) 2009, *Consumer Attitudes to Mortgage Brokers 2009: Based on surveys of 2000 mortgage brokers*.

Rice Warner 2016, *Insurance through superannuation*, 20 April, http://www.ricewarner.com /insurance-through-superannuation/ (accessed 8 May 2018).

Richards, T. 2014, 'The Way We Pay: Now and in the Future', presented at The Australian Savings & Deposits Conference 2014, Sydney, 4 June.

—— 2016, 'The New Regulatory Framework for Surcharging of Card Payments', presented at 26th Annual Credit Law Conference, Gold Coast, 14 September.

—— 2017, 'Merchant Payment Costs and Least-cost Routing'.

RiskInfo 2015, *ANZ Latest Bank to Report Advice Issues*, April, http://riskinfo.com.au /news/2015/04/21/anz-latest-bank-to-report-advice-issues/ (accessed 28 December 2017).

Rochet, J.-C. and Tirole, J. 2003, 'Platform competition in two-sided markets', *Journal of the European Economic Association*, vol. 1, no. 4, pp. 990–1029.

Roddan, M. 2016, 'Mortgage Choice chairman in abrupt exit', *The Australian*, 18 October.

Roy Morgan 2017, *Nearly three and a half million increase in mobile bank users since 2013*, http://www.roymorgan.com/findings/7311-mobile-banking-channels-june-2017-201708211041 (accessed 24 November 2017).

Ryan, T. and Hurwood, J. 2016, *What is Dynamic Currency Conversion & The Benefits?*, Canstar, www.canstar.com.au/travel-credit-and-debit-cards/what-is-dynamic-currency-conversion-canstar/ (accessed 20 April 2018).

Safaricom 2017, *Using M-PESA*, www.safaricom.co.ke/personal/m-pesa/getting-started/using-m-pesa (accessed 10 November 2017).

Saleh, A.S. and Moradi-Motlagh, A. 2014, 'Re-Examining the Technical Efficiency of Australian Banks - A Bootstrap DEA Approach', *Australian Economic Papers*, vol. 53, no. 1–2, pp. 112-128.

Samuelson, W. and Zeckhauser, R. 1988, 'Status quo bias in decision making', *Journal of Risk and Uncertainty*, vol. 1, no. 1, pp. 7–59.

Schwartz, C. and Tan, N. 2016, 'The Australian Government Guarantee Scheme: 2008–15', *RBA Bulletin*, March Quarter, pp. 39–46.

SCTI (Southern Cross Travel Insurance) 2017, *About SCTI*, https://www.scti.com.au /about/southern-cross-travel-insurance/ (accessed 20 December 2017).

Sedgwick, S. 2017, *Retail banking remuneration review*.

SERC (Senate Economics References Committee) 2009a, *Government measures to address confidence concerns in the financial sector - The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September.

—— 2009b, *Report on bank mergers*.

—— 2012, *The post-GFC banking sector*, November.

—— 2015, *Inquiry into Matters Relating to Credit Card Interest Rates*.

—— 2017, *Australia's General Insurance Industry: Sapping Consumers of the Will to Compare*.

Sillar, D. 2018, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Witness Statement of Donald Mark Sillar, ANZ*, Exhbit 2.3.

Silva-Goncalves, J. 2015, *Australians' Switching Behaviour in Banking, Insurance Services and Main Utilities*, Queensland University of Technology, Brisbane.

Simon, J., Smith, K. and West, T. 2010, 'Price incentives and consumer payment behaviour', *Journal of Banking and Finance*, vol. 34, no. 8, pp. 1759–1772.

Sims, R. 2018a, '2018 Compliance & enforcement priorities', CEDA Conference, Sydney.

—— 2018b, 'Synchronised swimming versus competition in banking', AFR Banking and Wealth Summit, Sydney.

Smartline 2018, *Smarline Personal Mortgage Advisors*, https://www.smartline.com.au/ (accessed 16 May 2018).

Smith, P. 2017, 'Fintech start-up PromisePay changes name to Assembly Payments and signs key Gumtree deal', *Australian Financial Review*, 13 February.

Snow, D. 2017, 'Australia's big four banks have ditched ATM fee', *The Sydney Morning Herald*, 24 September.

S&P (Standard and Poor's) 2017, *Ratings on 23 Australian financial institutions lowered on buildup of economic imbalances*, 21 May.

Square 2015, *Square Opens Office in Australia*, https://squareup.com/au/news/square-opens-office-in-australia (accessed 4 April 2018).

—— 2018, *Can I accept EFTPOS cards?*, https://squareup.com/help/au/en/article/5665-can-i-accept-eftpos-cards (accessed 17 January 2018).

State Revenue Office Victoria 2017, *Insurance*, http://www.sro.vic.gov.au/insurance (accessed 4 December 2017).

Stevens, D. 2015, 'The Australian Wealth Management Industry - 2020 and beyond', *The Australian Journal of Financial Planning*, vol. 10, no. 2, pp. 31–37.

Stewart, C., Chan, I., Ossolinski, C., Halperin, D. and Ryan, P. 2014, *The Evolution of Payment Costs in Australia*, Research Discussion Paper 2014-4, December, Reserve Bank of Australia.

Strategic Insight 2017, *Analysis of Wrap, Platform and Master Trust Managed Funds at June 2017*, Media Release, 19 September.

Stuckey, J. and White, D. 1993, *When and when not to vertically integrate | McKinsey & Company*, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/when-and-when-not-to-vertically-integrate (accessed 20 June 2018).

Suncorp Banking Group 2017, *Annual Report 2017*, August.

Suncorp Group Limited 2017, *Directors' Report and Financial Statements 2016-17*.

Swan, W. (Deputy P.M. and T. 2011, *Exit fee ban — a victory for Australian families*, 23 March, Media Release.

Swan, W. (Deputy Prime Minister and Treasurer) 2008a, *Proposed Acquisition of Bank of Western Australia and St Andrew's by the Commonwealth Bank of Australia*, Media Release no. 144, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/144.htm&pageID=003&min=wms&Year=&DocType= (accessed 19 November 2017).

—— 2008b, *Proposed Acquisition of St George Bank Limited by Westpac Banking Corporation*, Media Release no. 116, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases /2008/116.htm&pageID=003&min=wms&Year=&DocType=0 (accessed 19 November 2017).

—— 2011, *Taking the Headache out of Switching Bank Accounts*, Media Release no. 095, http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/095.htm&pageID=003&min=wms&Year=2011&DocType=0 (accessed 28 November 2017).

Swish 2017, *About Swish*, www.getswish.se/om-swish/ (accessed 8 January 2018).

Tasmanian Government 2017, *Insurance duty calculator*, http://www.sro.tas.gov.au/motor-vehicle-and-insurance-duty/insurance-duty/insurance-duty-calculator (accessed 12 May 2017).

Taylor, A. 2017, *Australians to own their own banking, energy, phone and internet data*, 26 November.

Taylor, J. 2000, 'Low inflation pass-through and the pricing power of firms', *European Economic Review*, vol. 44, pp. 1389–1408.

Telstra (Telstra Corporation Limited) 2016, *Millennials, Mobiles & Money: The Forces Reinventing Financial Services*.

Terrano, M. 2017, *Thanks a Bundle: Comparison of Bundled Home Loans*, 18 September, https://www.finder.com.au/bundled-home-loans (accessed 5 December 2017).

The Economic Times 2017, 'Ten million sign up for Paytm Payments Bank', *The Economic Times*, 13 September.

The Economist 2015, 'Why does Kenya lead the world in mobile money?'

The Hindu 2015, *All you need to know about payment banks*, www.thehindu.com/business/all-you-need-to-know-about-payment-banks/article7561353.ece (accessed 10 November 2017).

The Treasury nd, *Treasury portfolio*, https://treasury.gov.au/the-department/about-treasury/our-portfolio/ (accessed 5 June 2018).

—— 2011, *Treasury Executive Minute: Banking Package -- Recommendations on LMI*.

—— 2013, *The exemption of retailers from the National Consumer Credit Protection Act 2009*, Discussion Paper, January.

—— 2014, *The Department of the Treasury's submission to the Financial System Inquiry*, 3 April.

—— 2015a, *Aftermath of the HIH collapse*, treasury.gov.au/publication/economic-roundup-issue-1-2015/economic-roundup-issue-1/the-hih-claims-support-scheme/3-aftermath-of-the-hih-collapse/ (accessed 19 December 2017).

—— 2015b, *Fit for the Future: A capability review of the Australian Securities and Investments Commission*, http://192.195.49.161/PublicationsAndMedia/Publications/2016/ASIC-capability-review (accessed 19 January 2018).

—— 2015c, *Northern Australia Insurance Premiums Taskforce*, Final Report, November.

—— 2016, *Backing Australian FinTech*.

—— 2017a, *Financial Services Advisory Council - Views on Government Regulators*, https://consult.treasury.gov.au/small-business-and-consumer-division/copy-of-financial-services-advisory-council-views/ (accessed 1 May 2018).

—— 2017b, *Government response to the Productivity Commission Inquiry into Business Set-up Transfer and Closure*, May.

—— 2017c, *Review into Open Banking in Australia*, Issues Paper.

—— 2017d, *Review of the financial system external dispute resolution and complaints framework*, 3 April.

—— 2017e, *Treasury Annual Report 2016-17*.

—— 2017f, *Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017 - Exposure Draft Explanatory Materials*.

—— 2018a, *Government Response to Review into Open Banking*, https://treasury.gov.au /publication/p2018-t286983/ (accessed 10 May 2018).

—— 2018b, *Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018 - Explanatory Memorandum*.

Thompson, B. 2017, 'Insurance issues a speed hump for driverless cars', *Australian Financial Review*, 14 November.

Thompson, S., Macdonald, A. and Moullaki, J. 2018, 'Lendi taps investors in fresh capital raising call', *Australian Financial Review*, 16 January.

——, —— and Moullakis, J. 2017, 'Netwealth's five-pronged pitch to save IPO market', *The Australian Financial Review*, 3 August.

du Toit, G. and Burns, M. 2016, *Customer Loyalty in Retail Banking - Global Edition 2016*, 29 November, Bain & Company.

Treasury 2017, *Strengthening Penalties for Corporate and Financial Sector Misconduct*, treasury.gov.au/consultation/c2017-t229819/ (accessed 20 June 2018).

Trōv 2017, *On-demand Insurance for Your Things*, https://trov.com (accessed 6 December 2017).

Turnbull, M. (Prime Minister) 2016, *Address to Westpac 199th Anniversary, Sydney*, https://www.malcolmturnbull.com.au/media/address-to-westpac-199th-anniversary-sydney (accessed 26 April 2018).

—— 2017, *Press Conference with the Treasurer, and the Minister for the Environment and Energy*, https://www.pm.gov.au/media/press-conference-treasurer-and-minister-environment-and-energy (accessed 12 January 2017).

Turner, G. 2011, 'Depositor protection in Australia', *RBA Bulletin*, December Quarter, pp. 45–56.

Turner, M., Varghese, R., Walker, P. and Chaudhuri, S. 2014, *The impacts of information sharing on competition in lending markets*, October, PERC.

Tyro (Tyro Payments Limited) 2015, *Tyro Payments Secures $100 Million In Funding*, www.tyro.com/press-releases/tyro-payments-secures-100-million-in-funding/ (accessed 23 November 2017).

—— 2017a, *EFTPOS & Banking for Australian Businesses*, www.tyro.com/ (accessed 17 November 2017).

—— 2017b, *Submission on the Reserve Bank of Australia's Dual-Network Cards and Mobile Wallet Technology Consultation Paper*, February.

—— 2018, *Tyro first-to-market ahead of government deadline on contactless payments*, www.tyro.com/press-releases/tyro-first-market-ahead-government-deadline-contactless-payments/ (accessed 13 March 2018).

Vickers, J. 2010, *The Independent Commission on Banking*, London, United Kingdom.

Victorian Government 1991, *First Report of the Royal Commission into the Tricontinental Group of Companies*, Royal Commission, 30 July, Legislative Assembly.

—— 2016, *Putting Innovation in Motion*, Melbourne.

Visa 2017, *Visa Interchange on Domestic Transactions in Australia*, www.visa.com.au/about-visa/interchange.html (accessed 14 November 2017).

Vow Financial Pty Ltd 2018, *Vow Business Partners*, https://www.vow.com.au/business-partners (accessed 16 May 2018).

Vu, H. and Turnell, S. 2011, 'Cost and profit efficiencies of Australian banks and the impact of the global financial crisis', *Economic Record*, vol. 87, no. 279, pp. 525–536.

Wallace, T. 2015, 'Digital-only challenger bank Atom wins licence', *The Telegraph*, 24 June.

—— 2016, 'Twenty more banks want a licence in flood of new competition', *The Telegraph*, 3 July.

Wallach, P.A. 2012, 'Moving beyond calls for a "New Glass-Steagall"', *Issues in Governance Studies at Brookings*, no. 51.

Wallis, S., Beerworth, B., Carmichael, J., Harper, I. and Nicholls, L. 1997, *Financial System Inquiry - Final Report*, Australian Govt. Pub. Service Canberra.

Wang, A., Mullin, K. and Penafuerte, A. 2017, *Let Us Pay: A Quick Guide to Setting up WeChat Wallet or Alipay*, www.thebeijinger.com/blog/2017/07/16/let-us-pay-no-more-excuses-remain-without-wechat-wallet-or-alipay (accessed 17 January 2018).

WBC (Westpac Banking Corporation) 2017, *Annual Report 2017*.

WEF (World Economic Forum) 2015, *The future of fintech: a paradigm shift in small business finance*, October.

—— 2017a, *Beyond Fintech: A Pragmatic Assessment of Disruptive Potential in Financial Services*, August.

—— 2017b, *Global Competitiveness Index. Historical Data Set 2007-2017*.

Westpac (Westpac Banking Corporation) 2017a, *2017 Pillar 3 Report*.

—— 2017b, *Westpac abolishes ATM withdrawal fees*, Media release, 24 September, Sydney.

—— 2018, *Westpac to introduce least-cost routing for merchant customers*, Media Release, April, www.westpac.com.au/about-westpac/media/media-releases/2018/04-april/ (accessed 12 April 2018).

Woolard, C. 2017, *Competition and innovation in financial services: the regulator's perspective*, 11 May, Financial Conduct Authority.

World Bank 2017, *Global Financial Development Database*, 12 June, Washington DC.

Worthington, D. 2016, *Tokenization: Everything you need to know*, Rambus, Rotterdam, The Netherlands.

Wu, T. 2017a, *General Insurance in Australia*, August, IBISWorld Industry Report K6322.

—— 2017b, *Insurance Brokerage in Australia*, August, IBISWorld Industry Report K6420.

Xinja and Equitise 2018, *Media release: Equitise launches Australia's first Equity Crowdfunding with Neobank Xinja – Xinja*, 11 January, https://xinja.com.au/press/2018/media-release-equitise-launches-australias-first-equity-crowdfunding-with-neobank-xinja/ (accessed 15 January 2018).

Yeates, C. 2016, 'ANZ Bank CEO Shayne Elliot eyes bigger domestic share', *The Sydney Morning Herald*, 3 March.

—— 2017a, 'American Express cuts fees for small businesses to double its presence', *The Age*, 6 July.

—— 2017b, ‘Bankers warn tech giants Google and Apple are the real threat, not past misconduct’, *The Sydney Morning Herald*, 23 November.

—— 2017c, ‘One in three don’t understand their interest-only loans, says UBS’, *The Sydney Morning Herald*, 4 October.

—— 2017d, ‘Regulator’s dilemma as interest-only mortgage returns hit 42 per cent’, *The Sydney Morning Herald*, 4 July.

—— 2018, *Westpac to offer cheaper tap and go payments for retailers*, The Sydney Morning Herald, www.smh.com.au/business/banking-and-finance/westpac-to-offer-cheaper-tap-and-go-payments-for-retailers-20180403-p4z7l9.html (accessed 11 April 2018).

Yellow Brick Road 2018, *Yellow Brick Road Wealth Management*, https://www.ybr.com.au/ (accessed 16 May 2018).

Youi 2017, *About Us - Youi Insurance*.