



Australian Government
Productivity Commission

Competition in the Australian Financial System

Productivity Commission
Draft Report

January 2018

This is a draft report prepared for further public consultation and input. The Commission will finalise its report after these processes have taken place.

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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).

Opportunity for further comment

The inquiry team thanks the industry associations, businesses, individuals and government bodies who have contributed data, information and insights to the inquiry to date.

We invite examination of this draft inquiry report and comment on it by **written submission** to the Productivity Commission, preferably in electronic format, by **20 March 2018** and/or by attending a public hearing.

The final report will be prepared after further submissions have been received and public hearings have been held and will be forwarded to the Australian Government by 1 July 2018.

Public hearing dates and venues

Location	Date	Venue
Sydney	Wednesday 28 February 2018	Wesley Conference Centre 220 Pitt Street
	Thursday 1 March 2018	
Melbourne	Monday 5 March 2018	Productivity Commission Rattigan Rooms Level 12, 530 Collins Street
	Tuesday 6 March 2018	

Closer to the time of the hearings, further details will be provided on the inquiry website at: <http://www.pc.gov.au/inquiries/current/financial-system>.

Commissioners

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* the powers of the Productivity Commission have been exercised by:

Peter Harris	Presiding Commissioner
Julie Abramson	Commissioner
Stephen King	Commissioner

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.

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 innovation, 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 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]

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Abbreviations

ABA	Australian Bankers' Association
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
AFS	Australian Financial Services
ANZ	Australia and New Zealand Banking Group Limited
AOFM	Australian Office of Financial Management
APL	Approved product list
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
ATM	Automatic Teller Machine
ATO	Australian Taxation Office
AUM	Assets under management
AUSTRAC	Australian Transaction Reports and Analysis Centre
BCBS	Basel Committee on Banking Supervision
BPAY	Bill payment system operated by BPAY Pty Ltd
BSB	Bank state branch identifier number
CALC	Consumer Action Law Centre
CBA	Commonwealth Bank of Australia
CCI	Consumer credit insurance
CCR	Comprehensive credit reporting
CET1	Common Equity Tier 1 capital
CFR	Council of Financial Regulators
CLF	Committed Liquidity Facility
COBA	Customer-Owned Banking Association
COIN	Community of Interest Network
COSBOA	Council of Small Business Australia
CRF	Capture Reimbursement Fee
D-SIB	Domestic systemically important bank

FCA	Financial Conduct Authority (UK)
FCS	Financial Claims Scheme
FSI	Financial System Inquiry
FOFA	Future of Financial Advice
FUM	Funds under management
GAP	Guaranteed asset protection (insurance)
GFC	Global financial crisis
HHI	Herfindal–Hirschman Index
HQLA	High quality liquid assets
IMF	International Monetary Fund
IRB	Internal risk-based
IRRBB	Interest rate risk in the banking book
LCR	Liquidity Coverage Ratio
LGD	Loss given default
LMI	Lenders mortgage insurance
LVR	Loan-to-value ratio
MEI	Mutual equity interests
NAB	National Australia Bank
NCC	National Competition Council
NIM	Net interest margin
NPP	New Payments Platform
NPPA	New Payments Platform Australia Limited
NSFR	Net stable funding ratio
PC	Productivity Commission
PDS	Product disclosure statement
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
SME	Small and medium enterprise
SVR	Standard variable rate
UFI	Unauthorised foreign insurer
WBC	Westpac Banking Corporation

OVERVIEW

Key points

- Competition — and the innovation it fosters — has given us a financial system that offers ready access to funds at all hours of the day, safe and quick movement of money between accounts, payment via personal devices such as mobile phones, and speedy loan approvals.
- Yet the system is also generally highly profitable (which may be no bad thing) and lacking strong price rivalry. We examine why this is so.
- First, the benefits of competition to the individuals and businesses for whom the financial system exists are being reduced in the quest for stability. **Regulators** have focused almost exclusively on prudential stability since the Global Financial Crisis, promoting the concept of an unquestionably strong financial system.
- Second, although financial institutions generally have high customer satisfaction levels, customer loyalty is often unrewarded with existing customers kept on high margin products that boost institution profits. For this to persist, channels for **provision of information and advice** (such as mortgage brokers) must be failing.
- In **retail banking**, market concentration is very high in many product markets, but concentration *by itself* is not the calamity that it is often made out to be, so long as new and innovative business models can thrive.
 - Scope for *price* rivalry in principal loan products is constrained by a number of external factors: price setting by the Reserve Bank facilitating price coordination by banks; expectations of ratings agencies that large banks are too big to fail; and some prudential regulation (particularly in risk weighting) that favours large institutions over smaller ones.
 - Competition in *quality* of services — effective use of technology to better price risk, responsiveness to demand shifts, simpler and cheaper processes — is not so constrained. But much of what passes for competition is more accurately described as persistent marketing and brand activity designed to promote a blizzard of barely differentiated products and ‘white labels’.
 - The growth in mortgage brokers and other advisers does not appear to have increased price competition. The revolution is now part of the establishment. Non-transparent fees and trailing commissions, and clear conflicts of interest created by ownership are inherent. Lender-owned aggregators and brokers working under them should have a clear best interest duty to their clients.
- In **general insurance**, market concentration is high and camouflaged, with a proliferation of brands but far fewer actual providers. Consumer confusion on product differences is attributable to the poor quality of information required to be provided to consumers and, to a lesser degree, the incentives faced by advisers.
- While **new entrants** to financial markets have brought increased competitive pressure in the past, evidence over the past decade suggests they cannot be counted on as a primary source of competitive pressure. Thus, reforms to the regulatory framework under which incumbents operate are also essential to realise further benefits of competition in the financial system.
- The **institutional responsibility** in the financial system for supporting competition is loosely shared across APRA, the RBA, ASIC and the ACCC. In a system where all are somewhat responsible, it is inevitable that (at important times) none are.
- More nuance in the design of APRA’s prudential measures — both in risk weightings and in directions to authorised deposit-taking institutions — should be sought. This would help address issues of market power and imbalance that have emerged in lending between businesses and housing.

Overview

Australia's financial system has changed beyond recognition in the past several decades. Australians have ready access to funds at all hours of the day, can get home loan approvals in under 24 hours, quickly and safely move money between accounts with the swipe of a finger, pay for products with the tap of a card, smartphone or watch, and have investment portfolios managed by robo-advisers.

Competition — and the innovation it fosters — has underpinned these developments. When firms have been driven to offer improved or better value financial products in order to strengthen their competitive positions, benefits have also flowed to those for whom the financial system exists — the businesses investing in the Australian economy, and the individuals whose consumption drives the majority of economic activity.

The financial system must be strong and stable. But equally, it should ensure that Australia's businesses and households are well-served and can have confidence that 'unquestionably strong' institutions are not exploiting the market power that might accompany this exalted status.

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 financial system innovation — without undermining financial stability objectives.

Competition is constrained

Market concentration

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 strength.

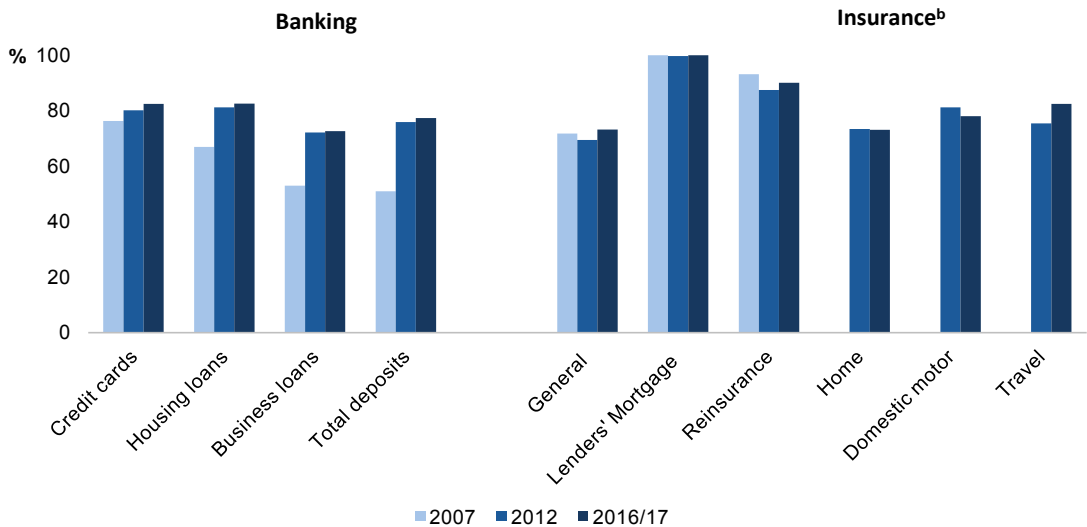
The combined market shares of major players in banking and insurance are well over 70% in some product lines (figure 1). Internationally, Australia's banking concentration is on par with that of Canada and the Netherlands, but well above that of the United Kingdom, United States and Japan.

These large market shares do not necessarily indicate that competition is weak or that community outcomes will be poor. Markets can be competitive and deliver beneficial outcomes even when they are dominated by large players, provided it is possible for:

- new providers to enter easily (including through takeover of incumbents) and offer innovative products that the community values
- existing smaller incumbents to expand and capture market share from their rivals
- consumers to conveniently switch to alternative products or providers.

Among some particular customer groups, smaller financial institutions have comparatively high market shares. For example, some regional and customer-owned authorised deposit-taking institutions (ADIs) and some of the foreign-owned banks structure their operations to target a particular part of the community (such as their home state, employees in a particular profession, or dual nationals from their base country) to overcome the disadvantages of potentially limited scale, higher funding costs, or in the case of foreign-owned banks, limited public-facing branches.

Figure 1 Concentration in banking and insurance markets
Major institution share^a, annual average^c



^a Major banks are the CBA, Westpac, NAB and ANZ. The top 4 level 1 general insurers are IAG, AAI Limited (Suncorp), QBE Insurance, and Allianz Australia Insurance Limited. ^b Insurance concentration estimates are calculated at the level 1 insurer level. General insurance includes direct general insurance only (excludes reinsurance and lenders mortgage insurance). ^c For banking markets, values for 2007 and 2017 are shown. For general insurance markets, values for 2006 and 2016 are shown.

Market entry and consolidation

The number of ADIs has halved since 1999 to 148 institutions in 2017, with many small banks, credit unions and building societies merging or being absorbed by larger domestic banks.

There have been limited new entrants in general insurance and a steady decline overall in regulated insurers from 171 in 1999 to around 104 in 2017.

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 and governance protections in other laws. At worst, in this consolidation era it protects some institutions from takeover, the most direct form of market discipline for inefficiency and management failure. Raising the cap on ownership would offer a greater threat of market discipline, without green-lighting mergers.

When there have been periods of heightened competition in the Australian financial system, these have typically been driven not by established providers but by new entrants — such as Aussie Home Loans providing home loan competition in the 1990s and early 2000s, foreign banks such as ING offering online retail banking, and Rabobank providing services to medium/large agribusinesses. But this revolution is over. All new entrants to the banking system over the past decade have been foreign bank branches, usually targeting important but niche markets (and these entrants have evidenced only limited growth in market share).

Although a very small part of the financial system, fintechs represent a group that could fundamentally change the nature of competition in the banking system. While the overall trend towards collaboration between fintechs and incumbents may improve efficiency of operations and reduce transaction costs for both fintechs and incumbents, it also reduces the potential for these new entrants to be a source of competition. If barriers to entry and expansion continue to fall, and data reforms are pursued effectively by the Australian Government, fintechs will find it easier to compete against incumbents.

It remains to be seen how the big tech players (such as Apple, Google and Amazon) will ultimately choose to compete in the global and Australian financial systems. These companies have already established a large network of customers with multifaceted relationships and trust. This gives them a strong position to offer competitive financial services.

Despite consolidation in provision of financial services and indications that new entrants have brought competitive pressure in the past, most analysts and consumer advocates have suggested to us that more banks or more insurers should not be counted on as a primary driver of improved market outcomes.

Rather, we need: regulatory settings that do not thwart competition between existing institutions; more customer-oriented providers that consider their existing customers (not just potential new customers); less of a blizzard of new but barely-distinguishable products with labels that obfuscate; much better and far more open information on product prices and conditions; and scope for consumers to more easily become unstuck (should they wish to be) from their current banks and insurers.

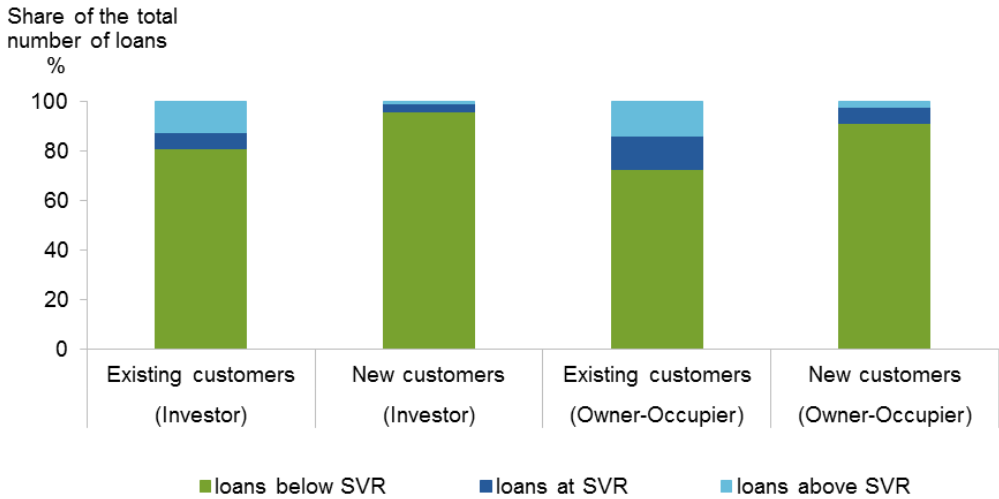
Consumer choice and switching

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. ‘Too much hassle’ and a desire to keep most accounts with the same institution are the main reasons given for the lack of switching, with home loans being a particularly difficult product for consumers to switch.

Barriers to switching can make loyal customers ripe for exploitation. The Reserve Bank of Australia (RBA) reports that the variable interest rates of existing home loan customers average around 0.3 to 0.4% points higher than rates on new home loans. These higher rates are paid by around 15% of existing customers and equate to an extra \$66 to \$87 per month on the average home loan balance (figure 2).

That 50-70% of Australians interact with more than one bank (this tendency increases with age and home ownership), should make switching product providers a more realisable proposition. It may appear that there is reasonable competition here, but it exists only in those markets (such as transaction accounts and some credit cards) where it costs you little to have multiple versions of very similar products.

Figure 2 **New home loan customers pay lower interest rates**
 Compared with standard variable rate (SVR)



In practice, multiple accounts or flick and tick account changing are not panaceas for more competition in markets. Awareness and convenience must be added to make opportunities attractive.

In banking, there is often no evident trigger for consumers to consider making a change that saves them costs or earns them a higher return. But there is in insurance. The annual renewal point for insurance should act as a trigger point for reconsidering insurance providers, yet the complexity of product offerings and an overwhelming orientation to trusted brands induces inertia.

Satisfaction of consumers with their own financial institutions is very 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 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.

The channelling of products offered to consumers through the vertical integration of brokers and other distribution channels can mean these consumers are not given the choice of products that are better for them. Unlike in wealth management (a similar advisory business, involving serious financial cost) mortgage brokers are not obliged by law to act in the best interests of the customer. And an important source of advice subsequent to the transaction is compromised, as trailing commissions encourage broker loyalty to the financial institution, not the customer.

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. While enabling ready comparisons between a selection of home loan providers and reducing consumer search costs, mortgage brokers do not consistently get lower home loan interest rates for consumers than would be available to the consumer by going directly to the provider.

The current approach to the provision of many financial products still, ultimately, puts the onus on consumers to find better deals and negotiate with providers, which places many at a disadvantage.

Rivalry through price competition is rarely evident

As in many other sectors in the economy, financial service providers offer a choice of products varying to some extent on price, service, product features and add-ons to attract additional customers, enhance existing customer satisfaction and prevent loss of customers. Compared to banks overseas, Australia's banks offer products that have comparatively low fees but give the banks moderately high interest margins.

While industry participants point to lower fees and falls in some loan interest rates as indicative of price competition, lower input costs (the RBA's target cash rate has fallen from 7.25% to 1.5% over the past decade) are substantially responsible.

The fall in the cash rate does not appear to have been fully passed on in lower prices across the board. Instead, the spread between home loans and the cash rate, for example, has largely increased in recent years (figure 3). The RBA reports similar increases in interest rate spreads for business lending. In credit card markets, interest rates were estimated by CHOICE to be around 3% points higher than they would be had the reduction in the cash rate in recent years been reflected in credit card interest rates. In part, the lack of pass through of cash rate changes to other interest rates reflects the decreasing importance of the cash rate (relative to other factors such as prudential settings) on the cost of funds to institutions.

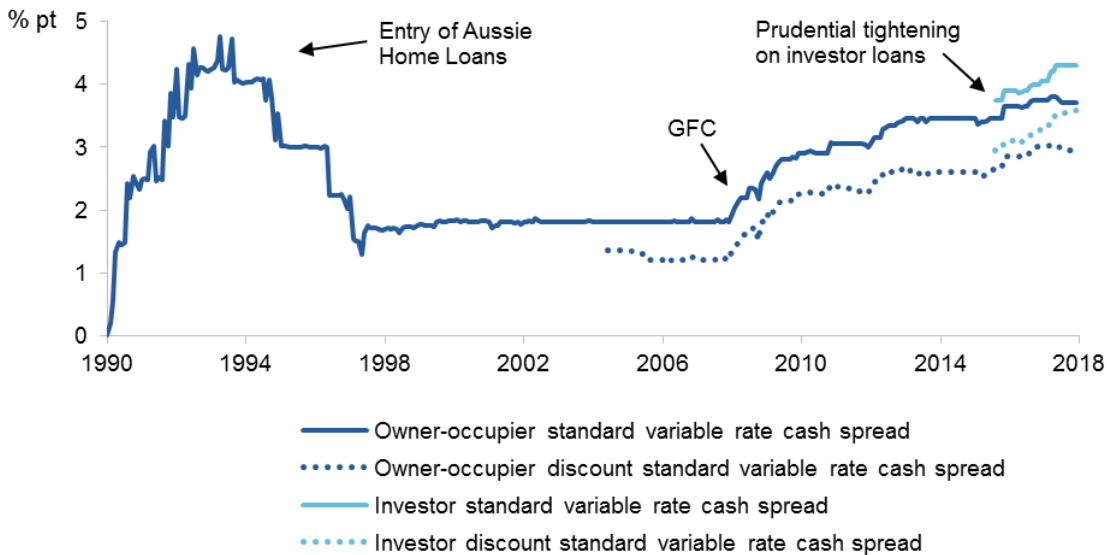
In general insurance, there have been substantial increases in claim costs in some markets which have flowed through to increased premiums. The overall decline in profitability in these markets though is indicative of some level of price competition.

Prices of many comparable banking products tend to converge (but not necessarily to the marginal cost of provision) between the different providers — with a congruence in underlying influences on bank pricing and with smaller players (including the so-called challenger banks) following the pricing decisions of the major providers.

For competition analysis it is significant that the state of the market persistently allows this.

The forces at work here are not all under the control of the ADIs. There are two broad drivers of the pricing of retail banking products: externally-imposed factors (features intrinsic to the regulated market) and internal factors (features within the control of the ADIs themselves).

Figure 3 Home loan interest rate spread



Price competition in banking is limited by external factors

Australia's key financial regulators — the RBA, the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) — work together to create a stable financial system, coordinated to a degree through the Council of Financial Regulators (CFR). Through the setting of the cash rate in response to market conditions, capital holding requirements and other prudential requirements, the RBA and APRA indirectly determine the costs of funds for all ADIs. This, in turn, influences the interest rates the ADIs need to charge to borrowers to cover funding costs. For non-ADIs (that are not able to take retail deposit funds), regulatory settings affect the amount they have to pay for funds through warehouse funding (temporary lines of credit provided by larger banks to other lenders) and securitisation arrangements. Other operating costs of the ADI (for example, IT maintenance, branch and back-office costs) and a return on capital are added onto funding costs.

Evidence suggests that despite consolidation of smaller financial institutions and efforts by these institutions to develop shared solutions and use service providers to reduce operating expenses, a gap remains between the average costs of Australia's major banks and its smaller institutions. Operating costs for major banks are around 45% of income, compared with 65% for other smaller domestic banks (figure 4). Australia's major banks also have relatively low operating costs compared with foreign banks operating in Australia and overseas. But they also tend to have a comparatively large and increasing component of their business centred on lower-cost traditional retail lending activity (home loans) rather than on higher-cost areas such as business lending.

There is also variation between larger and smaller institutions in funding costs (with a large regulatory-determined component). Not all ADIs face the same regulatory arrangements and regulatory effects on their pricing capacity. A source of differential funding costs to banks is a series of regulatory measures and levies that apply (both positively and negatively) to the major Australian-owned banks but not to smaller Australian-owned ADIs or foreign banks operating in Australia. These include:

- Risk models — Westpac, CBA, ANZ, NAB and Macquarie have all invested in the necessary risk management capability to operate internal ratings-based (IRB) risk models. This allows them to decide on the amount of regulatory capital they hold based on their own models, subject to APRA's scrutiny and some limits on minimum capital holdings. All other ADIs use APRA's standard risk weighting. Specifically, in the case of home loans, an IRB bank holds 25-29% of the value of its home loan portfolio as regulatory capital — whereas for a standardised bank this ranges between 35% and 45%. In July 2017, APRA announced that in order to be 'unquestionably strong', IRB banks would be required to hold an additional 1.5% points in common equity tier 1 capital, and other ADIs would be required to hold an additional 0.5% points. The more capital required, the more costly it is for the institution to lend, and the less capacity it has to compete on price.
- Domestic systemically important banks (D-SIBs) — In 2013, APRA designated Westpac, CBA, ANZ, and NAB as D-SIBs, which have the size, interconnectedness,

substitutability and complexity that necessitate they hold extra capital to address the potential risk to the stability of the financial system should they become stressed or fail. While not intended to reinforce a ‘too big to fail’ labelling of banks, APRA states that the designation is intended to ensure that banks perceived to be too big to fail have a greater capacity to absorb losses. The international ratings agencies reflect this designation of D-SIBs in a three-notch credit rating uplift, significantly reducing the interest they pay on wholesale funding.

- Major bank levy — In its May 2017 Federal Budget, the Government introduced a 0.015% levy paid quarterly on the balance of bank liabilities of Westpac, CBA, ANZ, NAB and Macquarie. The motivation for the levy was explained as: ensuring that the banking sector makes a fair contribution to the economy, improving competition and accountability, and complementing prudential reforms.

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. RBA estimated this advantage to have averaged around 20 to 40 basis points from 2000 to 2013 (worth around \$1.9 billion annually to the major banks). More recently, the funding cost advantage of major banks has been estimated to have declined to about 10 basis points, due in part to prudential reforms. But it nevertheless persists, and ratings agencies are unlikely to rate institutions’ fund raising such that there is no effective differential between Australia’s major and smaller banks.

To the extent that smaller institutions use securitisation as a source of funding and rely on larger banks to act as intermediaries in accessing wholesale debt markets, their cost of funds and scope for initiating or persisting with price competition will be even more limited. New APRA measures that take a one-size-fits-all approach to risk weightings in this area will further increase the costs of warehouse funding. Again, this will reduce the capacity of smaller institutions to compete even at the margin, let alone in a market-shifting fashion.

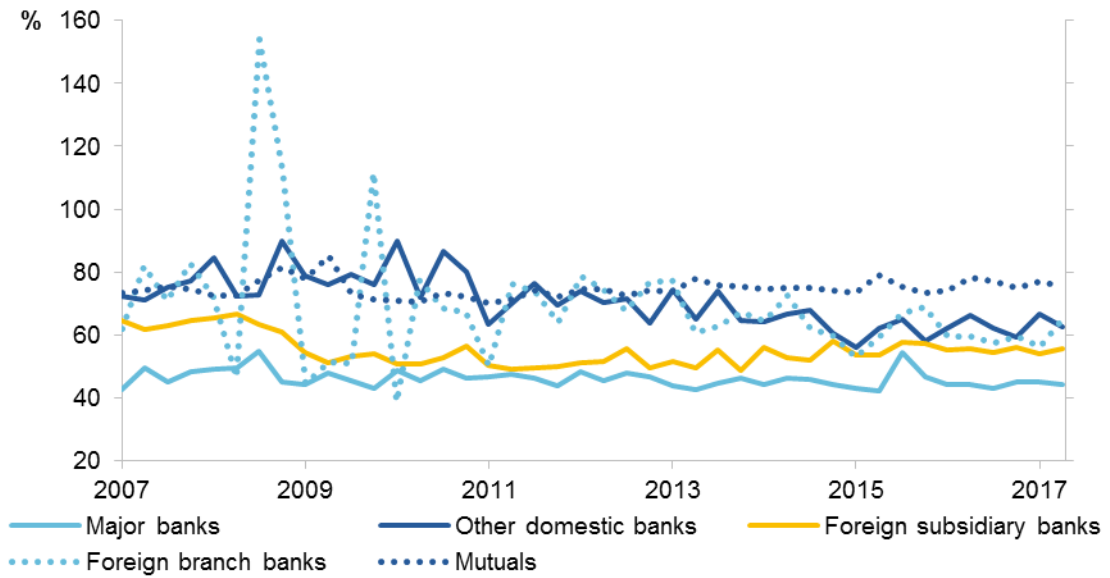
History suggests that even where Australia’s smaller ADIs are given a regulatory advantage over the major banks, they do not noticeably take advantage of major bank price rises by maintaining their own loan prices in an attempt to gain market share. Rather, they seek to raise prices and improve margins earned from their existing customer base.

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 average 0.4 to 0.8% points lower than the major banks’ rates. However, their scope to lower lending rates further is probably even more limited than other ADIs simply due to narrower sources of funding.

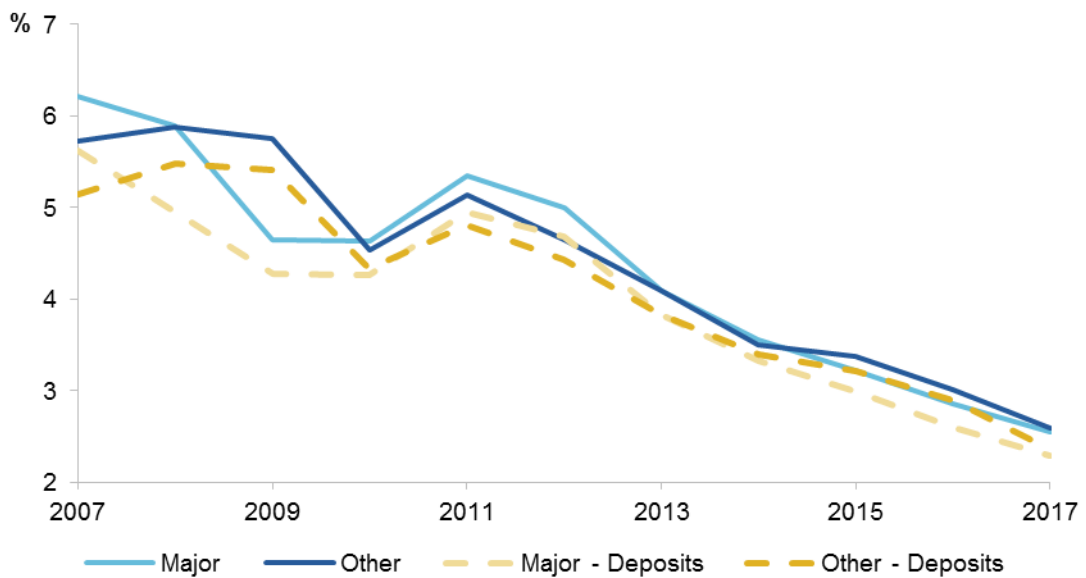
The prudential requirements (including capital requirements) for insurers similarly contribute to the premiums insurers charge. We have not, however, observed similar issues in the regulatory arrangements for different size insurers.

Figure 4 **Bank input costs**

Operating efficiency (operating costs as % of operating income)



Funding costs



This persistent advantage suggests that the scope for smaller ADIs and non-ADIs to compete on price is more limited than for larger institutions, unless margins are sacrificed — and this has not occurred since the global financial crisis (GFC).

But the solution is not to increase major bank costs. It is one thing to lift IRB risk weights, as the Murray FSI proposed, if they were demonstrably too low. It is entirely another to add to one sub-group's costs and expect this will improve outcomes for consumers.

Consumers have lost their market power to shareholders

Publicly listed institutions are required to act in the interests of their shareholders when devising their competitive strategies. This means that they are motivated to keep prices high in order to deliver profits that are in line with market expectations. But if the market were competitive, such practices would cause consumers to switch to a lower price provider, lowering profits and 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.

Australia's major banks have delivered substantial profits to their shareholders (figure 5) — over and above 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 high returns on equity (ROEs).

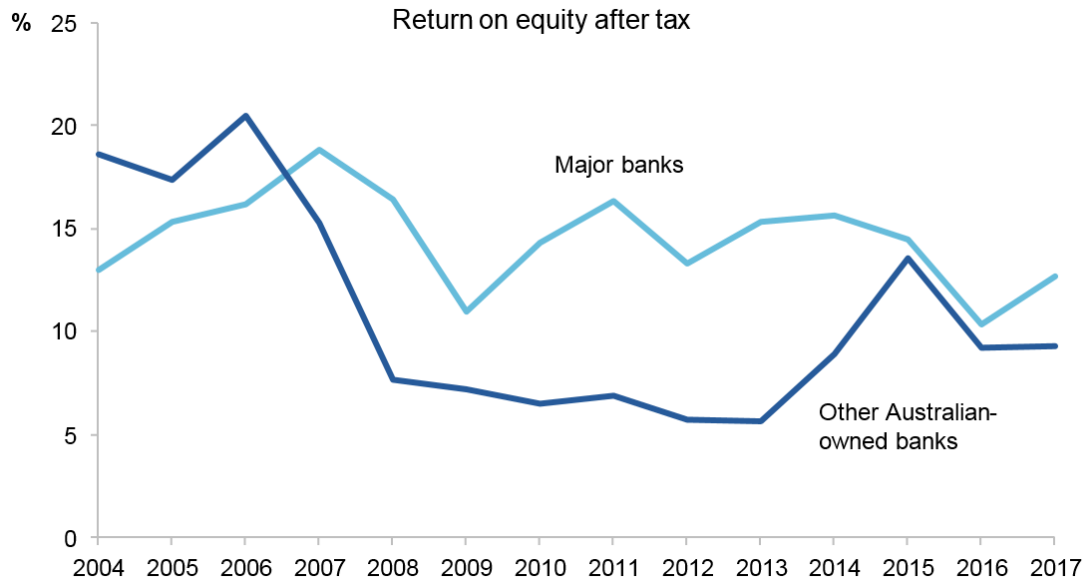
The ROE on interest-only investor loans doubled, for example, to reach over 40% after APRA's 2017 intervention to stem the flow of new interest-only lending to 30% of new residential mortgage lending (reported by Morgan Stanley). This ROE was possible largely due to an increase by banks in the interest rate applicable to *all* interest-only 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 unable to pick up dissatisfied customers from this re-pricing of their loan book because of the application of the same lending benchmark to them.

To be clear, it is completely unsurprising that faced with the opportunity to re-price their loan book as a consequence of a regulatory changes, banks did just that. Shareholders expect that of their managers. But this additional cost impost — part of which (through the tax deductibility of interest on housing investment loans) is being paid now by all Australian taxpayers — was not an objective of the regulator and means that the intervention could have been better focused.

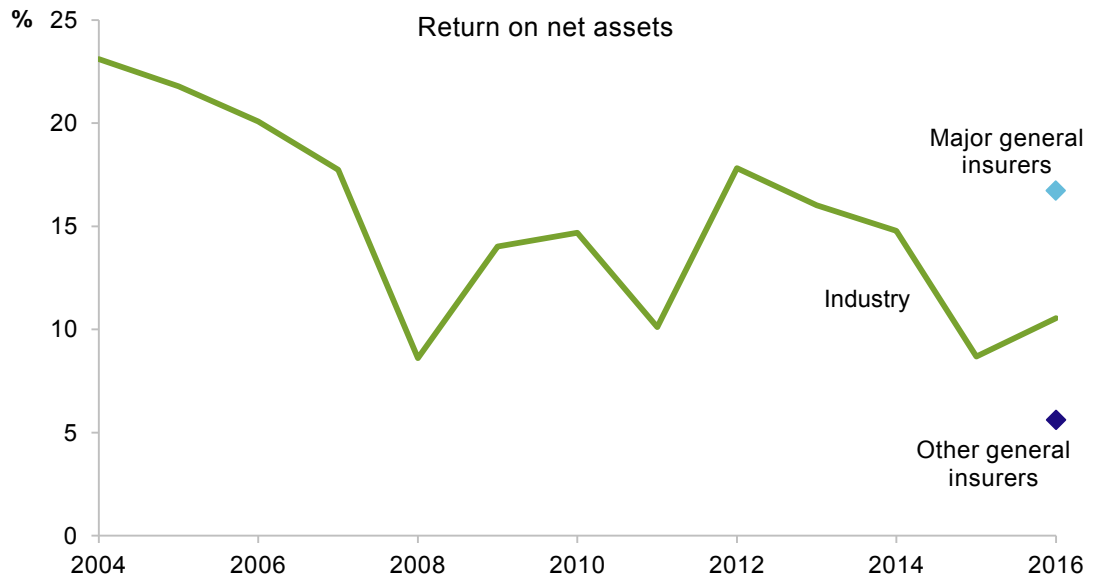
These type of macroprudential interventions by APRA seem likely to be widely used in future. As such, clear objectives should be set, banks' responses should be forecast, and the Council of Financial Regulators (CFR) should consider a tabled analysis of these. Regulators should seek to keep costs to the least necessary to achieve their objectives in all material future macroprudential actions. This must include the impact on competition.

Figure 5 Profitability

Banks



General insurance



Product proliferation: poorly aligned with consumer interests

Providers of financial products emphasise their service levels and product features (such as increased functionality in internet banking or online services provided by insurance companies) in attracting and retaining customers.

Scope for product features based on technology improvements is considerable, given Australia's relatively high use of 'self-serve' digital channels for financial services compared with that reported in other countries. The level of technical innovation in service provision in some parts of Australia's financial system is indicative of a strong and adaptive system that has the capacity and motivation to innovate. From 'tap and go' payments with near real time payment clearance, high uptake of online retail banking, and product comparison websites, Australians are, for the most part, at the forefront internationally of innovative banking services and payments systems.

In contrast, insurance and innovation have often been described as co-existing only in the dictionary. There exists some innovation in Australia's general insurance markets, but it is typically more focused on using masses of consumer data (such as from shopper loyalty programs) in novel ways to increase returns, than in innovation that improves consumer outcomes. The UK insurance market offers, by way of comparison, much more innovation in insurance products.

Product proliferation is confusing consumers and enabling price discrimination

Across the financial system, there is a continual flow of new products and a re-packaging of existing products to appeal to specific groups of consumers. As a consequence, there is a very large number of products in financial markets, with sometimes only marginal differences between them: nearly 4000 different residential property loans and 250 different credit cards are on offer, for example. The same situation is apparent in insurance markets: the largest 4 general insurers hold more than 30 brands between them. In the pet insurance market this is particularly pronounced — 20 of the 22 products (with varying premiums) on offer are underwritten by the same insurer.

The need to decide between a large number of options makes product comparisons difficult and leads to 'choice overload'. Product features can be useful, but white labelling as a practice does not offer different features, just proliferation. Moreover, consumers consistently report that price, rather than extras, is the most important factor to them when choosing products such as home loans.

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.

The huge product variety also provides latitude for price discrimination between consumers (for example, insurers may offer policies with relatively high premiums to existing customers compared to new customers posing a similar level of risk), with associated profit opportunities for those institutions able to do so.

A web of products and providers

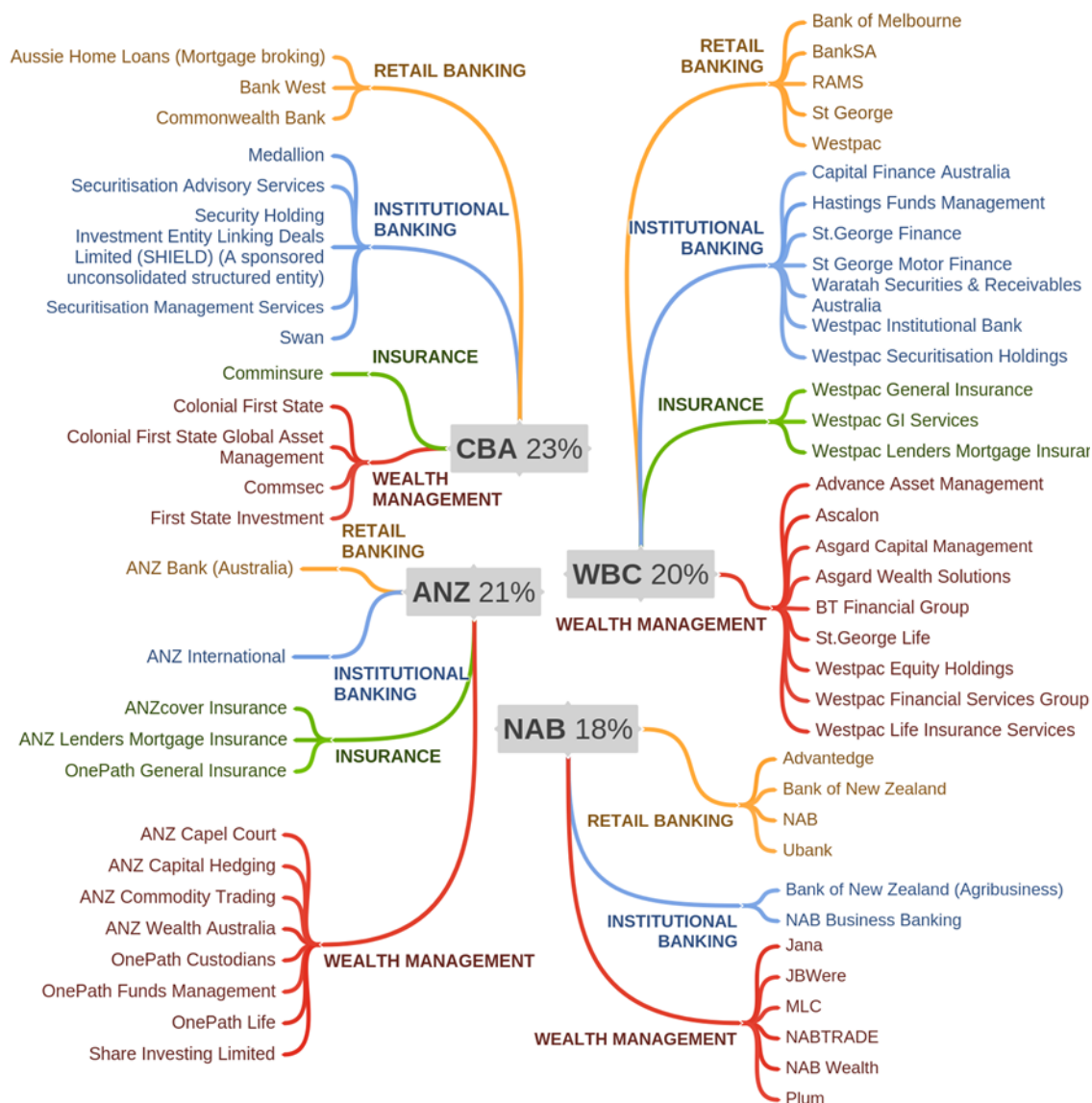
Scope for bundling of products to be used as a relationship feature is high, given strong consumer preferences to keep their financial products together. A CHOICE survey found that half of all Australians who have a transaction account, home loan and credit card have all three products with the same institution. One third of people who had not switched accounts gave keeping all their accounts at the same institution as the reason for their lack of change.

Australia's largest financial institutions, in particular, 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) — offering more scope to bundle products and services (figure 6).

To the extent that integration is reducing product search costs for consumers and offering bundling benefits, it is a market feature that should be welcomed. But where integration is used as a means to create impediments to new entrants, to lock in consumers or up-sell them into additional products with poor quality information on the options available to them, this could distort market outcomes.

The effects on systemic risk of the greater complexity that comes with integration can be overstated. When prudentially regulated institutions expand into high risk unregulated areas, this might have the effect of raising the risk of their regulated activities. Offsetting this will be the effectiveness of the regulators. In Australia, some of APRA's prudential measures, including requirements for the major banks to be 'unquestionably strong', diminish these potential risks for those regulated institutions that expand into other markets.

Figure 6 The major bank networks a,b
 Select subsidiaries and other entities of major banks



^a Banks include Australia New Zealand Banking Group (ANZ), Commonwealth Bank Group (CBA), National Australia Bank Group (NAB), Westpac Banking Corporation (WBC). Total assets of group as % of total assets of all Australian financial institutions. ^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.

The state of competition

Overall, the extent of competition in Australia's financial system is widely variable across different product areas. This inquiry focuses on *markets* where there is evidence of limited competitive effect.

Innovation and rivalry in price is limited in most of the markets we examined. There appears to be more evidence of competition in product features. The markets for home loans, consumer credit cards, household insurance, wealth management and financial advice demonstrate this. Yet the proliferation of products appears excessive. And its contribution to paralysing consumers with uncertainty about the benefits of switching call into question the scope for product proliferation to improve outcomes for consumers.

In some key markets — for example, small business credit and lenders mortgage insurance — competition appears constrained by factors that may be alleviated by regulatory reform.

Reforms that promote competitive behaviour by firms

When competition in the financial system is strong, rival providers strive to deliver better services and greater choice to consumers as efficiently as possible, and well informed mobile consumers place competitive pressure on providers. The Commission's reforms that actively promote competition in Australia's financial system are therefore directed at delivering:

- clarity around how prices or features vary with product differentiation, with minimal scope for a provider or group of providers (or, of less bearing in financial markets, for any single consumer or group of consumers) to exert significant influence over price;
- sufficient information for both providers and consumers to make informed decisions based on factors such as credit worthiness, risk or product choice (given product terms and conditions);
- low barriers for industry participants entering the market, for those expanding within it, and for existing providers that want to exit;
- a regulatory environment that does not impose undue distortions on the provision or access to particular financial products or particular providers, and is able to effectively assess and deal with the risks for competition that are posed by regulatory measures and market developments.

Adding competition via reforms to the regulatory framework

The financial system needs a competition champion

Competition in Australia's financial system is without a champion among the existing regulators — no government agency is tasked with overseeing and promoting competition in financial markets, including forcing consideration of whether actions by regulators materially harm competition. Under the current regulatory architecture, promoting competition requires a serious rethink about how the RBA, APRA and ASIC consider competition and whether the Australian Competition and Consumer Commission (ACCC) is well-placed to do more than it currently can for competition in the financial system. As a forum for coordinating input from financial system regulators on regulatory interventions,

the CFR should be a key avenue through which consideration of competition impacts is promoted, analysed and made more transparent.

The Murray Financial System Inquiry made a series of recommendations intended to strengthen regulators' ability to consider competition, and to consider the effects of their actions on competition. The most direct recommendation — giving ASIC an explicit mandate to consider competition — is yet to be implemented.

In the absence of a competition advocate in the financial system, the role of balancing competition and financial stability falls mainly to APRA — which has financial system stability as its primary objective but is required to also consider the effects of its interventions on financial system efficiency, contestability, competition and competitive neutrality. 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'. We do not propose to change the nature of APRA's obligations in this draft report.

Yet in the current environment of emphasis on maintaining unquestionably strong institutions, and with macroprudential supervision likely to dominate regulator behaviour 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.

Blunt application of some prudential measures is costing the community

Some of APRA's interventions in the market — while undertaken in a way that is perceived by the regulators to reflect competitive neutrality — have been excessively blunt and have either ignored or harmed competition. Such consequences for competition were neither stated nor transparently assessed in advance.

In particular, APRA's interpretation of Basel guidelines on risk weightings that non-IRB banks use for determining the amount of regulatory capital to hold, puts it among the most conservative countries internationally (table 1).

- For home loans, the main area in which Australia's risk weights vary from international risk weightings is for (lower risk) home loans that have a loan to value ratio below 80%. Australian non-IRB lenders are required to use a risk weight of a flat 35%, compared with Basel-proposed guidelines of 25% to 35% for such loans.
- For small and medium enterprise (SME) loans, the main area of difference is lending that is not secured by a residence. A single risk weight (of 100%) applies 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. In contrast, Basel proposed 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.

Table 1 How Australia’s risk weights compare with Basel

Type of lending	Basel II Standard risk weightings	Basel III Standard risk weightings	Australia’s standardised ADIs	Australia’s IRB banks
Home loans	35%	25 – 55% (depending on LVR)	35 – 75% (depending on LVR and mortgage insurance)	Avg 26% (with range from 5 – 137%)
SME lending	75 – 100% ^a	75 – 150% ^a	100%	Avg 48 – 55%

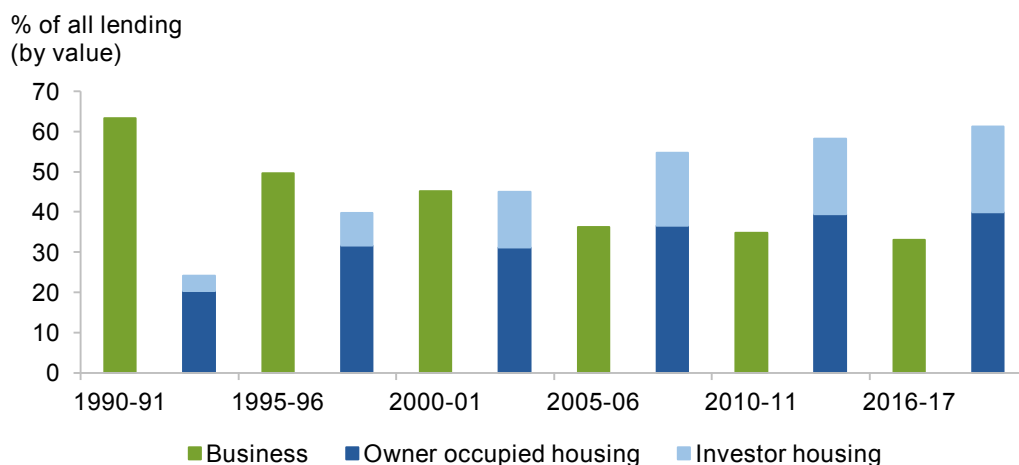
^a Risk weights vary with loan size, ownership structure of the business, loan to value ratio, and type of security.

These higher risk weights mean that Australia’s non-IRB lenders are generally required to hold more regulatory capital than are Australia’s IRB (major bank) lenders; foreign bank branches in Australia; and institutions with comparable loans in other countries.

This means that for SME loans that are not secured by a residence, Australia’s smaller banks need to hold twice as much capital as the major banks — in effect, paying twice as much to be able to offer loans to their customers. This difference is smaller for loans secured against a residence.

These differences in costs associated with regulatory capital holdings are passed on to borrowers. 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, they create a strong preference for home loan lending over SME lending unsecured by residential property (figure 7).

Figure 7 Trend in ADI loans for business and housing



We consider that APRA should broaden its approach to the standardised risk weights for residential mortgages and small business lending. Such a review should be focused on more finely calibrating the risk weights to better reflect the risk in individual loans. In particular, consideration should be given to replacing the single risk weight that applies to standard eligible residential mortgages that have a loan-to-valuation ratio below 80% with risk weights defined in bands. Further (and more significantly for consumers), 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.

APRA's recent intervention to set a growth benchmark of 30% on new interest-only residential mortgages is a further example of a blunt intervention with detrimental effects on market competition. It followed a similarly blunt benchmark (in 2014) on investor home loans of 10% of new residential mortgage lending. Lenders interpreted the benchmark as a hard limit on lending.

APRA's actions to slow new lending in what it determined are higher risk areas resulted in higher interest rates on both new and existing investment loans, boosted lenders' profit on home loans, and saw a decline in competition from some smaller lenders in the home loan market. 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 partially offset by increased tax paid by the lending institutions on their profits).

Differences in the underlying risk of an ADI's loan book should be the basis for such interventions. 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.

APRA's new capital holding requirements for banks that offer warehouse funding similarly take a comparatively blunt approach — focused on the prudential outcome for the major banks with little apparent consideration of the impacts on those institutions (and lending) that rely on warehouse funds. At the margin (the only area where price competition seems a reasonable probability, in a highly regulated market), competition is consequently likely being 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. For the non-ADIs (that are not prudentially regulated and are not likely to represent a systemic risk), how the new warehouse funding requirements would impact on this segment of the lending market should have been comprehensively assessed before such measures were introduced. In the absence of this assessment, implementation of the new capital holding requirements should, in the first instance, apply only to those warehouse funds provided to ADIs. Further consideration should be given to the funding sources and costs for non-ADIs before they are covered by the measure.

Some other regulatory measures are also likely to come with significant costs

Other regulatory measures, such as which institutions can use the descriptor ‘bank’, have created artificial barriers to entry and innovation. Such measures have also potentially hindered the growth of smaller institutions, with consumer perceptions that ‘banks’ are somehow more secure than non-bank financial institutions.

The Government should prioritise for completion by end-2018 any changes being considered to facilitate new entry and expansion of existing market participants, including phased licensing for authorised deposit-taking institutions, and changes to shareholding rules for entrants.

Stability and competition must co-exist

The interaction between competition and financial stability is a conceptual and practical challenge for financial regulators (box 1). It is only in those markets (such as retail banking) where liquidity is a material risk, that the impact of competition on stability is potentially an issue. However, to the extent that adverse outcomes from competition eventuate in some product areas and are able to threaten liquidity in others (for example through a major commitment to vertical or horizontal integration), a broader consideration of the interaction of product markets is also warranted.

Competition and stability in the financial system can coexist, 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.

The Commission’s assessment is that while *unmonitored* competition could result in risky ventures — and Australia does not have unmonitored competition — desirable growth in employment and national welfare is necessarily fuelled by risk-taking. We cannot therefore simply prefer stability, without acknowledging a significant cost to economic activity from having that as a default position. And there is no detectable evidence of risk to Australia’s financial system from integration, even in the GFC.

Box 1 **Stability and competition**

Australia has a well-established system of financial regulation, which has served the country well in ensuring stability across financial markets in recent years. While the regulatory framework is effective at promoting stability in all aspects of the financial system, it is the balancing of stability with competition in banking that attracts debate.

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 undermined. The potentially devastating consequences of an unstable financial system on the welfare of households and businesses and the operation of an economy are well apparent in those overseas countries that were less well placed to cope with the global financial crisis.

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 — a ‘too big to fail’ scenario that characterises banking in Australia and many other countries (although at its extreme, a financial system that contains only one or two large dominant providers that are too big to fail could be very stable, at least in the short term). Competition can also stem distortions presented by large banks that might have become subject to internal inefficiencies and increased operational risk, deliver more consumer-oriented products and lower interest rates in the economy, reducing the risk of borrower default.

On the other hand, some regulators consider that strong competition could erode standards of conduct and cause banks to take more risks in lending activity and undermine system stability. This could occur because competition lowers margins and profits of banks, potentially making them more willing to take higher risk than they otherwise would and less able to withstand negative shocks (for given capital holdings). Competition could also lead banks to focus on increasing market share with less regard to the credit worthiness of borrowers. APRA considers that Australian banks’ lending on interest-only home loans was evidence of competitive pressures eroding stability.

Our view is that competition and stability in the financial system can coexist but not at the extremes: adding competitive pressures to a highly oligopolistic system could initially increase stability as borrower risk drops, but vigorous competition could become destabilising if banks attempt to maintain shareholder returns by taking higher levels of risk. Australia, with an oligopolistic banking system, is likely somewhere between the ‘no competition’ and ‘vigorous competition’ extremes: in some product markets there is considerable scope to increase competition, subject to regulatory oversight, without increasing the risks to financial stability.

Who should promote financial system competition?

Given the size and importance of Australia’s financial system, and the increase in 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 Commission envisages that a designated competition champion would not be a new regulator, but rather, a designated entity that holds all parties in the financial system to

account on competition. Such an entity should also undertake functions that include: transparent analysis of impacts of prudential and other regulatory measures on competition; recommend action where integration imposes barriers to competition; and ex-ante testing of the impacts on competition and community outcomes of additional provider integration.

This analysis has the virtue of also offering the basis for an ex-post evaluation. The absence of evaluations is a common failing of many Australian regulatory systems.

We considered two possible candidates for a government body that would champion competition when decisions on financial system interventions are made at the CFR: the ACCC and ASIC. APRA and the RBA have not been included as options since their primary focus is rightly, and should remain, financial stability.

Option 1 — ACCC

As Australia's competition and consumer regulator, the ACCC may be well placed to take on the role of competition champion in the financial system. The ACCC has expertise in assessing competition issues across the economy and a newly established role in reviewing major bank responses to the bank levy.

There are, however, several challenges that the ACCC would need to overcome. Primary among these are issues that arise from the sheer size of the financial system and the pivotal role it plays in the Australian economy. Unless a substantial level of dedicated resources are made available, the need to pay greater attention to competition in the financial system would likely skew the ACCC's focus towards financial services at the expense of other parts of the economy, or limit the regulator's ability to monitor competition developments in the financial system as closely as required.

We envisage that the role of competition advocate would be proactive. For the ACCC, this would mean a switch in both legislated powers and culture from its current (largely and legitimately reactive) role with regard to competition. Furthermore, although its powers extend to some parts of the financial system, the ACCC is not currently an ongoing presence in either financial system regulation or policy setting and it does not have a regular seat on the Council of Financial Regulators (CFR).

To overcome these limitations, the ACCC would need additional authority to intervene at CFR and to be made a permanent member of the Council, particularly as CFR becomes (as we propose) the principal forum for discussing the competition effects of proposed regulatory changes.

Option 2 — ASIC

A second option is to task ASIC with this role. ASIC already has the legal authority for consumer protection in the financial system and has direct powers to intervene, as the regulator responsible for financial system licensing, conduct and disclosure, and consumer outcomes.

Unlike the ACCC, ASIC operates primarily within the financial system — although its responsibilities under the *Corporations Act 2001* (Cth) do give it a national perspective. It already has the expertise and capability to analyse competitive behaviour across a broad range of markets for financial products, and it can do so within its existing scope of operations. There is considerable synergy between its existing responsibilities and the need to advance competition in the financial markets. The Government has already committed to adding competition explicitly to ASIC’s mandate, although the form of that mandate has not been settled.

As the only member of the CFR with a clear orientation towards advancing *consumers’* interest in financial products, ASIC is in a position that would enable it to influence the actions of other financial regulators without the need to change existing institutional arrangements. That it has not already done so is of concern. Although to be fair, neither has the Government given ASIC advice that proactive effort focusing on its regulatory partners is required in this era of ‘unquestionably strong’ thinking.

Turning ASIC into a strong and pro-active financial system advocate for competition would require changes to its culture. Structural change might also become relevant and we seek information on this.

Principle among these changes would be the need for ASIC to move beyond just an enforcement regulator, to plan, prepare and advocate for greater competition in the financial system in a systemic way. The UK’s Financial Conduct Authority (FCA) takes this role. Its approach would provide important lessons for ASIC in refocusing its culture on proactive regulation, to achieve both effective competition and consumer protection. Created post GFC, the FCA has an objective to promote effective competition in consumers’ interests in regulated financial services, including to identify and address competition problems and adopt a more pro-competition approach to regulation.

Shedding light on regulator decision making

As part of the broader adjustment in regulatory focus required, greater transparency around decision making by the financial regulators, including the CFR, is essential to ensure accountability and an active consideration of effects on competition.

As a first step in this process, and as a matter of priority for the Government, the Statements of Expectations for ASIC and APRA need to be updated from their 2014 versions and reported against annually. Such statements would 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 draft report should influence those documents.

The decisions made at the CFR are profound in their impact on the financial system and the economy but there is no public transparency around them. Regulation has tended to err on

the side of financial stability. Due to a lack of transparency, it is difficult to establish whether this approach is justified in all cases.

The CFR's consideration of competition analysis (and other market interventions) should be minuted and published, as the RBA Board meetings are. An assessment that analyses in depth the competition implications of a proposed regulatory intervention should be discussed at the CFR meeting prior to the intervention starting. Regulators should, in their Statement of Expectations, be required to consider amending policies to alleviate adverse impacts on competition.

Getting more competition in the payments system

The majority of retail payments in Australia are now made through non-cash methods — Australia has the fourth highest number of non-cash payments per person, the highest level of contactless card use in the world and digital payments are growing at an estimated 10% per year. The payment system is a part of the financial system that has attracted much fintech activity (in part because of the comparatively low start up requirements), including from major tech firms such as Apple and Google.

Giving merchants a choice

Card payment systems are dominated by the major banks (as the issuers of over 70% of Australia's debit and credit cards), and the global card schemes, MasterCard and Visa (which enable over 80% of credit card payments).

The larger banks also offer acquiring payments services to merchants, usually bundled with card acceptance facilities. This market is slightly less concentrated than the market for card issuers, with strong growth in recent years by institutions such as Cuscal, Tyro, Indue and Square, and a number of new entrants.

The dominance of the major credit card schemes has been reinforced by developments such as 'tap and go' facility at point of sale, which defaults dual network card payments through the higher charge credit card route rather than the lower cost eftpos system.

Because of the limited technology offered to merchants by banks, consumers and merchants in Australia have little practical choice about payment pathway at the point of sale. In many overseas countries, either the merchant or the card holder is given the choice of payment pathway for dual network cards. In the United States, for example, merchants are given scope to select from at least two payment pathways and change between these; in Malaysia, merchants have first choice of the default pathway but the customer can override it. The technology is readily available to offer dual payment choice in Australia and we consider this must now be mandated.

The fees banks charge each other for card payments are passed on to merchants. These are, in turn, paid by consumers either as surcharges on particular purchases or more commonly in the case of smaller merchants, as higher prices overall. In practice, the fees also vary with the types of cards — a customer who pays with a premium credit card may cost the merchant a higher fee than a customer who pays with a basic ‘no frills’ card. To give merchants some control over their payments system costs, we consider that merchants should be given the capacity to select their own default route that is to be used for payments by dual network cards.

Regulation of bank interchange fees and surcharging has proved complex and there is little genuine commercial justification for interchange fees. The Payments System Board of the RBA should ban, by mid-2019, all card interchange fees as a way to lower overall costs to users.

Creating clear thresholds for when regulation begins

Digital wallets such as Apple Pay complement existing payment methods by providing another way to access card schemes and bank transfers — for example, use of apps on a mobile phone, rather than a physical card, to make payments. Some digital wallets, such as PayPal, have also developed their own purchased payment facilities (PPF), which act as a competitor to traditional payment methods. PPFs compete directly with debit cards, credit cards and traditional bank transfers. In Australia, PayPal now has over 6 million active customer accounts.

PPFs that are ‘widely available’ and redeemable upon demand for Australian currency, such as PayPal’s stored balance, are prudentially regulated by APRA. PPFs that are not widely available or not redeemable for Australian currency (such as electronic road toll devices) are either authorised or exempted by the RBA. Between the two regulators is a gap in which PPFs such as Alipay and WeChat (that have funds held in digital wallets that can be withdrawn to foreign bank accounts) operate.

PPFs may be a significant source of competition in the future. For this reason, a two tier regime for PPFs should be created to encourage innovation and offer an important alternative to incumbent payments systems. Under such a regime, PPFs without systemic risk would be *not regulated* if a consumer has only minimal funds (\$500 or less) at risk and the PPF has less than \$50 million in total stored value. The present system seems to have this thought in mind, but in practice there is an unnecessary grey area.

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 mistaken payments) should be made mandatory for any organisation that sends or receives electronic payments, with more clearly defined liability provisions.

The new payments platform requires an Access Regime

The new payments platform (NPP), to be operational in early 2018, enables transaction settlement in real time. The NPP was set up, and is mutually owned by 13 initial shareholder participants (including 9 banks, 3 key payment facilitators, and the RBA).

The NPP is expected to reduce *technical* barriers for new financial institutions to enter the payments system. The basic infrastructure of the NPP gives new entrants the ability to join the network using one single connection, rather than establishing bilateral links with all of the existing participants, a notable efficiency. Institutions can also choose to join the network by using an outsourcing arrangement to a shareholder participant who is already connected. It is, however, up to the board of the New Payments Platform Australia Limited (NPPA) (which includes 7 banks) to determine whether or not to accept an applicant.

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 impending model requires new competitors to be accepted by the initial participants, which could reasonably be expected to involve conflicts of interest. A recent sample 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 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 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.

Strengthening the power of consumer choice

In the absence of a shift in orientation on the provider side to a more consumer-oriented approach to business, reforms to enable consumers to more readily switch providers of financial services provide perhaps the greatest scope to bring about more competition in those retail banking and insurance markets where it is costly (or not possible) for a consumer to hold multiple versions of the same product (such as home loans or insurance policies for a given item).

While not all financial institutions are the same, the vast majority are using tactics designed to lure new customers in and then exploit the system complexity to retain them.

Measures that should be prioritised to help consumers become a competitive force in the longer term include:

- consumer rights to have their financial data transferred directly from one service provider to another, either facilitated through Open Banking arrangements or as part of a more broadly-based consumer data right
- automatic reimbursement of the ‘unused’ portion of lenders mortgage insurance when a consumer terminates the loan
- payment system reforms that help detach consumers from their financial providers
- provision of information on median home loan interest rates provided in the market over the previous month
- inclusion on insurance premium notices, of the previous year’s premium and percentage change.

In contrast to many banking products, consumers are reminded annually of their option to renew general insurance policies. Despite this, renewal of existing insurance policies is the default taken by many consumers. Yet there is a wide disparity between insurers in quotes for essentially the same risks and customer passivity is exploited by providers. The scope is considerable for improvement in consumer outcomes from more information on insurance renewal, such as by inclusion of the previous year’s premium and percentage change on renewal notices.

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.

Reforms that give individuals a greater role in competitive outcomes

Consumers are in a weak position in financial services. Reforms aimed at improving the opportunity for individuals to defend their own interests can largely be achieved within the existing regulatory oversight framework.

Usable information, without the overload

Ensuring a critical mass of consumers have sufficient information to make informed decisions is necessary for a competitive outcome. Financial service providers in the product markets we examined have largely shifted liability to individuals via terms and conditions that are too dense, multi-layered, and poorly designed to understand. An exception is wealth management, under the Future of Financial Advice (FOFA) reforms.

Overwhelming evidence demonstrates that few consumers either read or understand terms and conditions for products purchased, and it would not be hard to conclude that a segment of the financial system is motivated to keep it that way. Financial literacy of the general population is also low. Even when ‘consent’ has been given, there can be a clear lack of understanding of terms and conditions of consent, and the ‘take it or leave it’ nature of many products discourages consumer engagement. This can be particularly problematic for disadvantaged consumers who may face both economic and social barriers in accessing financial products, but the problem is widespread.

A new design and distribution regime being considered by Government is intended to, at least partly, remedy the apparent shift in liability. The proposed regime would impose obligations directly on issuers and distributors of products to identify appropriate target and non-target markets for their products, and use distribution channels that take this into account.

Such a regime should be an approach to financial product disclosure that recognises incentives faced by providers and the realities faced by consumers, and takes advantage of digital data published in real time to show what the market opportunities are.

Knowing how your home loan rate stacks up with what others are actually paying

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. It is an unusual market indeed, when consumers are conditioned to expect a discount from a published comparison rate, but that rate is most often *not* the market price.

To improve the negotiating power of consumers, data should be collected on an ongoing basis from lending institutions by APRA on the interest rates for pre-determined and commonly used categories of new residential home loans. This data should be published regularly (monthly) on ASIC’s website in a form that would enable consumers to determine, for their particular circumstances, what home loan interest rate others in those same circumstances have received. Currently available digital data collection methods allow close to real time updating of such data.

Even in financial advice, all is not solved

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).

Dealing with conflicted brokers

With just over 50% of all new home loans now originating through mortgage brokers, the competitiveness of Australia’s home loan market centre is substantially dependent on incentives faced by home loan providers, brokers and aggregators (intermediaries between lenders and brokers) being aligned to customers’ best interests when advice is being given.

Particular concerns are that: commission payments made by lenders to aggregators and brokers are high (compared with other financial services and brokers overseas); and there is a lack of awareness by borrowers about how much their broker is being paid and how the payments are structured to keep borrowers in a loan, even if it is no longer a competitive product. Mortgage brokers receive, on average, an upfront payment from lenders of around 0.6% of the loan value and a trailing commission of just under 0.2% of the loan outstanding per year over the life of the loan. For an average loan value and duration, this amounts to a total fee of around \$6000 per loan (compared with \$200 to \$700 for basic financial advice).

Further, the ownership of aggregators by lenders exacerbates potential conflicts of interest for brokers and carries the obvious risk that consumers have an illusion of choice rather than genuine choice in the market. In particular, the commission structure by which brokers are paid, combined with any incentives related to aggregator ownership, may mean that home loan options presented to consumers are limited. Mortgage aggregators and brokers *that are owned by lenders* should consequently be required to have a duty to act in consumers’ best interests.

Transparency to mortgagees of broker fees and commissions would also help improve outcomes for the community.

Addressing the power imbalance with add-on insurance

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. ASIC has exposed very poor practices in this market.

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.

Draft findings and recommendations

Competition framework and assessment

DRAFT FINDING 2.1 KEY FEATURES OF WORKABLE COMPETITION IN THE FINANCIAL SYSTEM

The key features of *workable competition* in Australia's financial system must include:

- an open digital information capacity for consumers to assess how prices or features vary between products and choose (including switching to) preferred products
- consumers actively supported by public advice or private advisers to conveniently make informed decisions regarding aspects such as risk (including credit worthiness)
- an Open Banking regime that gives consumers perpetual access to their data that is useful to other providers, with the capacity to see it safely moved from one provider to another
- minimal limits to entry by new providers, and expansion by existing providers, into regulated product markets (subject to other regulatory objectives such as prudential outcomes)
- regulators more open-minded towards innovation and aware of the effects of their actions on weakening competition and creating consumer detriment
- effective scrutiny of the adverse use of market power by any participant or set of participants.

DRAFT FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST

Competition and stability are both important to the Australian financial system. In order to preserve both, a genuine debate is essential before every material regulatory intervention.

The stability of Australia's financial system has increased since the global financial crisis and prudentially regulated institutions are unquestionably strong. However, competition has suffered. It is important to ensure that the essential role of competition in economic growth is not eroded further by having stability as the default regulatory position.

DRAFT FINDING II.1 STATE OF COMPETITION IN THE FINANCIAL SYSTEM

Australia's banking sector is a strong oligopoly with a long tail of smaller providers. The general insurance sector similarly has a small number of very large providers and a long tail of smaller providers.

Prudential regulation substantially limits the scope for traditional price competition in banking and, to a degree, in insurance. The Reserve Bank of Australia setting of cash rates offers an opportunity for coordinated pricing in banking that is unique to this industry.

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

- Although at less than desirable levels, there is evidence of more competition (albeit on product features rather than price) in the markets for home loans, consumer credit cards, home insurance, wealth management and financial advice.
- There is evidence of less competition in the markets for small business credit, lenders mortgage insurance, add-on insurance and pet insurance.

DRAFT FINDING III.1 CONSUMERS' CAPACITY TO PUT COMPETITIVE PRESSURE ON PROVIDERS IS OFTEN LIMITED

For many financial products, consumers are limited in their responses to variations in price and service and currently cannot be a source of significant competitive pressure on financial institutions. Consumers face information and switching barriers; and they perceive insufficient ongoing difference between providers and product offerings to make the process of switching worthwhile.

The landscape of retail banking

DRAFT FINDING 3.1 THE MAJOR BANKS' OLIGOPOLY POWER

Australia's four major banks hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is further 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 — without losing market share.

The smaller banks and non-bank financial institutions follow the pricing trend set by the major banks, where they can. 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.

DRAFT FINDING 4.1 A CONSOLIDATION IN BANKING

In the past decade, there has been substantial consolidation in Australia's banking system. The number of organisations with a banking licence reduced by more than 30%. This was largely a result of mergers between institutions, rather than exits.

DRAFT RECOMMENDATION 4.1 REDUCING REGULATORY BARRIERS TO ENTRY AND EXPANSION

The Australian Prudential Regulation Authority (APRA) and the Australian Government should prioritise reforms that reduce regulatory barriers to entry and expansion in banking.

- APRA should finalise and implement its phased approach for licensing authorised deposit-taking institutions (ADIs) and revise its policies and guidelines for removing restrictions on the use of the term 'bank'.
- The Australian Government should determine revised ownership rules (including a higher threshold on ownership) under the *Financial Sector (Shareholdings) Act 1998* (Cth) to improve access to capital for both new entrants and existing banks. For existing ADIs, share ownership limits should be reviewed, without the presumption of the Four Pillars policy.

These reforms and determinations should be completed no later than end-2018.

DRAFT FINDING 4.2 FOREIGN BANKS REMAIN PREDOMINANTLY NICHE OPERATORS

Foreign banks have shown that they are willing to enter Australia's banking system — between 2007 and 2017, all 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 most foreign banks thus remain relatively niche operators, offering financial services to subsets of the population, they cannot be relied on to be the primary source of new competition in the retail banking sector.

DRAFT 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 wealth, small-scale lending and payments systems. It remains to be seen if and how global technology companies will compete in banking and the broader financial system.

DRAFT FINDING 4.4 FINTECH COLLABORATION AND COMPETITION

Many fintechs are attempting to work with and provide services to incumbent banks, rather than compete against them. Incumbent banks are also looking to collaborate with fintechs as a way to innovate and lower the threat of future competitors.

While this is a legitimate and sensible commercial strategy for many, it means that these fintechs are unlikely to provide the basis for vigorous competition against incumbent banks in the near future.

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

INFORMATION REQUEST 4.1 SHOULD ASIC'S REGULATORY SANDBOX BE EXTENDED?

Should the fintech licensing exemption offered under the Australian Securities and Investments Commission's (ASIC's) regulatory sandbox be extended to prudentially regulated fintechs that want to take retail deposits and issue other eligible financial products? If extended, would:

- *an extension encourage new fintechs to become banks or providers of financial products*
- *any additional consumer protections be necessary to prevent poor conduct and retain consumer confidence?*

DRAFT FINDING 5.1 COST OF FUNDS FOR DIFFERENT SIZE BANKS

Larger authorised deposit-taking institutions (ADIs) benefit from lower costs of funding, compared with smaller institutions, as they can access funding markets overseas more easily and have higher credit ratings, which in part reflect an expectation of government support.

In addition, larger institutions gain a cost advantage from being allowed to use risk weights that are lower than the Australian Prudential Regulation Authority's standard requirements.

These lower costs of funds are not fully passed on to borrowers in the form of lower interest rates.

Attempts to artificially raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and harm consumers.

DRAFT FINDING 6.1 COST OF APRA INTERVENTIONS ON HOME LOANS

The Australian Prudential Regulation Authority's (APRA's) actions to slow interest-only lending on residential property in early 2017 resulted in higher interest rates on both new and existing residential investment loans, despite the regulatory objective being to slow 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.

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

The residential home loan market

DRAFT FINDING 8.1 INTEREST RATES FROM BROKERS VS OTHER CHANNELS

Home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels. Further analysis is needed to inform the Commission's view of the sources of such differences and whether they are significant.

DRAFT FINDING 8.2 COST OF HOME LOANS THROUGH BROKERS VS BRANCHES

Mortgage brokers enable smaller lenders to gain wider reach, increasing product variety in the home loan market. Whether brokers are an efficient, lower-cost distribution channel for lenders depends in large part on the way lender branch costs are apportioned between different activities.

That the providers of half of Australia's home loans were unable to give evidence on how they assess the costs and benefits of using brokers rather than branches to source home loans is surprising.

DRAFT RECOMMENDATION 8.1 DUTY OF CARE OBLIGATIONS FOR LENDER-OWNED AGGREGATORS

The Australian Securities and Investments Commission should impose a clear legal duty on mortgage aggregators *owned by lenders* to act in the consumer's best interests. Such a duty should be imposed even if these aggregators operate as independent subsidiaries of their parent lender institution, and should also apply to the mortgage brokers operating under them.

INFORMATION REQUEST 8.1 HOW SHOULD NEW DUTY OF CARE OBLIGATIONS FOR LENDER-OWNED AGGREGATORS BE IMPLEMENTED?

How should obligations on lender-owned aggregators to act in clients' best interests be imposed? Can such obligations be imposed under the current regulatory and licensing regime (the National Consumer Credit Protection Act 2009 (Cth)), or is there a need for a separate regime for mortgage aggregators and brokers?

INFORMATION REQUEST 8.2 SHOULD CONSUMERS PAY BROKER FEES FOR SERVICE?

Should consumers pay mortgage brokers directly through fees for service (rather than brokers receiving commissions from lenders)? What is the likely effect on consumers' use of brokers and on home loan providers' ability to source home loans through brokers? What is the likely effect on brokers' incentives to recommend loans to consumers?

DRAFT RECOMMENDATION 8.2 MORTGAGE BROKER DISCLOSURE REQUIREMENTS

The Australian Securities and Investments Commission should require that before mortgage brokers recommend loans to consumers, they must have a discussion with consumers about, and provide plain-English documents to consumers on:

- the types of products offered by different lenders (including white-label loans and which lender provides the funding for them) and associated loan features
- the role of mortgage brokers in matching borrowers with home loan providers, including how brokers are limited in their ability to help consumers apply for loans from all lenders because not all lenders are on the aggregator's panel or the broker is not accredited with a particular lender
- how mortgage brokers are paid (including specific information about their payment arrangements)
- any ownership relationships between lenders and the aggregator, and the requirement for brokers to act in consumers' interest where an ownership relationship exists (draft recommendation 8.1).

Specific details regarding the information provided and the way it is presented should be developed through consumer testing to ensure that consumers understand the information, and the effect of these measures should be reviewed after they have been implemented.

DRAFT RECOMMENDATION 8.3 COLLECTION OF HOME LOAN INTEREST RATE DATA

As part of the modernised Economic and Financial Statistics collection, the Australian Prudential Regulation Authority should, on behalf of the Australian Securities and Investments Commission, collect monthly data from mortgage lenders (ADIs and non-ADIs) on median interest rates for different categories of new residential home loans.

The categories of loans should be developed through consultation, but the data to be collected may include that relating to features of the loan or borrower, such as:

- the size and length of the loan
- the loan-to-value ratio
- loan fees
- the type of borrower (owner-occupier or investor)
- the type of repayments (principal-and-interest or interest-only)
- the type of interest rate (fixed or variable), and, for fixed rates, the length of the fixed period
- the credit rating(s) of the borrower(s)
- the nature of employment of the borrower(s) (for example, permanent full time, permanent part time, self-employed)
- the industry of employment of the borrower(s).

DRAFT RECOMMENDATION 8.4 INTEREST RATE TRANSPARENCY FOR HOME LOANS

The Australian Securities and Investments Commission should, using data collected on its behalf by the Australian Prudential Regulation Authority (draft recommendation 8.3), develop an online tool that:

- allows consumers to select different combinations of loan and borrower characteristics
- reports median interest rates for loans issued in the previous month with those characteristics, by lender
- details the specific fees and charges that would affect the total cost of a loan.

The Australian Prudential Regulation Authority should also publish the underlying data in a way that is accessible to third parties such as web application developers, so that these parties are able to develop comparator websites 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.

DRAFT RECOMMENDATION 8.5 LENDERS MORTGAGE INSURANCE REFUND

The Australian Government should require all lenders to offer home loan customers refunds for the cost of lenders mortgage insurance when customers choose to refinance or pay out their loan. The refund schedule for the remaining life of the loan should be set and made available to the borrower at the time the policy is started.

DRAFT FINDING 8.3 IF YOU HAVE A HIGH LOAN-TO-VALUE RATIO, YOU ARE PROBABLY PAYING FOR IT TWICE OVER

Home loan consumers with a loan-to-value ratio in excess of 80% are often required to compensate lenders twice for this risk: by bearing the cost of lenders mortgage insurance, and also by paying a higher interest rate on their home loan, even after other loan and borrower characteristics have been accounted for.

INFORMATION REQUEST 8.3 ARE CHANGES NEEDED TO LENDERS MORTGAGE INSURANCE?

Are there any circumstances in which it is reasonable for a home loan consumer to be paying both lenders mortgage insurance and a higher interest rate? If not, what changes could feasibly be implemented?

Competition in credit provision to small and medium businesses

DRAFT RECOMMENDATION 9.1 STANDARDISED RISK WEIGHTINGS FOR SME LENDING

Instead of applying a single risk weight to all small and medium business lending not secured by a residence, the Australian Prudential Regulation Authority (APRA) should provide a broader schedule of risk weights in its 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. International best practice should be closely considered.

In light of apparent major improvements in the use of Artificial Intelligence algorithms and data collection via the new payments platform, APRA should consider proposals by ADIs for variations to the standardised risk assessment for business lending, based on their data and risk management systems.

Integrated services and the provision of warehouse funds

DRAFT FINDING 7.2 NEW 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 between smaller authorised deposit-taking institutions (ADIs) and non-ADIs. This will increase the costs of warehousing and reduce the competitiveness of those institutions that rely on warehouse funding.

INFORMATION REQUEST 7.1 HOW WILL PRUDENTIAL STANDARD APS 120 AFFECT YOU?

We are seeking detailed estimates or hypothetical scenarios of how revised APS 120 will affect warehouse costs for standard ADIs and non-ADIs.

We are also seeking estimates of the costs of obtaining similar levels of finance to that obtained through warehousing, such as through commercial loans in retail markets.

DRAFT RECOMMENDATION 7.1 A PROPORTIONATE APPROACH TO RISKS NON-ADIs POSE

The implementation of the revised Prudential Standard APS 120 that came into effect on 1 January 2018 should be revised and limited in its effect, in the first instance, to warehouse funds provided to authorised deposit-taking institutions (ADIs). Prior to any later extension of the standard funds provided to non-ADIs, the costs to non-ADIs of changes to regulatory capital requirements for the provision of warehouse facilities should be subject to a public cost-benefit analysis that includes calculation of regulatory capital costs and any pass-through.

DRAFT RECOMMENDATION 7.2 BUILDING AN EVIDENCE BASE ON INTEGRATION

Firms that are undertaking mergers or acquisitions within the financial system — including banks, insurers and other financial services firms — should notify the Australian Competition and Consumer Commission and the Australian Securities and Investments Commission (ASIC) on the nature and size of these acquisitions as they undertake them.

ASIC should maintain a publicly accessible database of the relationships between parent and subsidiary companies, and report annually on all notifications received.

Competition in the payments system

DRAFT RECOMMENDATION 10.1 REVIEW REGULATION OF PURCHASED PAYMENT FACILITIES

The Australian Prudential Regulation Authority should, either itself or outsourced elsewhere, design a tiered prudential regime for Purchased Payment Facilities to reduce barriers to growth.

- Purchased Payment Facilities with total stored value below \$50 million and individual holdings of no more than \$500 would not face prudential regulation.
- The lower prudential tier would maintain the current 100% liquidity ratio requirement but reduce other prudential requirements to lower compliance costs.
- The higher prudential tier would reduce liquidity requirements but strengthen other prudential requirements.

These reforms should be implemented no later than mid-2019.

DRAFT RECOMMENDATION 10.2 MAKING THE EPAYMENTS CODE MANDATORY

The Australian Securities and Investments Commission should amend the ePayments Code to make subscription to the code mandatory for any entity that intends to send or receive electronic payments.

INFORMATION REQUEST 10.1 HOW SHOULD LIABILITY FOR UNAUTHORISED TRANSACTIONS BE SHARED?

What would be the costs and benefits of different ways that liability for unauthorised transactions under the ePayments Code may be shared between financial institutions and third parties, including participation in financial dispute resolution schemes? This includes the feasibility of having Code subscribers provide unique access details to third parties approved by customers.

We are also interested in stakeholder views about whether the new Open Banking policy (once implemented) could be relied upon as a better alternative for secure, shared access.

DRAFT RECOMMENDATION 10.3 BAN CARD INTERCHANGE FEES

The Payments System Board should introduce a ban on card payment interchange fees by mid-2019.

Any remaining fees should be directly related to the costs of operating the system. Such fees should be made transparent and published.

DRAFT RECOMMENDATION 10.4 MERCHANT CHOICE OF DEFAULT NETWORK ROUTING

Merchants should be given the ability to choose the default network to route contactless transactions for dual-network cards. As the technology is readily available, this option should be offered from 1 January 2019 at the latest.

The Payments System Board should require that neither a scheme, nor any of its participants (including issuers and/or acquirers), can prevent merchants from setting (or asking their acquirers to set) the default route.

DRAFT RECOMMENDATION 10.5 ACCESS REGIME FOR THE NEW PAYMENTS PLATFORM

The New Payments Platform (NPP) is a significant piece of national infrastructure that can benefit competition in retail banking and payments. But more transparency is needed to facilitate third-party access. The NPP should be subject to an access regime imposed by the Payments System Board.

As part of an access regime, the Payments System Board should:

- review the fees set by participant entities of the NPP and transaction fees set by New Payments Platform Australia
- require all transacting participant entities that use an overlay service to share de-identified transaction-level data with the overlay service provider
- consult the Australian Competition and Consumer Commission on the final design of the data sharing obligations.

DRAFT FINDING 10.1 THE NEW PAYMENTS PLATFORM COULD DO MORE TO EASE CUSTOMER SWITCHING

The New Payments Platform's addressing service, PayID, has the potential to improve competition by making it easier for customers to switch financial institutions or products.

However, at launch, PayID will have very limited functionality.

New Payments Platform Australia Limited and its participating financial institutions have the capacity to improve the capability of PayID to give customers the ability to both send and receive *recurring* bank transfers, direct debits and card payments.

Changing bank accounts with many direct debits, or credit cards with recurring charges, would then require only a single update, removing one of the apparent reasons why there is limited switching of accounts.

Competition in general insurance

DRAFT FINDING 11.1 MARKET POWER IN GENERAL INSURANCE PROVISION

Because many general insurers provide insurance under multiple brands, this creates the illusion of more competition than actually exists in the general insurance market.

In every general insurance market considered — home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance — the largest four firms (which are not always the same four) account for more than 70% of the relevant market.

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

DRAFT FINDING 11.2 CONSOLIDATION OF GENERAL INSURERS

Australian general insurance markets have consolidated over the past 10 years. Despite some new entrants (including from overseas), mergers and restructures and exits have reduced the overall number of providers. Some of the new entrants have since been acquired by other insurers that are pursuing strategies of growth through acquisition. Of those remaining, many have links with banks and other large retailers, and some are niche providers that specialise in particular insurance lines.

DRAFT RECOMMENDATION 11.1 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.

DRAFT RECOMMENDATION 11.2 TRANSPARENCY ON INSURANCE UNDERWRITING

On the same part of an insurance brand's website that contains the information about which insurer underwrites their product, a list of any other brands that are underwritten by the same insurer, for that particular form of insurance, should be included.

Insurers should provide an up-to-date list of the brands they underwrite to the Australian Securities and Investments Commission (ASIC). ASIC should publish this information as a transparent list on its website.

DRAFT RECOMMENDATION 11.3 PHASE OUT DISTORTIONARY INSURANCE TAXES

Consistent with the Commission's 2014 Natural Disaster Funding Inquiry (recommendation 4.8), state and territory taxes and levies on general insurance should be phased out. This should commence from mid-2018.

Improving outcomes for consumers

INFORMATION REQUEST 12.1 POTENTIAL TO INCREASE THE SCOPE OF FINANCIAL ADVICE TO INCLUDE SOME CREDIT PRODUCTS

The Commission is considering recommending that ASIC-licensed financial advisers be able to provide advice on some credit products, in particular home loans, personal loans and credit cards. We seek views on:

- *the merits of such a proposal*
- *which credit products should be included in this increased scope to provide advice*
- *the nature of any duty advisers would have to their clients*
- *different licensing approaches including the form of the licence*
- *the regulatory costs and impact on the industry.*

DRAFT RECOMMENDATION 12.1 RENAME GENERAL ADVICE TO IMPROVE CONSUMER UNDERSTANDING

General advice, as defined in the *Corporations Act 2001* (Cth), is misleading and should be renamed. The Commission supports consumer testing of alternative terminology to ensure that misinterpretation and excessive reliance on this type of promotional information is minimised.

The term 'advice' should only be used in association with 'personal advice' that takes into consideration personal circumstances.

INFORMATION REQUEST 12.2 RENAMING GENERAL ADVICE AND MERITS OF FURTHER CHANGES

In implementing draft recommendation 12.1, we request feedback on:

- how the scale of transition costs associated with renaming general advice could be minimised, including the effect of varying the transition timeframe*
- barriers or unintended consequences of such a change, including licensing implications.*

We also seek information on the merits of:

- redefining the activities that are currently regulated under general advice and providing a more customised regime for some activities*
 - removing licensing and regulatory obligations currently associated with some or all forms of general advice.*
-

DRAFT FINDING 7.1 CONSOLIDATION IN ASSET MANAGEMENT AND FINANCIAL ADVICE

The Future of Financial Advice reforms appear to have contributed to consolidation in the asset management and financial advice markets. Consumers may be better protected against poor advice, but be offered a narrower range of in-house products.

INFORMATION REQUEST 13.1 TO WHAT EXTENT DOES HOLDING MULTIPLE ACCOUNTS REDUCE OR ENABLE SWITCHING?

We are seeking information about consumers who hold multiples of the same financial product, such as payment cards and deposit accounts. This includes information about:

- how product holdings are distributed across the Australian population*
 - how many of these products are inactive or not being used*
 - the extent to which consumers ‘switch’ providers or products without closing old accounts.*
-

DRAFT FINDING 13.1 MORTGAGE BROKER COMMISSION STRUCTURES WEAKEN CONSUMER SWITCHING

The payment of trail commissions creates perverse incentives for mortgage brokers by rewarding them for keeping customers in their existing loan. Broker loyalty appears skewed towards the institution, not the customer, and thus likely discourages refinancing.

The inclusion of commission clawbacks in the remuneration structure for mortgage brokers acts as a direct disincentive to consumer switching of home loans.

INFORMATION REQUEST 13.2 IS THERE A RATIONALE FOR THE STRUCTURE OF MORTGAGE BROKER COMMISSIONS?

The Commission is considering making a recommendation to the Australian Government on the matter of trail commissions and commission clawbacks. We are seeking feedback on the rationale for how mortgage broker commissions are structured. This includes the contractual or other obligations imposed on brokers in connection with:

- *trail commissions*
- *trail commissions that increase over time*
- *commission clawback.*

DRAFT FINDING 13.2 TICK AND FLICK HAS NOT BEEN EFFECTIVE

The ‘tick and flick’ account switching facility has not been effective at facilitating bank account switching for customers due to low awareness about the reform and delays in actioning a switch.

The low cost of retaining duplicate transaction accounts may also be a factor that reduces the importance of facilities such as tick and flick.

INFORMATION REQUEST 13.3 WHAT RED TAPE BARRIERS TO SWITCHING PERSIST?

To what extent do ‘red tape’ barriers to consumer switching persist in Australian financial markets? Such barriers may include:

- *contractual restrictions on switching*
- *unnecessary administrative or bureaucratic processes imposed by providers*
- *regulatory requirements that add unnecessary costs to switching.*

What can be done to lower or remove these barriers?

DRAFT RECOMMENDATION 13.1 DATA ACCESS TO ENABLE SWITCHING

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’s inquiry report, *Data Availability and Use*).

DRAFT RECOMMENDATION 14.1 DEFERRED SALES MODEL FOR ADD-ON INSURANCE

The Australian Securities and Investments Commission 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.

Following implementation, the Australian Government should establish a Treasury-led working group to extend the deferred sales model to all add-on insurance products in a practical timeframe.

The financial system regulators

DRAFT FINDING 15.1 APRA NOT WELL PLACED TO CONSIDER COMPETITION IN THE FINANCIAL SYSTEM

The Australian Prudential Regulation Authority (APRA) is not well placed to balance the cost to competitive behaviour in its regulatory actions. The preponderance in its remit favours system stability, even at a significant cost to competition.

The Commission does not propose to alter APRA's ability to consider competition in making its risk assessments and actions, but it is evident that a debate on the question of whether the public interest is served by restricting competition could be better authorised. The Council of Financial Regulators is a valuable forum for a rigorous and informed competition debate.

In the absence of such a debate and of a party specifically authorised to take on responsibility for representing competition, consideration of competitive effects inevitably will continue to be subordinate to stability.

DRAFT RECOMMENDATION 15.1 STATEMENTS OF EXPECTATIONS FOR REGULATORS

Regulator Statements of Expectations and Statements of Intent, as agreed in the response by the Australian Government to the Murray Financial System Inquiry, should be urgently implemented. They should be written in clear language and updated at regular intervals thereafter.

Statements of Intent should be published by regulators 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.

DRAFT RECOMMENDATION 16.1 REVIEW STANDARDISED RISK WEIGHTS FOR RESIDENTIAL MORTGAGES

The Australian Prudential Regulation Authority should commence and complete a review of the standardised risk weights for residential mortgages set out in Prudential Standard APS 112 by June 2020.

The review should be focused on more finely calibrating the risk weights to better reflect the risk inherent in individual mortgages.

In particular, consideration should be given to replacing the single risk weight that applies to standard eligible residential mortgages with a loan-to-valuation ratio below 80% with risk weights defined in more narrow bands.

INFORMATION REQUEST 16.1 WHERE CAN IRB ACCREDITATION PROCESSES BE IMPROVED?

We are interested in any suggestions for improvements to the internal risk-based (IRB) accreditation process to make IRB modelling more accessible to non-major banks. Of particular interest is:

- Information on existing international programs or proposals for alleviating data requirement burdens (such as use of external/shared loan data)*
- Availability of expertise to develop IRB models outside of major banks and potential to outsource IRB model development (or for external parties to develop ‘off the shelf’ solutions)*
- Any other recommendations for APRA’s accreditation processes (such as process transparency)*

DRAFT FINDING 16.1 RATINGS AGENCIES EXACERBATE THE PERCEPTION OF ‘TOO BIG TO FAIL’

By incorporating perceived government support in their relative ratings of Australia’s banks, ratings agencies further embed the major banks’ ‘too big to fail’ status, with consequent advantages to these banks in the costs of funds.

DRAFT FINDING 16.2 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 regulator power to intervene to ensure competition, prudential outcomes and the broader public interest are protected.

It is also not clear that the Four Pillars policy has met its stated objective of preserving competition, or whether instead it has eroded competition by embedding a fixed market structure.

DRAFT RECOMMENDATION 17.1 NEW COMPETITION FUNCTIONS FOR A REGULATOR

To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, an existing regulator must be given a mandate to take the lead on matters related to competition in the financial system.

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

There would 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 all members of the CFR the practice of reviewing, before they are implemented, regulator actions that may have material effects on competition.

The competition-related functions of the designated Council member would include:

- transparent analysis of competition impacts tabled in advance of measures proposed by regulators
- testing of the impacts of competition and community outcomes of additional provider integration.

DRAFT RECOMMENDATION 17.2 TRANSPARENCY OF REGULATORY DECISION MAKING

The Council of Financial Regulators (CFR) should implement a process of review before its members put in place regulatory interventions that may have a material impact on competition in a product market.

There must be a member of the CFR designated to take up the role of assessing planned interventions, to establish possible consequences for competition in financial markets.

The assessment of competition impacts should be discussed at the CFR meeting, and the regulator planning the intervention should consider amending its policies to reduce the effects on competition.

Competition analyses, as well as the minutes of the CFR meetings, should be made public in a timely manner.

INFORMATION REQUEST 17.1 WHICH REGULATOR SHOULD ADVANCE COMPETITION IN THE FINANCIAL SYSTEM?

The Commission has presented two possible options for a regulator to advance competition in Australian financial system and ensure robust consideration of competition in the regulatory decision making processes of the Council of Financial Regulators:

Option 1: that ACCC be afforded new proactive functions to supplement its current reactive role in the financial system

Option 2: that ASIC's existing financial system focus be expanded beyond participant conduct and consumer outcomes to include the advancement of competition.

We welcome feedback on the merits of each option or alternative possibilities.

DRAFT RECOMMENDATION 17.3 ROBUST AND TRANSPARENT ANALYSIS OF MACROPRUDENTIAL POLICIES

The Australian Prudential Regulation Authority should conduct and publish annually quantitative post-implementation evaluations of its macroprudential policies, including costs and benefits to market participants and the effects on competition.

SETTING THE SCENE

PART I

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 a reasonable price, 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 have examined a range of financial products and services to build a picture of how competition is operating in different parts of the financial system. Not all markets are covered in the same depth — our focus 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 about 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 repeatedly to explain their position, these reviews indicate a depth of community concern about the financial system 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 the banks cooperated in providing us with confidential information about their operations, we were surprised at some of the gaps in the information held (for example, on the profitability of key product groups or the relative costs of product distribution through different channels). 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 and insurers 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 and the overarching regulatory environment. But there have also been financial investment collapses in Australia over recent years involving poor advice, information imbalances and exploitation of consumer behavioural biases. These have affected over 80 000 consumers, with losses totalling \$4 billion after compensation and liquidator recoveries (Murray et al. 2014a). And many people have concerns about the level of profits earned in the financial services sector and the apparent tendency for prices to rise quickly and fall slowly.

Over the past decade, there have also been numerous scandals and allegations, including in relation to poor financial advice, the maladministration of life insurance claims and market manipulation (HoRSCE 2016d). The recently announced Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry will examine these issues of conduct (Morrison 2017f).

There are also concerns about the fact that banks' profits seem to rely on growing household debt, either through credit card interest and charges or through the need for increasingly large mortgages as house prices rise.

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.

It seems, therefore, 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 this perception exists, but have focused on rigorous analysis rather than simply impressions when making our recommendations.

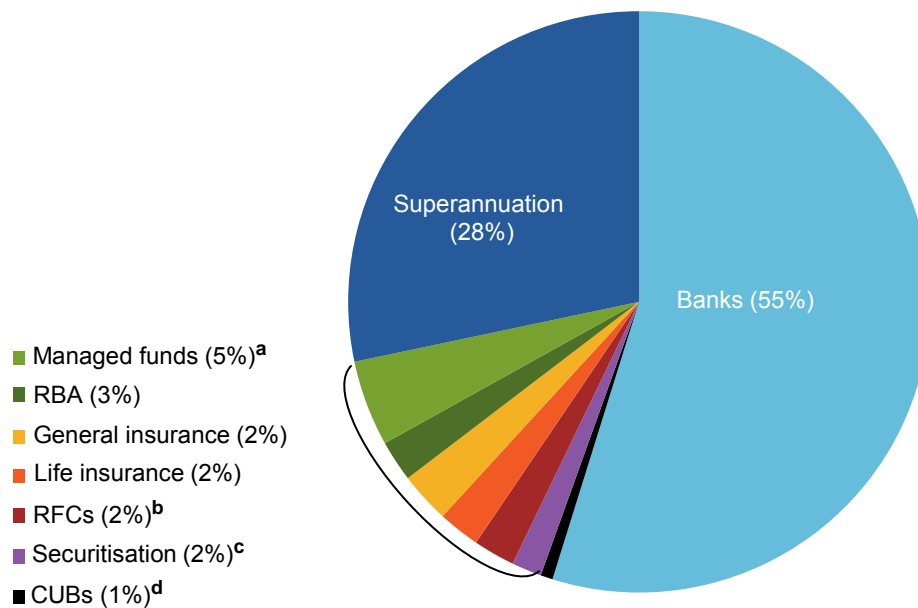
In accordance with the terms of reference, this inquiry looks at these issues through the prism of competition and, in line with our usual practice, on the basis of what the available data can tell us.

1.2 Australia's financial system

The financial system is a large, strong and growing part of the Australian economy. At 30 June 2017, banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies and most of the

superannuation industry¹ held a combined \$6.1 trillion in assets (APRA sub. 22). Figure 1.1 shows the relative size of the different segments of the financial system. This inquiry will not examine all parts of the financial system, as explained in more detail below.

Figure 1.1 Size of the financial system, by segment
Total assets as at September 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 (2017g)

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 just over 420 000 people (3.4% of the workforce) (ABS 2017g). The Australian financial system accounts for as large a proportion of the total value added in the economy as the financial systems of Canada and the USA, and a higher proportion than those of Japan or the Eurozone area (Maddock 2014).

The Australian financial system has grown in importance over the past 30 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 financial markets (Maddock 2014).

¹ The superannuation figures exclude self-managed superannuation funds, which are regulated by the Australian Tax Office (ATO). The ATO estimates the total net assets of this sector were \$628 billion at 30 June 2016 (ATO 2017a).

Whether Australia’s financial system needs to be as large as it is, is less important than ensuring such a large part of the economy 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).

1.3 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 because of its complexity 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)

The risks can then become systemic, not only endangering the whole banking sector, but also undermining the effectiveness of monetary policy, and exacerbating economic downturns. This can produce slower economic growth, rising unemployment, business failures and pressure on government finances.

In terms of microeconomic risks, the financial system has the ability to cause significant harm to consumers (both individuals and businesses). This can arise from the combination of a complex system and incentives faced by product providers that create an environment in which uninterested consumers become vulnerable to dishonest and predatory practices, or the adverse outcomes of providers exercising considerable market power.

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

In order to manage these risks, the sector is highly regulated.

- Prudential regulation focuses on ensuring that individual financial institutions are better able to withstand external shocks and can continue to meet their obligations to depositors

or the insured. Prudential regulation is also concerned with ensuring 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.

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.

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 is strong and increasing (RBA 2017t).

The question for this inquiry is whether the benefits of a strong and stable financial system are being captured primarily by the incumbent firms and their shareholders, or whether increased competition could be used to produce broader benefits, for example, lower priced loans, higher returns on investments or more innovative products which better meet consumers' needs.

1.4 Concerns about the level of competition in financial services

The Australian Competition and Consumer Commission's (ACCC) submission sets out the arguments for competition:

All else being equal, we expect that competition will deliver better products, greater innovation, lower prices and improved international competitiveness. We expect competition to spur inefficient financial institutions to improve their performance or exit the market. (ACCC, sub. 17, p. 8)

There are reasons to be concerned about the levels of competition in Australian financial services. Although the Murray Financial System Inquiry (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 that:

... the current oligopoly structure of the banking system is not vigorously competitive and has not been for some time (ACCC, sub. 17, p. 1).

These indicators included:

- concentrated market structure, with the largest players maintaining significant market shares over a considerable time
- the largest players had maintained high margins and high overall profits by international standards, without attracting significant new entry or expansion by smaller players
- the large banks had been 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, and little evidence of strong rivalry to be the first to roll out new products and services to meet customer needs
- 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 differential 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 public information aimed at improving the circumstances for consumers, to the point where key product prices and reasons for variation amongst different customers are often a matter of guesswork.

Subsequent chapters within this report provide analysis of these issues.

1.5 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. Despite the Government accepting the majority of the Murray FSI recommendations, few reforms have been implemented to date and for many, implementation has taken on the appearance of not actively being progressed by agencies.

The Murray FSI concluded that policy settings in the Australian financial system did not focus on the benefits of competition and innovation, rendering Australia’s financial system prone to calls for more regulation:

... 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)

Despite the Government accepting the recommendations based on this conclusion, competition in Australia’s financial system remains (as discussed later in this report) without a champion amongst the existing regulators — financial system competition is the neglected cousin to financial system stability.

The Murray FSI recommended that there should be proactive and regular monitoring of competition in the financial system. 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 2017 completed inquiry into Data Availability and Use (PC 2017c)
- the concurrent inquiry into the Competitiveness and Efficiency of the Australian Superannuation System, for which an issues paper was published in July 2017.

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.

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).

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).

There has also 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 was established on 14 December 2017. The terms of reference allow the Royal Commission to exclude areas which are being, or will be, considered by other inquiries, investigations or proceedings (Australian Government 2017g).

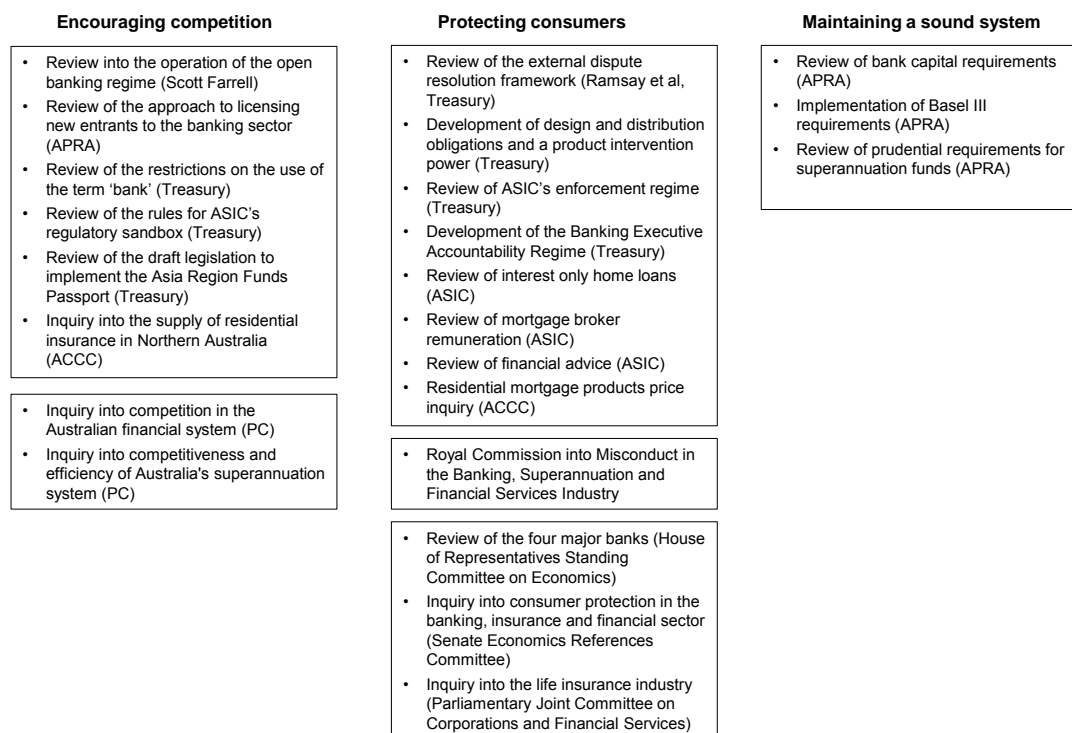
The range of current reviews relating to competition in the financial system is illustrated in figure 1.2. A summary of the current regulatory arrangements is provided in appendix B.

1.6 The Commission's approach

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.

We held early roundtable public hearings 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. We also undertook a very diverse initial round of fact-finding meetings with representatives from financial product markets, consumer groups, regulators and academics. We published a short consultation paper in early July 2017 to detail the scope of the terms of reference and assist participants in preparing submissions to the inquiry.

Figure 1.2 Financial system reviews under way
As at January 2018



We have consequently adopted a targeted market-specific analysis focused on competition. Inquiry participants advocated this, identifying a range of issues and concerns in particular parts of the financial system as the least addressed aspects of competition. Where we confirmed that there is a link between these issues and competition, the Commission has proposed reforms. We have not attempted to address issues that are not fundamental to competition in the financial system — many of these issues are being covered by other current reviews.

In line with our usual approach, we have analysed a wide variety of material during the course of the inquiry, including evidence received in other hearings, public submissions, our own roundtable hearings and confidential briefings. We 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.

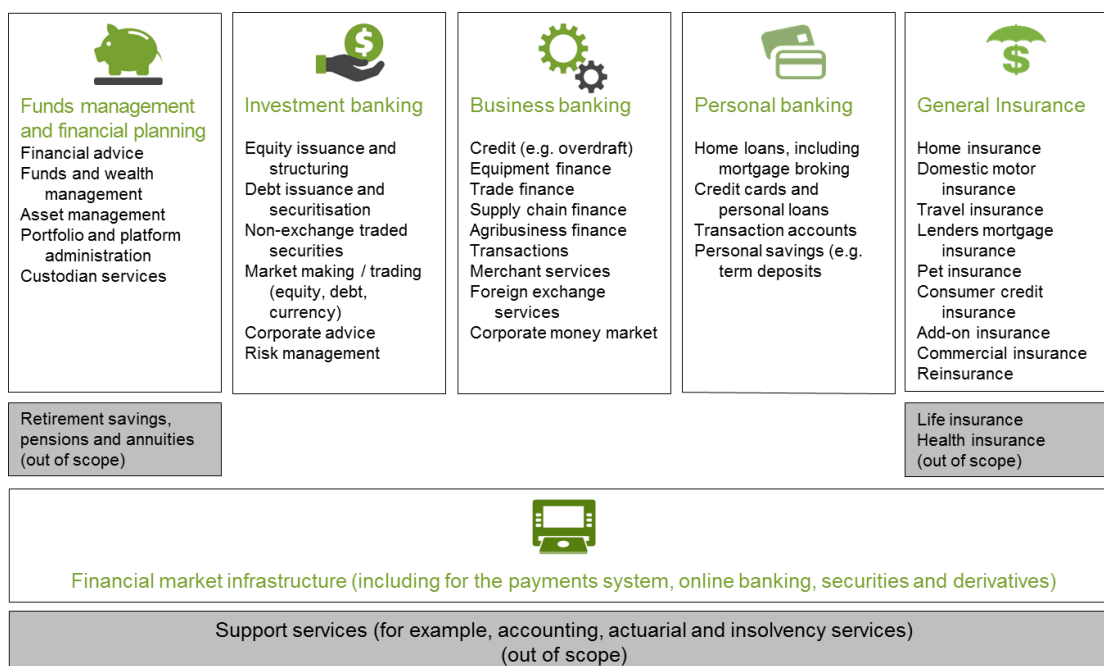
Markets covered by the inquiry

The potential scope of the financial services and entities covered by the inquiry remains very broad. For this draft report, we have focused on a selection of services and activities, set out in figure 1.3.

Due to the diversity of the services examined, we have covered, in depth, most aspects of retail banking and general insurance. On the latter, following feedback received since publication of the Commission’s consultation paper, the inquiry is taking a broader view of the insurance market, rather than the original idea of limiting consideration to insurance policies sold as part of a vertically or horizontally integrated business model.

However, life insurance is not being 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 is not being considered as part of this inquiry, as an examination of Australia’s private health insurance system would require consideration of issues that extend well beyond the financial system.

Figure 1.3 Segments of the financial system within scope ^a



^a Shaded areas are out of scope for the inquiry. Not all segments of the financial system have been examined to the same level of detail.

Source: Adapted from Australian Financial Centre Forum (2009)

Structure of the inquiry report

From our early consultations and analysis, a number of key areas became apparent in which there are particular issues pertinent to competition. In order to give these adequate attention in the time available for the inquiry, the Commission selected a number of key areas for in-depth analysis, with a view to determining specific reform options that would improve competition in these areas.

Specifically, the Commission looked at **nine** areas related to the provision of financial services and the interaction of market participants, **three** areas examining issues facing consumers of financial services, and **three** areas exploring the functions and activities of the regulators. The report chapters are supported by four appendixes that outline the inquiry process and provide detailed descriptions of segments of the Australian financial system.

2 Framework to examine competition in the financial system

Key points

- Key features of workable competition in Australia's financial system must include:
 - a ready scope for consumers to assess how prices or features vary with product differentiation and be able to act on that assessment
 - information flows sufficient to make informed decisions regarding aspects such as credit worthiness, risk or product choice
 - 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 open-minded towards innovative new financial products and ways of delivering financial services
 - effective scrutiny of the adverse use of market power by any participant or set of participants.
- The Productivity 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 within a market over time: provider concentration and market shares; profit levels; limits on new entrants or absence of services that are evident in similar markets overseas.
- Indicators of poor levels of demand-side competition in the Australian financial system would include: low financial literacy and level of engagement of consumers; an imbalance of information between consumers and providers; evidence of an inability or lack of motivation to switch providers.

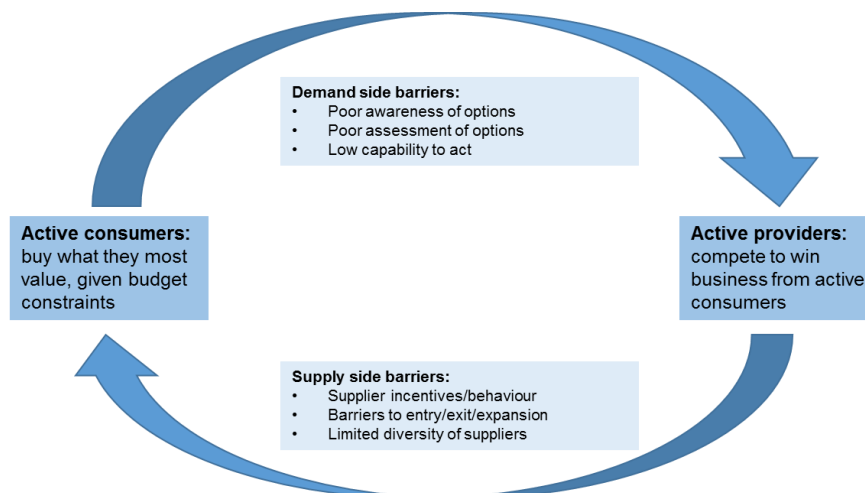
2.1 Competition in the financial system — what it looks like and why it matters

Why competition matters

Competition has been demonstrated persistently, in both the Australian context and abroad, as one of the strongest 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)

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, in fact, also consumers of related products or services, often offered 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.

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.

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. 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. Entry will remain restricted, even if barriers are lowered, and the strategies of key providers will remain influential on the pricing and supply decisions of other providers and on market outcomes. Such a state is characteristic of an oligopolistic market structure.

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

The Productivity Commission has identified a number of features of workable competition in Australia's financial system (draft 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, what workable competition looks like would 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 costs rather than any attempt to discriminate and seize excessive profits from groups of consumers. Market pressures would be such that there would be little capacity for providers to successfully collude or reach tacit agreements in their strategic decision making, including pricing. Attempts by some providers to artificially raise prices or reduce service quality would simply drive customers to their competitive rivals.
- On the consumer side — Consumers would have access to information on their own interactions with the financial system and on alternative products on offer. The Government's new Open Banking regime should meet the terms of the Commission's proposed Comprehensive Right to allow consumers to use their data held by financial system institutions (PC 2017c). More broadly, information would be presented publicly in a way that would reasonably allow them to readily discern and switch to those products that are of most benefit to their situation. Switching costs would be low. Scope would be limited for consumers to hide aspects of their circumstances in order to secure themselves a more favourable financial product than might otherwise be offered to them.
- On the regulator side — Regulators would be open-minded towards new financial products and ways of delivering them, with regulation remaining, as far as possible, outcome-oriented. There would be as few as possible (consistent with other regulatory objectives) impediments to entry of new financial products or providers noted in the remainder of this report. Scrutiny of adverse use of market power by any participant or set of participants would be effective and timely.

Overall, we acknowledge as always that competition is not an end in itself, nor is it 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 (box 2.1).

Box 2.1 **Competition is the journey not the destination**

A number of submissions have recognised that competition is a dynamic process rather than an outcome.

Competition is not an end in itself but rather is and must always be seen as a means to economic benefit. (PayPal, sub. 19, p. 2)

The ultimate aim of competition is to provide customers with choice so they can access the best products and services appropriate for their needs and circumstances. (ABA, sub. 11, p. 1)

Competition is not an end unto itself: it is a means to promote the welfare of Australian consumers by allowing them to access the best products at the lowest price, and facilitating easy comparison of and switching between products. (CHOICE, sub. 42, p. 3)

Recent reviews have highlighted similar features.

Competition is desirable not for its own sake but because, in most circumstances, it improves the welfare of Australians by increasing choice, diversity and efficiency in the supply of goods and services. In other words, competition is a means to an end. (Harper et al. 2015, p. 397)

As competition is a dynamic process, rather than an outcome, it is difficult to measure and must be assessed indirectly using a range of indicators. (Murray et al. 2014b, pp. 2–4)

DRAFT FINDING 2.1 KEY FEATURES OF WORKABLE COMPETITION IN THE FINANCIAL SYSTEM

The key features of *workable competition* in Australia's financial system must include:

- an open digital information capacity for consumers to assess how prices or features vary between products and choose (including switching to) preferred products
 - consumers actively supported by public advice or private advisers to conveniently make informed decisions regarding aspects such as risk (including credit worthiness)
 - an Open Banking regime that gives consumers perpetual access to their data that is useful to other providers, with the capacity to see it safely moved from one provider to another
 - minimal limits to entry by new providers, and expansion by existing providers, into regulated product markets (subject to other regulatory objectives such as prudential outcomes)
 - regulators more open-minded towards innovation and aware of the effects of their actions on weakening competition and creating consumer detriment
 - effective scrutiny of the adverse use of market power by any participant or set of participants.
-

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 evidence 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 16); prudential settings on outcomes in retail banking markets (chapters 5, 6 and 8); conditions around the entry of new entities into parts of banking and payments systems (chapters 4 and 10); international obligations on Australia's financial institutions (chapter 16); and requirements on providers to improve opportunities and outcomes for consumers in both banking and insurance (appendix B and chapter 14).

As discussed in depth in chapter 15, 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 2017b). 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 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 were less well placed to cope with the GFC.

The balancing of stability with competition remains, however, a conceptual and practical challenge for Australia's regulators (chapter 15). It is primarily in those markets (such as retail banking) where liquidity is at risk, that the impact of competition on stability is potentially an issue. However, to the extent that adverse outcomes from competition eventuate in some product areas (for example, through vertical or horizontal integration of product providers) and prudential settings are not able to prevent a threat to liquidity in others, a broader 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 (a 'too big to fail' scenario that characterises banking in Australia and many other countries). At its extreme, a financial system that contains only one or two large dominant providers (that are too big to fail and hence are explicitly or 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 risky behaviour over the longer term, knowing that any upside would be captured by shareholders while losses would be protected by government guarantee 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, some regulators consider that strong competition could erode standards of conduct and lead banks to take more risks in lending activity in order to maintain their profitability — at a cost to system-wide stability. But in our view 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 prefer stability, without acknowledging a significant cost to economic activity from such a default position.

The Productivity 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. 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 balance the two objectives. This report will look at whether regulators are adequately doing so; and how banks and insurance firms respond.

The most prospective way to analyse the weaknesses and opportunities for improvement is not at the system-wide level, which in any event has had a number of eyes cast over it already — not least the Murray FSI. As noted in chapter 1, 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.

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).

APRA noted that it is possible to have too much of either stability or competition.

To borrow a phrase, we don't want 'the stability of a graveyard'. But we have all seen instances of excessive, or reckless, competition too. Eliminating the excess, and finding the optimum level of both, is a matter of careful balance. And, if we get the balance right, they will be mutually reinforcing: competition will support stability, and stability will support a competitive environment. (Byres 2015, p. 1)

These issues are considered further in chapter 15.

DRAFT FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST

Competition and stability are both important to the Australian financial system. In order to preserve both, a genuine debate is essential before every material regulatory intervention.

The stability of Australia's financial system has increased since the global financial crisis and prudentially regulated institutions are unquestionably strong. However, competition has suffered. It is important to ensure that the essential role of competition in economic growth is not eroded further by having stability as the default regulatory position.

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.

New and enhanced technologies and increased computing capabilities are enabling the development of new products and services that can meet the needs of financial consumers and market participants more efficiently and more cost effectively. These advances also have the potential to enhance financial inclusion, bridge financing gaps and develop financial capabilities.

Within the context of financial services, technology has the potential to:

- (a) reduce the cost and improve the efficiency of product and service delivery;
- (b) empower customers by enabling them to deal directly, more seamlessly, and more flexibly with product and service providers; and
- (c) empower businesses by enabling them to deliver a better value proposition and customer experience to their customer base. (ASIC, sub. 40, p. 58)

The impact of technology was also highlighted in the Murray Inquiry.

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 focussed. 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 2016a, p. 1)

Competition policy and microeconomic reform will be driven by the innovations in FinTech, especially in payments systems, and the ASX has already announced that it is seeking to introduce Blockchain technology for its clearing and settlements process. FinTech is going to revolutionise how consumers and businesses, as the drivers of economic activity, interact. This is going to have big implications for demand in the future. (The Treasury 2016a, p. v)

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 Productivity 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 10).

2.2 How we will assess competition in the Australian financial system

This inquiry is broad ranging, but is not considering every aspect of the financial system. Rather, the 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 of this is likely to require government intervention to bring about a material improvement in competitiveness and community-wide outcomes. In other cases, we find that — while perhaps markets are not highly competitive — there is a limited amount that intervention can achieve; and a risk that it could be damagingly misdirected.

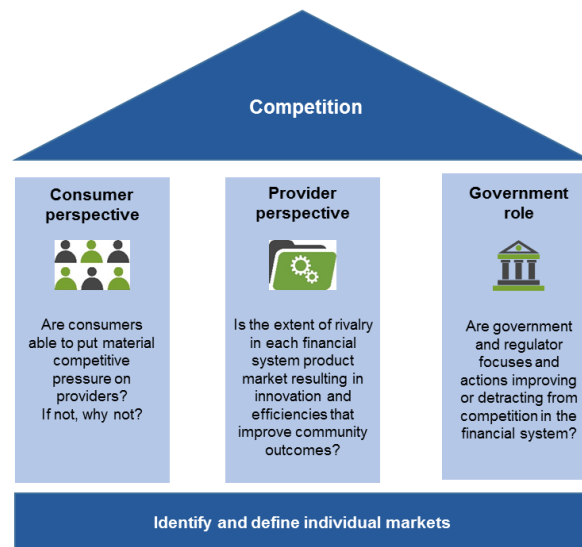
For the most part, we have started from the point of provision of financial products to households and businesses, and seek evidence or indications of where either the current regulatory settings are having a detrimental effect on competition, or the incentives faced by market participants are resulting in poor market outcomes. The markets that we looked at were informed by initial consultations and research, and include (see figure 1.3 in 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 are considering 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?

Figure 2.2 **Competition Framework**



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 able to adapt to different technologies (including new technologies and be technology neutral) and
- fit within the context of ongoing reforms.

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 9).

In its merger guidelines, the ACCC notes that two features of financial markets — bundling and vertical integration — 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 (chapter 13) — although there may be consumer behaviour that makes switching less of a characteristic of competition in some finance markets than is normally observed.

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 8).²

² 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 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 (see also figure 2.3), the ACCC considers whether competition analysis is best conducted in the context of one relevant market enveloping 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)

For some services, the **financial institutions are platforms**. For example card payments, where both merchants and customers are consumers; and in basic deposits-lending where households both supply deposits and demand loans. Where these two-sided markets occur, we will 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.

Competition among providers

The providers of products within the Australian financial system are considered in chapters 3 to 11. As outlined in those chapters and appendixes C and D, 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 framework 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 (chapter 16). This risk assessment translates heavily into regulation that limits pricing and product availability (chapter 6). While we will assess regulator and government behaviour directly, it 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 innovation, including innovation seen in equivalent markets offshore), it should not slip through the cracks of this inquiry.

A number of provider indicators are outlined below and are considered in chapters 3 to 11.

Concentration

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).

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)

Box 2.3 **Measuring market concentration**

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 with the change in market concentration as a result of the merger (the delta) is less than 100. However, the ACCC does note that there are exceptions in cases where the products of the merger parties are particularly close substitutes or where the target firm has shown a recent rapid increase in market share, has driven innovation or has tended to charge lower prices than its competitors in one or more markets (properly defined) in which the merged firm would operate (ACCC 2008a).

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)

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

High levels of market concentration can raise concerns about the level of competition in that market, but they are not determinative and the need to consider other issues has been raised a number of times.

...other important factors must also be appropriately taken into account in order to develop an informed view on the level of competition within a market. In particular, important variables – such as the net turnover in the number of industry participants, barriers to entry and other unquantifiable factors – are unaccounted for by solely relying on concentration analysis that can have a material influence on the level of competitiveness in a market. (ICA, sub. 32, p. 6)

...concentration of itself does not necessarily imply a lack of competition. Indeed, indicators of market structure such as measures of concentration are not regarded as a very accurate measure of competition. In principle, four large banks could still compete very actively among themselves. (Bullock 2017, p. 1)

...market concentration is not determinative in itself. For example, firms can gain a high market share by adopting more efficient technology, lowering costs and reducing prices. In such cases, high levels of market concentration are not necessarily reflective of a non-competitive market. Measures of concentration in markets characterised by product differentiation may also obscure the closeness of competitors. (ACCC 2008a, p. 36)

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. In addition, the threat of new entrants can exert price discipline over an incumbent, even in the absence of existing competitors. This threat of competition is called ‘contestability’. (Murray et al. 2014b, p. 2.4)

The relationship between market structure and performance 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. For example, a high net interest margin could reflect a low level of competition particularly when paired with a high return on equity. However, it may also reflect high fixed costs that need to be recovered through the interest margin, particularly if the return on equity is low. 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 Productivity Commission’s assessment of concentration is included in chapter 3 (for retail banking), chapter 7 (for wealth management), chapter 10 (for aspects of the payments system) and chapter 11 (for general insurance).

Contestability

A contestable market is one where 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 more efficient or seeks 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.

In finance, the capacity for new entry is often deeply controlled by regulators.

The RBA notes that periods of heightened competition in the Australian financial system have typically been driven by new entrants rather than established players (RBA, sub. 29). The ACCC also 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)

Barriers to firms entering or expanding their operations in markets can consist of regulatory requirements — in the financial system this particularly applies to requirements for authorisation or the holding of minimum amounts of capital. Arbitrary shifts (either real or anticipated) in the requirements to hold capital can deter entry.

Non-regulatory barriers also inhibit firms' ability to compete and these can include the actions of ratings agencies, technology and know-how, branding, product differentiation and structural issues including the minimal return needed to cover fixed costs. Box 2.4 includes information on barriers to entry identified during consultation and other inquiries.

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)

The Productivity Commission’s assessment of market contestability is included in chapter 4 (for retail banking), chapter 10 (for aspects of the payments system) and chapter 11 (for general insurance).

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’. Different providers may balance these ‘prices’ in different ways, 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 interest rates alone. Similarly, the RBA noted that:

A bank’s revenue on a credit card product can include interest paid by cardholders, fees paid by cardholders (offset by any rewards paid) and fees paid indirectly by merchants, all of which can be rebalanced to maximise the profitability of the product. (RBA, sub. 29, p. 9)

In terms of insurance, the recent Senate Economics Reference Committee in its final report which was 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 price 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 product bundling (chapter 7) and consumer switching (chapter 13).

Integration

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), and horizontal integration, where a provider extends across the supply chain (for example an insurer with multiple brands that compete against each other), are both features of Australia’s financial system (figure 2.3).

Vertical integration in and of itself is neither good nor bad for consumers. 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)

As outlined in chapter 7, the Murray FSI considered that the high 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. That said, three years later most major banks are now exiting or have exited life insurance and wealth management businesses, as returns are not as healthy as other aspects of their business. And reputation costs are belatedly being recognised.





As an example of horizontal integration, the RBA notes that bundling of products can be convenient for consumers, but it can make later choice to switch individual products difficult and, by obscuring the pricing of individual products, it can support cross-subsidisation between more and less competitive markets (RBA, sub. 29). Integration is discussed further in chapter 7.

Figure 2.3 Vertical and horizontal integration

Examples in the financial system

Vertical integration: where a financial system provider expands its operations throughout its supply chain.

A bank offers the following services:

-  banking
-  investment through a bank-owned business
-  financial advice through a bank-owned business
-  insurance through a bank-owned business

Horizontal integration: where a financial system provider expands its operations by acquiring additional business activities at the same level of the supply chain.

An insurance company acquires another insurance company



Source: ACCC (sub. 17); CIFR (2015); Harper et al. (2015); Munchenberg (2015)

Fear of risk discourages innovation

As outlined above, a key feature for competition in Australia's financial system should be that regulators are open-minded towards innovation. 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)

The Murray FSI noted that rapid technological innovation brings opportunities to improve user outcomes and system efficiency, but also raises new risks and challenges and suggested 'Policy settings should facilitate innovation and accommodate market developments where these improve system efficiency and user outcomes' (Murray et al. 2014a, p. 9).

Government and regulators should remove unnecessary impediments to innovation by applying graduated functional frameworks in a range of areas, including the payments system. The 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)

Four Pillars is an example of a policy that may be inhibiting innovation, as are regulatory requirements for residential mortgages that affect the ability of smaller ADIs to compete against the four major banks. These and other policies and regulations are considered in chapters 16 and 17, which identify reforms to facilitate pro-competitive behaviour that supports innovation.

Price discrimination and competition

In competitive markets, prices closely reflect costs. 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 due to factors relating to competition, rather than cost. The presence of this type of 'price discrimination' can be indicative of low levels of competition.

For example, in the market for home mortgages, some consumers have relatively low costs of 'shopping around' and, where necessary, switching providers to gain a lower interest rate. Other consumers have higher search costs. If there is limited competition, banks can use this difference to price discriminate. By offering a low 'starter rate', a bank can attract both types

of borrower. The starter rate may be a competitive price, reflecting the bank's costs of the mortgage. But once the initial rate finishes, the customers with high search costs can be moved to a relatively high interest rate, with little risk that they will move to another provider. In contrast, the borrowers with low search costs will seek out and be offered another low 'starter rate'. So some customers receive a competitive price while others pay 'above the odds' over time. This can be considered sharp but normal commercial practice, but it is inefficient pricing in most circumstances and worthy of a public policy solution if one can be found that is cost effective.

Price discrimination depends on limited competition. However, it should not be banned — this simply risks banks *raising* prices to all types of customers. Moreover, some price discrimination reflects consumers' choices and such price differences are, in principle at least, efficient. Rather, reforms to inform and empower consumers and enhance competition can lead to long term benefits. We discuss issues of price discrimination in more detail in chapters 3 and 5.

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 the rewards are well-recognised. 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 (chapters 12 and 13).

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 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 and 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 about small business access to redress by the Ramsay Review of the Financial System External Dispute Resolution and Complaints Framework.

Small businesses can possess characteristics which means they face many of the same issues as consumers in dealing with disputes and when seeking redress. This can include the owner's personal characteristics (language and cultural barriers), the nature of small business (lack of time and money) and the power imbalances they face against larger businesses. (Ramsay, Abramson and Kirkland 2017, p. 160)

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 considered further in chapter 12.

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.

[E]vidence and insights from the behavioural sciences show that there are much more complex factors that can affect consumers' interaction with information and their decision making. A significant body of work by policy makers, academics and regulators has been built over recent years. These factors are particularly relevant in the context of the retail financial services sector,

which is recognised as a rich environment for behavioural factors to affect individuals' decision making... [include]:

- (a) the 'credence' quality of some financial products and services, which means suitability and quality are hard to gauge before or even after purchase;
- (b) asymmetric information and power between providers, intermediaries and consumers;
- (c) the inherent risk and uncertainty, and complexity, of many financial products and services; and
- (d) the fact that financial products are an infrequent purchase, and it may be more difficult to shop around and exert competitive pressure. (ASIC, sub. 40, pp. 4-5)

In their joint submission, the Consumer Action Law Centre, Financial Rights Legal Centre and Financial Counselling Australia highlight some extra considerations required when looking at the consumers of financial products and services.

For competition in the financial system to improve consumer outcomes, policy must be based on an understanding of how consumers actually make decisions. Too often competition policy has focused on how we think consumer should make decisions: the traditional economic view of 'rational consumers' making decisions based on available information. This approach ignores the behavioural biases which can inhibit rational decision-making. While the extent to which individual consumers exhibit these various behavioural biases varies, all of us exhibit such cognitive limitations at some point ... For consumers to benefit from effective competition in the financial system, they must be empowered to select products that fit their individual needs and assess the features of those products. Empowered consumers depend on the availability of safe products and fair sales practices. In this way, effective consumer protection supports healthy competition. (CALC, FCA and Financial Rights, sub. 23, p. 5)

In designing much-needed information improvements, we have focused on how to inform consumers effectively, rather than assume more information is necessarily always better.

Demand-side indicators

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? We have considered a number of indicators in making this assessment — financial literacy, level of engagement, level of product complexity, information asymmetry, extent of switching, basis of decision making and use of 'properly motivated' agents. These are outlined below and considered in general terms in part 3 of the inquiry draft report.

Financial literacy

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, by relying on information and advice from a capable and ‘properly motivated’ agent (see section below).

The ANZ survey of adult financial literacy in Australia (ANZ 2011) highlights a number of indicative behaviours of financial literacy, including:

- keeping track of finances: approaches to managing everyday expenses
- planning ahead: planning for the medium and longer term, including retirement and beyond
- choosing financial products: shopping around, and understanding and assessing investment risk
- staying informed: use of information, tools and guidance when needed
- financial control: savings behaviour and managing debts.

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.

We analyse where complexity (such as through product proliferation) seems to be contributing to consumers’ inability to act in their own best interest (chapter 13).

Level of engagement

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).

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).

Level of product complexity

Financial products are inherently complex and this complexity may lead investors to misunderstand the nature of a product and its risks.

... 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 2014i, p. 13)

This may be exacerbated where firms have the ability to ‘unilaterally/easily change product terms and conditions’ (ASIC, sub. 40).

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)

ASIC has identified 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).

It is difficult for end users in financial markets to exert effective demand-side pressure due to factors such as the inherent complexity of some financial products and services, and the ‘credence’ quality of some financial products and services, making them inherently difficult for consumers to assess even after consumption. (ASIC, sub. 40, p. 12)

This complexity in products, and the inability of many consumers to compare them, means intermediaries play a significant role in the financial system. As outlined in chapter 12, some consumers go to brokers to help get better outcomes.

Brokers play a very important role in the home loan market. They are responsible for arranging around half of all home loans in Australia. Consumers are increasingly turning to brokers to get help in obtaining a home loan — in 2012 brokers arranged 47.7% of home loans for the lenders in our review. In 2015, this increased to 54.3%. Brokers arranged almost 520 000 new home loans from the lenders in our review in 2015 (compared to 340 000 in 2012). (ASIC 2017ac, p. 8)

As noted in chapter 7, this advice comes at a cost, which UBS estimated in 2015 increased home loan prices by \$4623 on average, or 0.16% per annum in interest (UBS 2017).

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. As outlined in chapter 12, 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 our 2017 Data Availability and Use inquiry.

Many individuals do not read disclosure statements because of their complexity. One study examining whether people read privacy policies found that 95% of participants agreed to a ‘gotcha’ clause in the terms and conditions they were given that signed away rights to their first born child. In other words, providing a disclosure statement does not guarantee either understanding or agreement. (PC 2017c, p. 126)

Extent of switching

When consumers can easily switch between products or services, this sends a strong message to providers (chapter 13). As the ACCC noted in its submission, in competitive markets it expects to see ‘a healthy level of customer switching, generating better terms for consumers and more efficient processes for financial institutions’ (ACCC, sub. 17, p. 8).

However, the long-term nature of many financial products and services, for example home loans, mean there is often no trigger point for reviewing existing products and comparing alternatives. ASIC notes that this is exacerbated by the ‘credence good’ nature of many financial products, where consumers do not know whether a product is good value until a particular period of time passes or a certain event, such as needing to claim on insurance, is triggered.

These elements may lead to inertia on the part of consumers when the opportunity cost (both real and perceived) of searching for and comparing other products for which the real value to the consumer cannot be known upfront may be quite high. (ASIC, sub. 40, pp. 74-75)

High switching costs, indeed even the mere perception of high switching costs, can lead to customer inertia.

There are a range of reasons why consumers are staying put. In 2014 CHOICE research found: 36% of people who had not switched said switching was “too much hassle” (CHOICE, sub. 42, p. 14).

Removing the effort from the switching process is likely to lead to increased switching. As ING noted, ‘True competition comes when customers have control over their finances and can move and switch with ease’ (ING, sub. 20, p. 1).

Basis of decision making

As outlined above, behavioural biases can affect the decision-making of consumers of financial products and services. They take shortcuts and use contextual reference points to assist them in making choices in quick and routine ways that may be less than optimal. Good policy design should recognise this, and adapt to it. Exposure to these traits can be intensified where consumers perceive the decision to be an especially hard or time-consuming one to make, or is made under pressure (add-on insurance, for example — chapter 14). These circumstances may require tailored solutions.

Table 2.1 outlines a number of consumer biases which should be considered in better policy design. These issues include recent work that has been done by Professor Fletcher in the United Kingdom (Fletcher 2016a) and are considered in chapter 12 (Information and Advice) and chapter 13 (Consumer Switching).

Table 2.1 Consumer biases

<i>Bias</i>	<i>Impact</i>
Status quo bias and loss aversion	Giving disproportionate weight to maintaining the status quo.
Present bias, myopia, and hyperbolic discounting	Giving disproportionate weight to the present, and insufficient weight to the future.
Default bias, saliency bias, and other forms of framing	Applying rules to simplify decision-making which involve adopting the default option, focusing on the most salient or prominent aspects of the product.
Over-confidence bias	Feeling more confident than is justified about future behaviour.
Limited memory	Failing to learn from previous mistakes.
Influence of other people	Consumers will often be strongly influenced by what others tell them, especially if these others appear knowledgeable or trustworthy.

Source: CALC, FCA and Financial Rights (sub. 23)

Use of ‘properly motivated’ agents

One way consumers deal with the complexity of the financial system is by relying on information and advice to navigate the system.

This can range from information about what’s covered with an insurance product to assistance obtaining a home loan to personal financial advice about investing. These interactions are essential to bridge the information gap between consumer and product provider, but as the interactions are often between a consumer and a salesperson (or at least a party that stands to gain

financially), consumers frequently receive information and advice that is not in their best interests. (CHOICE, sub. 42, p. 22)

The Financial Planning Association of Australia notes the purpose of financial advice as being to help people achieve their life goals through proper management of their finances and recommends wellbeing measures should be used to assess competition in financial advice (FPA, sub. 26).

Submissions note that good quality advice from advisers can help consumers navigate complex financial decisions, however poor advice can lead to poor consumer outcomes. ‘Too often we have seen consumers led down the garden path to unsuitable products that only benefit the adviser.’ (CALC, FCA and Financial Rights, sub. 23, p. 28).

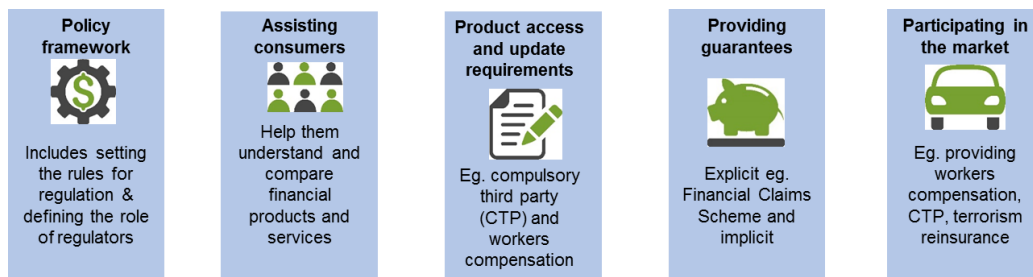
Agents may be motivated to not act in their clients’ best interests when wealth advisory businesses are integrated with other financial institutions, and advisers’ remuneration structures are designed to leverage the strategic benefits of the arrangement. Chapter 7 and appendix D consider the Future of Financial Advice (FOFA) reforms which, amongst other things, introduced a best interest duty and banned conflicted forms of remuneration.

Using ‘properly motivated’ agents, and not advisers who are conflicted improves consumers’ ability to generate competitive pressure on providers of financial products and services. Mortgage brokers, including their estimated reward of over \$4600 per home loan on average, are considered in chapter 8.

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 2.4 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 15 with recommendations for change in chapter 17.

Figure 2.4 **Interactions of Australian governments with the financial system**



Policy framework

Australia has 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. 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)

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.

[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)

There is very little activity in the financial system that does not come under regulatory scrutiny (box 2.5). As outlined above (and considered in further detail in chapters 5, 6 and 16) 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 for 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 11).

As noted in chapter 15, regulation has a 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 may curtail competition in order to achieve financial stability, both deliberately and accidentally.

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.

Box 2.5 Financial system regulators

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 17 (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 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 Inquiry 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 10, 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. Chapter 17 considers the CFR, including whether ACCC should also be a member (RBA 2017c).

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).

Whether all this paper achieves its ends is arguable.

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 13 on consumer switching). The UK Financial Conduct Authority trialled placing last year's insurance premium on renewal notices which may have caused 11-18% more consumers to switch or negotiate their home insurance policy (CHOICE, sub. 42).

Assisting consumers

Governments might also assist consumers by ensuring they have tools available to compare products, including through aggregator services. ASIC currently provides a website for North Queensland home insurance which allows consumers to compare insurance policies and indicative premiums. The ACCC's (2016i) good practice guidelines for comparator website operators and suppliers were supported by a recent Senate Economics Committee inquiry (SERC 2017).

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 build 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) is an

Australian Government scheme established in 2008 in response to the GFC. The scheme 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 (the scheme does not cover life or health insurance). 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 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 submission, but notes 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. The Financial Claims Scheme also minimises retail depositors' concern about the safety of deposits in smaller institutions. (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 16).

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 2001 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.

There have been some recent calls for government participation in the creation of more general public infrastructure banks by either the Commonwealth (The Greens 2015) or State governments (The Greens 2017) which would manage the financing and funding of

government investment in infrastructure, as has occurred recently in Canada (Department of Finance, Government of Canada 2017). We considered this issue as part of the 2014 Public Infrastructure inquiry, and found the costs likely to outweigh the benefits, so did not support the establishment of an infrastructure 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.

Finally, there is a risk that the establishment of an infrastructure bank would create pressure to fund projects that would otherwise not pass a cost–benefit assessment, simply because there is capital available at any given time. Role creep has occurred in the context of a number of apparently specialist institutions (both domestic and international). The Commission has previously observed this outcome in the context of Australia’s export credit arrangements. In that case, the agency in question utilised its growing capital base by progressively expanding its mandate to support a broader range of projects and supporting increasingly marginal ventures (PC 2014, p. 229).

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.

Source: Campbell et al. (1981); Parliament IRS (2006); Wallis et al. (1997)

WHICH FINANCIAL
SERVICES ARE
COMPETITIVE?

PART II

Part II Which financial services are competitive?

The behaviour of providers is a key indicator of a competitive market — are they continuously innovating and becoming more efficient, in order to satisfy consumer needs and trying to maintain or expand their market share? Or is their behaviour more indicative of a status quo, where providers have substantial market power that allows them to operate on their own terms, with less regard to community outcomes and little fear of their rivals?

Across the various markets that comprise the financial system, large companies dominate, with the four biggest players holding between 62% (in personal loans) and 100% (in lenders mortgage insurance) of market share. In most areas of retail banking and insurance, the four largest players hold 70-80% of market share. But even with high concentration, markets may be competitive and deliver beneficial outcomes for the community.

To assess competition, we have conducted a review of the key markets comprising the financial system. What emerges, unsurprisingly, is a complex picture of markets where the balance between providers, consumers and regulators is too often skewed in favour of providers, and concern for financial stability often trumps innovation and competition.

In banking, price competition — particularly for housing lending, banks' most substantial activity — is limited by regulatory intervention, including prudential standards and the RBA's cash rate decisions. Major banks hold substantial market power that enables them to pass on cost increases to consumers and maintain their profitability without losing market share. Service competition, mostly through the introduction of new products and services, is more evident — although as highlighted later in the report, product proliferation is not always to the benefit of consumers.

In insurance, competition may appear stronger than it is, as providers that do not necessarily have a public profile offer insurance under a multitude of well-known brands. For example, one relatively new entrant sells insurance under 30 brands.

We have identified a number of specific markets for financial products — small business credit, lenders mortgage insurance, add-on insurance and pet insurance — where competition is weaker. On the flip side, markets for home loans, consumer credit cards, home insurance, wealth management and financial advice have some competitive aspects. But even within those markets, there is much that can change to improve consumer outcomes.

Limited transparency creates an illusion of competition

The financial system offers thousands of different products, and seemingly new products and services are often advertised by providers. In the case of insurance, there is a high degree of differentiation in product features and pricing, as each insurance policy reflects an individual contract between consumer and insurer. In the case of banking, most new products do *not* represent genuine innovations, but are instead marginal variations on existing products. This ‘confusopoly’ by product proliferation allows banks to continue to charge high prices.

The lack of transparency across the financial system makes it very difficult for consumers to identify the most suitable products for their circumstances, let alone innovation that can benefit them. In the market for home loans, unadvertised discounts mean the standard variable rate is often a meaningless number, that few borrowers pay. This makes price comparison very difficult and some consumers end up with high-priced products even though cheaper and better products may be available. This ‘price discrimination’ protects banks’ profits.

With product proliferation and price discrimination, most consumers turn to mortgage brokers, in an attempt to simplify the process. But consumers are often unaware of the incentive structures faced by mortgage brokers and how these can affect the loans they offer. Mortgage brokers face conflicts of interest arising from the payment of commissions. Ownership by banks of aggregators — the businesses under which brokers often work — adds to this conflict.

Mortgage broking is not the only area of the financial system where vertical and horizontal integration are common; but in other parts of the system, many providers are winding back their integration, to focus on core activities.

Risk aversion restricts innovation — and imposes costs on consumers

Consumers and regulators alike place substantial value on financial stability, and it is undoubtedly important to maintaining a healthy financial system. For smaller providers, the value placed by consumers on ‘large and stable’ institutions makes expanding their market share very challenging. For the major providers, it adds to numerous other factors, such as lower cost of funds, benefits of scale, scope and geographic reach, that contribute to their substantial market power (chapter 3). The major banks’ market power has allowed them to pass on cost increases to their customers, and maintain their profitability even in the face of significant shocks. This has been less apparent in the case of insurance, where companies have not been able to shore up their profits to the same extent (chapter 11).

Regulators implement numerous policies to promote financial stability. These regulations increase operating costs. But not all institutions are affected in the same way, as the major banks have invested in regulator-approved approaches that enable them to comply with regulation at a lower cost. This regulated competitive advantage further contributes to their market power.

As regulators themselves have acknowledged, the cost of new regulation is passed on to the community. Borrowers pay higher rates on their loans; but it is all taxpayers who bear the costs of financial stability. We estimate that recent interventions intended to stem the growth in new lending to housing investors, which led to an increase in interest rates on *all* investment loans, cost the community up to \$500 million a year in additional income tax deductions (chapter 6).

In this risk averse environment, the benefits of competition and innovation are difficult to realise. Australia has a large, and growing, fintech sector, but most innovative companies choose to collaborate with incumbent banks, rather than compete against them. Regulatory barriers to entry play a part in fintechs' commercial strategies; in the long run, lowering these barriers and implementing other reforms around data availability and use may support innovation. For the time being, fintechs are unlikely to provide vigorous competition against incumbent banks (chapter 4).

The payment system is one area where innovation has been more common, with consumers willing to embrace new technologies. The New Payments Platform can further improve services to consumers. But as it presently stands, these benefits seem unlikely to be fully realised. Making full use of the system's capabilities should be a priority, as it can remove barriers to consumers choosing which bank they prefer to deal with (even if they retain accounts at multiple institutions) and make it easier for consumers to benefit from competition in the financial system (chapter 10).

Competition — or a game of 'follow the leader'?

Participants in this inquiry describe the banking market in particular as one that is characterised by vigorous competition. But in a competitive market, no single participant, or group of participants, is able to consistently set prices at high levels, without losing market share. Competition would see margins contract, and prices decline.

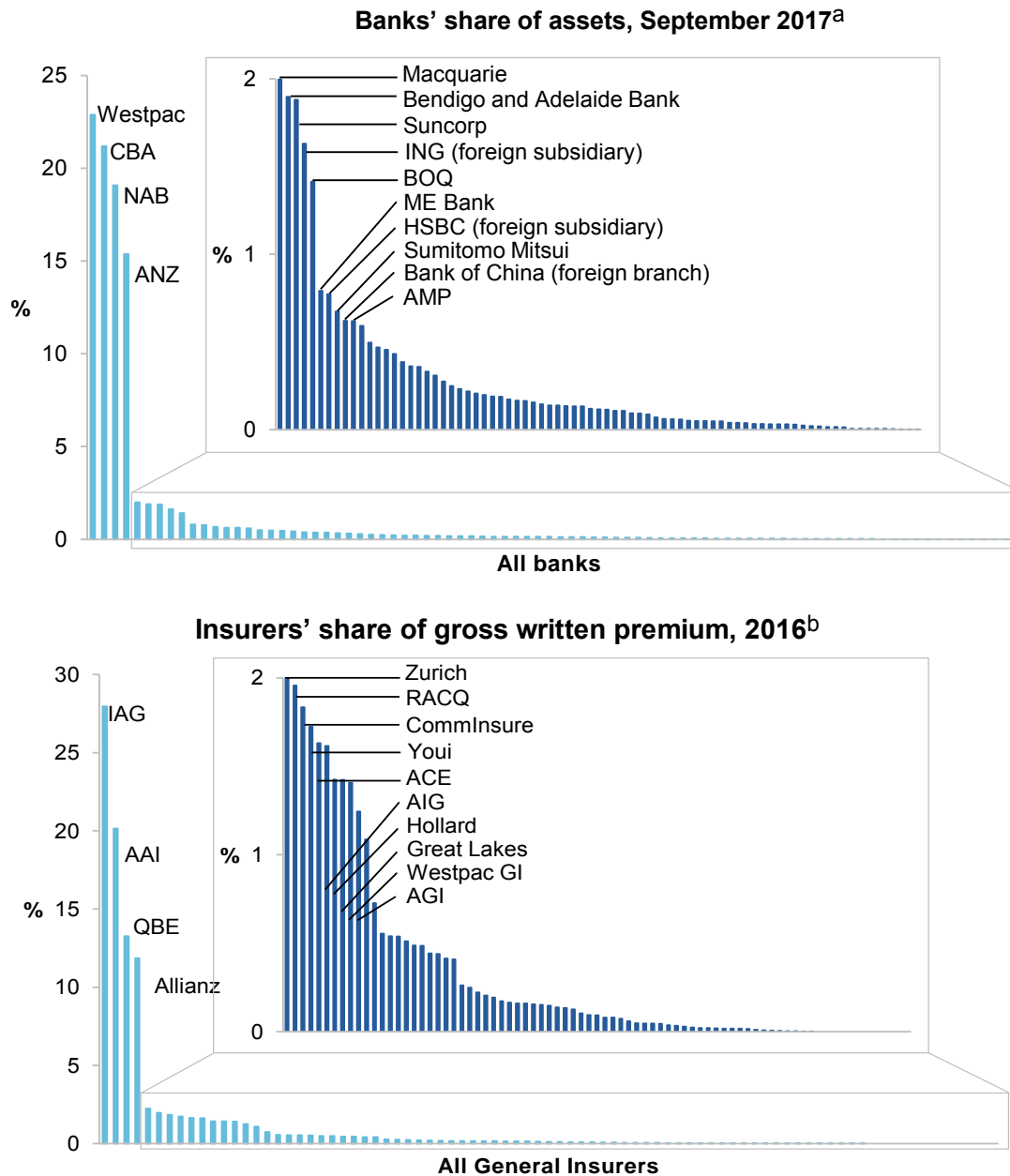
In contrast, in Australia's banking system, the major banks determine prices (subject to the RBA's cash rate and prudential regulation), and are able to pass on any cost increases to consumers without any substantial loss of market share (chapters 3, 6).

The 'tail' of smaller providers (figure II.1) aims primarily to match the major banks. 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 benefit from specialisation. 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.

And we cannot rely on the entry of foreign firms to re-invigorate competition. Most new prudentially-regulated entrants over the past decade have been foreign-owned, yet there has

not been a resulting noticeable change in the competitive behaviour of domestic providers in most product markets.

Figure II.1 Banking and insurance are dominated by large players — and long tails of other providers



^a Figures reflect share of assets held on banks' domestic books. ^b Calculations based on gross written premium, except home insurance and domestic motor insurance, which are based on gross earned premium. Calculations also based on level APRA 1 insurers, with level 1 IAG insurers aggregated. 'General' includes direct general insurance only, and excludes reinsurance and lenders mortgage insurance.

Source: APRA (2017m), Productivity Commission estimates based on APRA (General Insurance Institutional Level Statistics database; unpublished data for home, domestic motor and travel insurance)

Australia's banking sector is a strong oligopoly with a long tail of smaller providers. The general insurance sector similarly has a small number of very large providers and a long tail of smaller providers.

Prudential regulation substantially limits the scope for traditional price competition in banking and, to a degree, in insurance. The Reserve Bank of Australia setting of cash rates offers an opportunity for coordinated pricing in banking that is unique to this industry.

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

- Although at less than desirable levels, there is evidence of more competition (albeit on product features rather than price) in the markets for home loans, consumer credit cards, home insurance, wealth management and financial advice.
- There is evidence of less competition in the markets for small business credit, lenders mortgage insurance, add-on insurance and pet insurance.

Making competition a reality

Recent years have seen the introduction of a range of policies intended to induce competition by tackling the cost advantages of the major banks. These advantages, however, are a reflection of market factors, and investors' reasonable expectation that the government will step in and support major banks if they were in a crisis. We consider that policies intended to artificially raise the cost of funds are ultimately misguided and unlikely to yield any competition benefit.

Other policies are attempting to lower barriers to entry, and encourage further institutions to operate in the financial system. While lowering barriers to entry is a positive step, we consider that relying primarily on new entrants is unlikely to create long-term competitive behaviour in the financial system.

Much of what needs to change in order to promote competition in the financial system is the responsibility of regulators. Recommendations for reform in the regulatory system are discussed in part IV of this report.

We have also made recommendations to improve the behaviour of providers, in two key areas:

- promoting competition, by facilitating switching and overcoming existing barriers, through Open Banking and giving consumer rights over their data; creating a payment system that will give merchants choices in how payments are processed; and improving the availability of credit to SMEs, both through changes to prudential regulation that are

currently raising lending costs to small business without regard to risk profiles, and improved access to information.

- dealing with non-competitive outcomes, through better disclosure, making sure that consumers are given meaningful information about home loans and mortgage brokers; addressing conflicts of interest in the provision of mortgage broking services by introducing a clear legal duty on mortgage aggregators *owned by lenders* to act in consumers' best interests; and improving the information provided about insurance renewal prices, and the provider who underwrites the insurance.

These reforms are not intended to change the underlying market-driven structure of the financial system. As in other sectors of the economy, some providers will remain bigger and benefit from some advantages as a result of their size, and smaller operators will have to find ways to differentiate themselves. What these reforms intend to achieve is a better balance of power in the market for financial services, by removing the advantages afforded to some providers by regulatory intervention, and some of the obfuscation and confusion that make it difficult for consumers to benefit from competition.

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. While this level of concentration in itself does *not* mean markets cannot be competitive or deliver beneficial outcomes for the community, it does provide significant advantage to those large banks in a context where size is strongly associated with safety.
- 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.
- The major banks hold substantial market power, reflecting their structural advantages:
 - As a result of their size and scope, the major banks benefit from lower operating costs, including lower costs of funds. Vertical and horizontal integration may extend the benefit of this in some markets.
 - 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.
 - Although regulators are introducing policies that are said to offset some of these advantages, these policies may risk reducing competition and harming consumers.
- This high concentration of market power among a very small number of institutions is a concern if it results in poor consumer outcomes. There is some evidence that this is the case in Australia.
- The major banks' market power gives them the ability to pass on any cost increases to their customers. 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.
- Other institutions generally behave as market 'followers' and mirror the major banks' pricing decisions. As a result, prices for banking products tend to converge. This level of pricing is unlikely to be reflective of marginal costs, which should be the tendency in a competitive market.
- Overall, major banks *do* hold effective pricing power, and other operators in the market aim primarily to match them.
- Service competition is more apparent than price competition.
- 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, as it makes meaningful choice very difficult. It does, however, give the banks the ability to choose the level of price and conditions-based response in some markets.
- The ability for regulators or customers to alter the pricing paradigm is limited by the constant reference by both to the desirability of a safe banking system. For competition to be effective, risk-taking should not be unduly restricted.

Australia's banking system has been dominated by a handful of large players for many years. 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 application 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 stated that Australia's major banks hold substantial market power (for example, ACCC, sub. 17; Heritage Bank, sub. 51). However, as 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 allow some incumbents to gain substantial market power. Existing lenders have a substantial

knowledge base about their borrowers, and this gives them an advantage over new entrants, who need to make large investments in assessing the credit-worthiness of potential borrowers (chapter 4). This can also act as a deterrent to switching, as consumers perceive the process of transferring information from one bank to another to be a difficult process with little long term benefit (chapter 13). The information advantage held by incumbent institutions gives them substantial market power, as it both enables them to charge higher interest rates and limits new entry (Dell’Ariccia 1998).

Additional factors that influence the market power of individual institutions, or categories of similar institutions, include the scale and scope of their activities, the strength of their brands, and the behaviour of consumers and regulators.

Scale and scope

In Australia, the four major banks — Westpac Banking Corporation (Westpac), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Australia New Zealand Banking Group (ANZ) — are very sizeable institutions, with substantial market shares across all banking products. They employ tens of thousands of people and operate thousands of branches. They also hold very substantial assets, accounting for nearly 80% of the entire banking system (APRA 2017m).

This 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 operate on a large scale that enables them to expand their customer base. At the same time, size can create challenges — for example, changes are more difficult to implement in very large systems. There is also a tipping point beyond which large organisations are no longer efficient and they operate at declining returns to scale.³

Larger operators also benefit, to an extent, from vertical and horizontal 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 to access funding markets and other types of infrastructure. 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 5, 7). Horizontal integration gives the larger institutions the opportunity to cross subsidise their various products, and also offer consumers an integrated basket of services, which may help to lock customers into the provider and raise customer switching costs (chapter 13).

The one clear 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

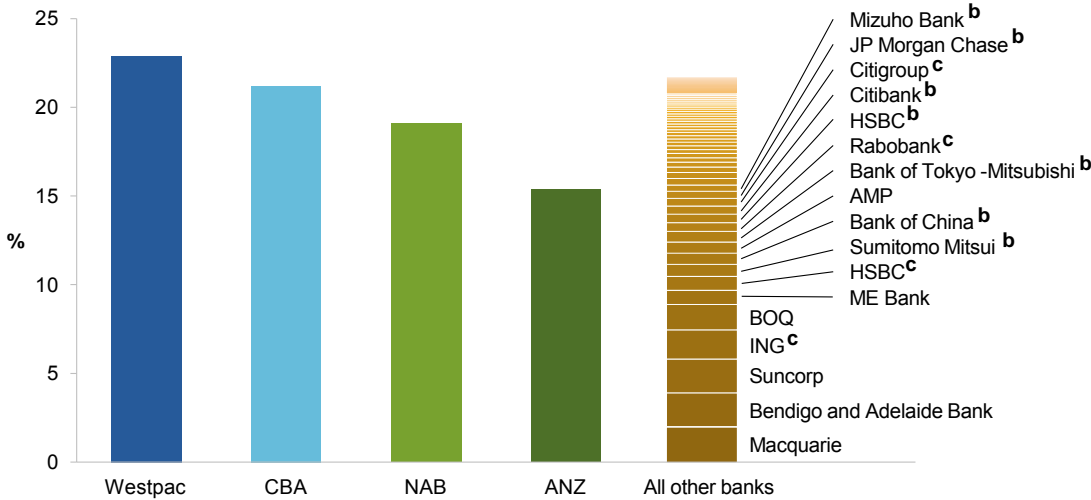
³ The most recent literature on bank efficiency in Australia uses pre-GFC data. Depending on the econometric technique used, different banks are found to be inefficient. Paul and Kourouche (2008) find that Westpac and ANZ are inefficient, while Moradi-Motlagh and Saleh (2014) find that Westpac, NAB and CBA are inefficient.

better credit ratings, and as a result, investors and depositors are willing to lend them funds at lower rates. These credit ratings benefit from explicit and implicit government guarantees, such as being considered ‘too big to fail’ (chapters 5, 16). These 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.

Given the importance of size, as well as the potential for cost savings, smaller players across the 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 September 2017, ANZ (the smallest of the majors) was five times bigger than Macquarie, the next bank by size of assets. Seventeen banks (ranking 5th to 21st 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, 17 other Australian banks would need to merge

Banks’ share of assets, September 2017^a



^a Figures reflect share of assets held on banks’ domestic books. ^b Foreign bank branch. ^c Foreign bank subsidiary.

Source: APRA (2017m)

Geography and distribution networks

An important aspect of size is geographical reach, either through branches or other distribution networks available to banks. In 2016, there were over 5300 bank branches, about 470 credit union branches and 76 building society branches. The major banks accounted for

nearly 70% of all branches, and only two other ADIs had branches in every state and territory (APRA 2016a). Major banks are also strongly represented in other distribution networks, such as mortgage brokers (chapter 8). Establishing large branch networks is costly, and most small providers are confined to a relatively small geographical area, or choose to operate mostly online or through third party distributors. These alternative distribution channels have increased the market reach of some smaller institutions, allowing them to expand their operations on a national scale (chapter 8).

Although consumers increasingly deal with their bank online, the physical presence of the major banks, through their numerous branches, contributes to their strong brand recognition and makes it easier for them to attract new customers. This further cements their existing market shares, and market power.

Branding and consumer behaviour

A strong brand is an important asset in any industry; for ADIs, it means they can attract customers more easily and develop a reputation as trusted, financially stable organisations.

Australia's major banks have some of the strongest 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 (see, for example, HoRSCE 2017b). At the same time, customer satisfaction with 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*.

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)

A strong brand 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 value or quality when purchasing a branded product (Porter 1976).

In the case of banking, 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 GFC, consumers transferred some of their savings to the major banks, as they were perceived as safer (chapter 6). Even when no financial crisis looms, small institutions may find it difficult to attract consumers from rivals that are perceived as safer.

Further, consumer behaviour contributes to market power; the low levels of consumer switching and a general disengagement from financial services (chapter 13) help ADIs maintain their position in the market, and make it harder for new competitors to gain any significant market share.

Regulation

Some of the regulation being introduced by the Australian Government and the Australian Prudential Regulation Authority (APRA) is intended to offset the cost advantages of the major banks — examples include the bank levy and the prudential regulation imposed on domestically significant banks, which only applies to the big four banks (chapters 5 and 16 discuss these policies and their effect on banks' funding costs in detail).

When such regulations unnecessarily raise the costs of the major banks, they may help smaller competitors. However, they harm consumers and are inherently anticompetitive. Competition is not about protecting competitors, such as smaller ADIs, but about creating an environment where consumers benefit from high quality products at the lowest prices. Raising major banks' costs, which are often passed on to customers through higher prices or lower levels of service, does not help competition.

Regulatory change may sometimes benefit the major banks. For example, Australia's big four banks and Macquarie have invested in developing internal ratings-based (IRB) models. Approved by 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 increase the institutions' operating costs (chapter 5).

This is in part intended to encourage all institutions to invest in IRB models, but this is yet to occur, given the large investments required in terms of time and money (chapter 6). Therefore, the larger banks enjoy lower *regulated* operating costs — aside from any ratings agency advantage that also comes with size — and overall again may increase their market power.

Some smaller players argue that the pace and extent of regulatory change has left them little resources to increase market share:

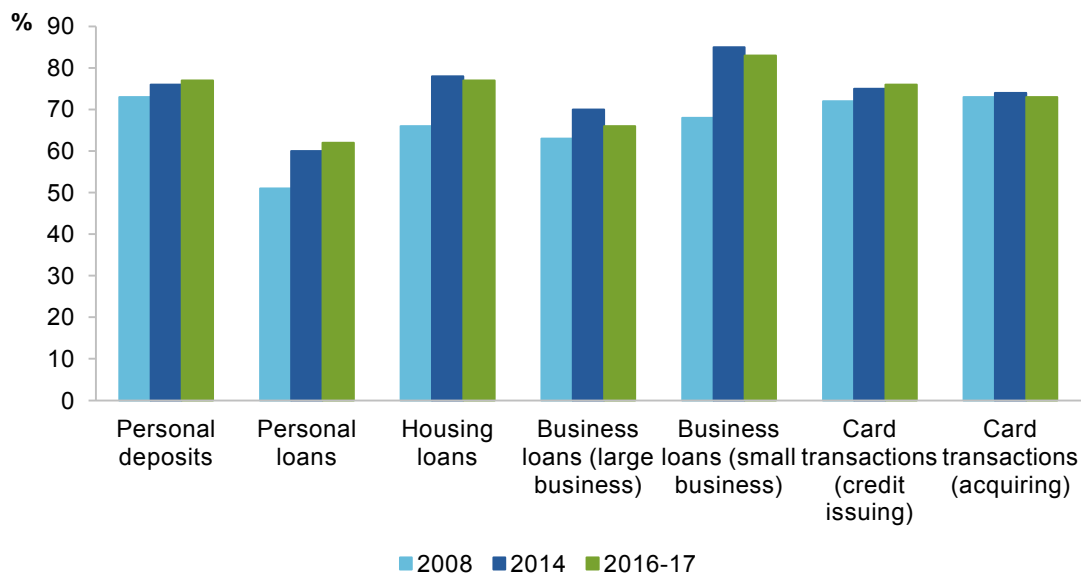
The increasing rate of regulatory change and speed of innovation in the sector means many mutual organisations need to focus on playing catch-up to meet the widening technical capability gap. They are doing this by investing capital in areas such as optimising core banking systems and enhancing loan 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)

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

3.2 The current balance of market power

A cursory glance at Australia’s banking system reveals a high level of market concentration. 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). The number of institutions has been declining, as smaller credit unions and building societies have consolidated. Nonetheless, there is still significant diversity within the banking system, and consumers can choose between a wide range of providers (chapter 4). Concentration indexes show that competition in some markets (for example, home lending) is higher 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



Source: RBA (sub. 29)

These high levels of concentration have led many stakeholders to raise concerns about the levels of competition in banking. In highly concentrated banking systems, large players are often able to exercise their market power and increase prices. This can result in losses to the

community, as it means prices to consumers are higher and banks are less efficient than they would otherwise be under competitive conditions (Berger and Hannan 1998).

Further, it has been suggested that the Australian banking system operates through tacit collusion between the major banks:

While each bank may act independently, its decisions must reflect the expected reactions of its rivals. A pattern of non-aggressive behaviour may emerge as a result. (Office of Regulation Review 1995, p. 23)

But high concentration on its own is not necessarily indicative of inefficient pricing or (tacitly collusive) oligopolistic behaviour. Therefore, the questions for this inquiry are:

- Are banks competing on price? If not price, do they compete in other ways and does this benefit consumers? Who holds the pricing power in the banking system?
- Are banks operating efficiently, or are they able to use their market power to support profits despite being inefficient?
- Has a ‘pattern of non-aggressive behaviour’ (tacit collusion) emerged among ADIs, and in particular the major banks?

Who sets the price of banking products?

In a competitive market, there should be limited scope for a single bank or a group of ADIs 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 rely on their pricing power 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 ADIs or any increases in their costs (Taylor 2000).

Fees have been declining — but that is 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 (RBA 2017k) (chapter 10 discusses merchant fees in detail).

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).

However, such evidence does not necessarily indicate that ADIs compete on fees. Product bundling makes it difficult to identify and compare the fees paid for specific products (chapter 7). 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 (chapter 13).

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 foreign ATM fees 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 foreign 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 (RBA 2017k).

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

Net interest income accounts for about 70% of banks' operating income, and housing loans are the largest single contributor — total income from interest on housing loans is double the amount of income ADIs generate from all types of fees (APRA 2017t). But unlike fees, where ADIs' decisions are generally not affected by regulation,⁴ the interest rates charged on housing loans are indirectly constrained by regulatory intervention. These interest rates reflect the effect of prudential regulation, which determines how much and what type of capital institutions must hold against each loan, and the effect of the RBA-determined cash rate, which affects the interest rates paid by institutions themselves for the funds they borrow (chapter 6).

Over the past five years, changes to prudential regulations have increased the cost of funding for the major banks. However, they have been able to recoup these higher costs by increasing interest rates for borrowers (Atkin and Cheung 2017) (chapter 6 discusses this issue in detail). This increase was 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 6).

Nonetheless, some smaller institutions, and in particular credit unions and other customer-owned ADIs, tend to charge lower 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). Given they have smaller market shares, they can ill afford to lose customers and need to keep their prices lower. But in many cases, the reference point for pricing decisions is the actions of the major banks — rather than marginal costs.

⁴ One exception is fees in parts of the retail payments system, which are regulated by the RBA (appendix B).

Are ADIs efficient?

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)

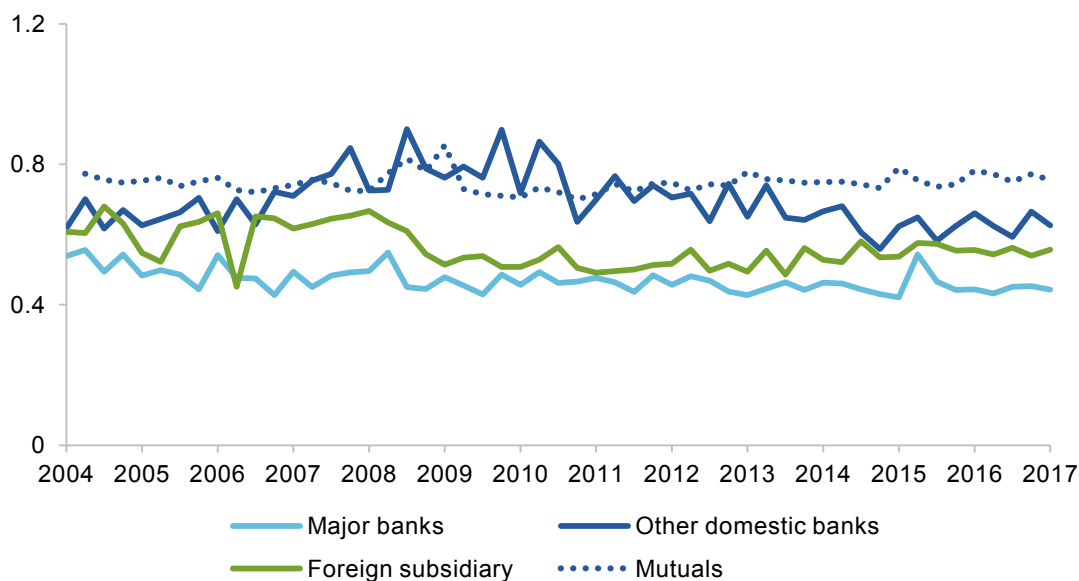
The RBA takes a different view:

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 3.3). But this ratio is only part of the efficiency picture. Larger banks tend 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). Some researchers have found that compared with smaller institutions, the major banks can generate more profits for a given amount of inputs, but incur higher costs. In other words, their business objective appears (perhaps unsurprisingly) to be maximising their profits rather than minimising costs (Vu and Turnell 2011).

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 2017). This has reduced the cost of providing banking service, but ADIs' market power means that they are not compelled to pass on their 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 delivered more convenient banking.

Figure 3.3 Cost to income ratios, by type of institution



Source: APRA (2017t)

Evidence of competitive behaviour?

In their submissions to this inquiry, the major banks as well as their regulators argued that competition in the banking system is evident in a number of market trends.

- Declining profits, as measured by net interest margins and return on equity⁵ (ANZ, sub. 49; APRA, sub. 22; NAB, sub. 31; 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)
- Price competition, including lower fees and interest rate discounts for home loans (ANZ, sub. 49; NAB, sub. 31; Westpac, sub. 28) and higher deposit rates (RBA, sub. 29)
- Service competition, such as an increasing range of benefits offered to consumers (CBA, sub. 25; Westpac, sub. 28).

Is competition affecting profits?

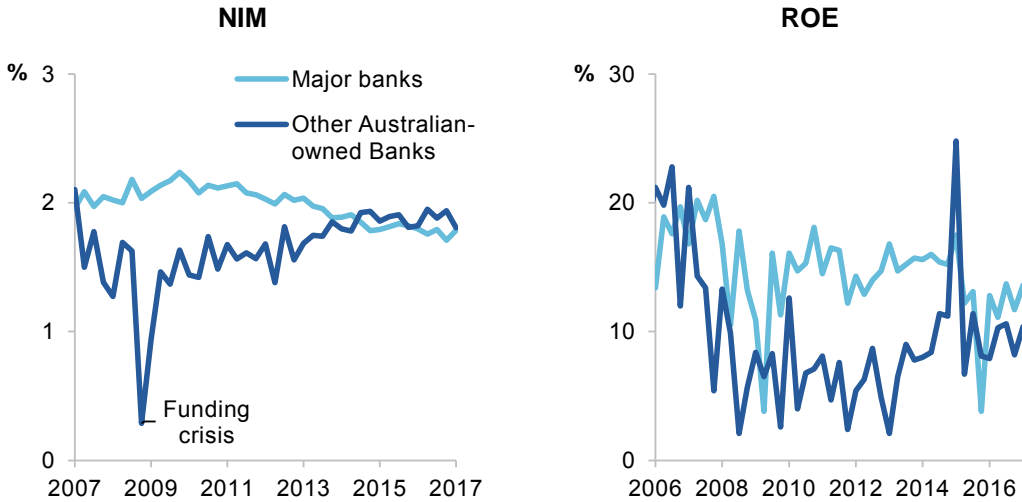
Banks' net interest margins declined substantially over the past three decades, as a result of deregulation. This has affected both major and other Australian-owned banks.

⁵ Net interest margin is 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).

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. In effect, the major banks benefited from the GFC — they raised the interest rates charged on loans, depositors moved back to them and consolidation led to an increase in their market power (Vu and Turnell 2011).

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 3.4). Major banks 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, it is not evidence of competition being effective.

Figure 3.4 Australian banks’ NIM and ROE



Source: NIM (net interest margin): APRA unpublished data; ROE (return on equity): APRA (2017t)

The reasons for the small shift that did occur in large bank margins in recent years appear to be related to factors other than competition. Regulation 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 increase their capital provision (RBA, sub. 29).

Major banks have taken a range of steps to support their ROE and NIM, including passing on higher costs to borrowers, and selling parts of their business that did not generate sufficient returns:

In an effort to improve ROE and refocus on core business, some banks have taken steps to unwind their vertically integrated business models by divesting components of their wealth management operations. A significant driver of this trend is that many of these businesses have failed to fulfil performance and shareholder return expectations; ADIs have typically been unable to realise all of the benefits that were expected of such financial activities. (APRA, sub. 22, pp.11-2)

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. All told, profitability for this industry has proven remarkably stable despite such a massive shock. Regulator action has also contributed to profitability — most recently, an increase in interest rates charged for investor and interest-only housing loans (chapter 6).

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, recover market shares and struggle to forecast future behaviour 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.

Is diversity of products and providers an indication of competition?

There are many operators in Australia’s banking system, some using different business models and different marketing strategies. 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 be indicative of a dynamic market, 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”) is 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). So we cannot at face value accept it as evidence of effective competition.

Is pricing competitive?

Banks, and in particular the major banks, have substantial pricing power. The thematic commonly used by all parties in the industry is that costs will have to be passed on to consumers. And so they are. This happened most recently with the changes to prudential regulation that increased banks’ funding costs (chapter 6). Whereas in competitive markets, the ability to do this is somewhat constrained by the variation in different businesses’ strategies to cope with a cost shift.

Australia has experienced such competitive market behaviour (such as being unable to pass on cost increases) in other industries over the past decade (from the time of the GFC). For example, the ACCC's inquiry into retail electricity prices included case studies from several sectors (from wineries to shopping centres operators), where suppliers were unable to pass on higher energy costs to their customers (ACCC 2017h). Costs can only be persistently passed on in sectors such as banking, where pricing power exists.

Many of ADIs' pricing decisions, particularly for housing loans, are directly affected by regulator activity (the actions of the RBA or APRA (chapter 6)). But as just described, profit margins have managed to persist despite shocks. Appendix C offers more data in support of the ability of banks as a group to persistently set prices in a cost-plus-margin fashion that allows them to remain highly profitable in almost any environment.

Moreover, 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 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 by each institution to customers for a given class of loan (chapter 8).

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 formal obligation to deliver them (chapter 8).

Discounts may or may not represent competitive behaviour. This is particularly so where they are based on a starting price that is not itself set competitively and (apparently) that 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,⁶ although not in banking where discounts are not advertised.

⁶ 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).

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 tend to converge to a mean. In a competitive market, such a mean can be expected to be the efficient price. But with the degree of regulatory influence over pricing (through the setting of the cash rate by the RBA and prudential requirements by APRA) and the follow-on language of passing on cost increases, the convergence in this case may not be solely a reflection of efficiency (chapter 6). Particularly for home loans, interest rates offered by the major banks tend to move together, and the smaller institutions tend to mirror their decisions (chapter 6).

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, and avoid being seen as offering identical products and services to their peers, which can threaten their profitability (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 horizontal 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. Local factors have been emphasised by smaller institutions that are regionally focused. 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 that 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 conditions, it has been suggested that there is ultimately little to distinguish the consumer experience across banks. Many may remain at risk of finding themselves in an environment characterised by little differentiation (PwC 2016a).

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 (chapter 5, appendix C).

Yet oligopoly behaviour and the ability to use market power adversely are also evident. The advantages gained through size, scope and strong brands, bolstered by regulation and consumer behaviour that favour safe, dominant entities give Australia's major banks a very strong position in the market. 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).

While competitive behaviour may show up occasionally in some parts of the market — in past decades, the entry of mortgage originators and foreign banks introducing online deposits (chapter 4) — it is hard to identify contemporary evidence of effective competition.

Not only do the major banks determine prices, other operators in the market compete only to match them. Matching the major banks' cost and scale advantages is in itself a substantial challenge for the 'long tail', comprising the smaller institutions that operate alongside the banking oligopoly. It is hard to envisage 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 the apparent safety of large, established operators — even when it comes at a considerable cost. 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; suppliers are limited by regulation in their ability to take on risks, and find it difficult to attract consumers if they are seen as operating outside the familiar environment of the banking system. As long as size acts as a protection from risk and a bulwark to competitive innovation, we will have few risk takers and limited competitive innovation and disruption.

DRAFT FINDING 3.1 THE MAJOR BANKS' OLIGOPOLY POWER

Australia's four major banks hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is further 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 – without losing market share.

The smaller banks and non-bank financial institutions follow the pricing trend set by the major banks, where they can. 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.

4 Can new players change the game?

Key points

- Australia has seen pockets of competition as a result of new entrants to the financial system, primarily from foreign banks and non-ADIs. While the entry of new institutions provides some evidence of contestability, this has largely been in markets other than retail banking.
 - In the past decade, there has been substantial consolidation in Australia’s banking sector, in particular among ADIs. Many ADIs have either merged or exited. Entities that have received a new ADI licence have all been branches of foreign banks.
- However, the experience to date suggests that new entrants have had limited success in spurring competition across financial services. More entrants alone cannot be relied upon to drive competition in the financial system.
- The Australian Government and regulators are gradually working towards reducing regulatory barriers to entry, such as making it easier to become and be known as a bank. Share ownership in both new and existing banks is unnecessarily restricted. Initiatives in these areas 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 several niche areas of the financial system. 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.
 - The market power held by the major banks reduces the scope for foreign banks to gain market share.
- The emergence of the ‘fintech’ sector provides an avenue for change in Australia’s financial system and worldwide. There is a strong case for fintechs to enter, grow and compete in Australia’s retail banking system — the provision of financial services tends to be vulnerable to disruption and evolution as technology advances and there is a premium on access to information and speed.
- Although a very small part of the system, fintechs represent a movement that could fundamentally change the nature of competition in the banking system. Insightful use of data may allow new challenger banks, enhanced customer experience, efficiency enhancements through the commoditisation of banking products and new financial services.
- However, more fintechs appear to be looking to collaborate with incumbent banks 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 locate 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 the financial services system, such as in the payments system. These companies have already established a large network of customers with multifaceted relationships and trust. This gives them a strong position from which to offer competitive financial services.

4.1 Entry, exit and contestability in banking

Contestability is a key condition to achieving competition in concentrated banking markets. A contestable competitive 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 is likely to, 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). While these rivals can be incumbent institutions, historically it has been new entrants into the financial system that typically drive 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)

Over the past 30 years, Australia has seen pockets of competition as a result of new entrants. For example, the entry of Aussie Homeloans into the residential mortgage market in 1996 is widely considered to have led to a dramatic reduction in overall home loan prices. And Tyro Payments (formerly MoneySwitch) which became a restricted authorised deposit-taking institution (ADI) in 2005, 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 last decade suggests that despite the presence of some more new entrants, they have had limited success in spurring competition across financial services. This suggests that more entrants alone cannot be relied upon to drive competition in the financial system.

In the past decade, 26 entrants received a new banking licence.⁷ All of these entrants were branches of foreign banks.⁸ Yet (as foreign branches with no authority to take domestic deposits) these banks have limited capacity to capture market share in Australia's retail banking markets.

At the same time, substantial consolidation in Australia's retail banking system has come from mergers between smaller players, particularly credit unions and building societies (APRA pers. comm., 14 September 2017).

Between June 2007 and 2017, the number of organisations with a banking licence dropped from 219 to 148 — a reduction of more than 30% (figure 4.1). This consolidation is to be expected given the benefits of scale economies and lower funding costs for larger institutions. Only a small proportion of ADIs actually exited the market.

⁷ Four of these have since exited the market.

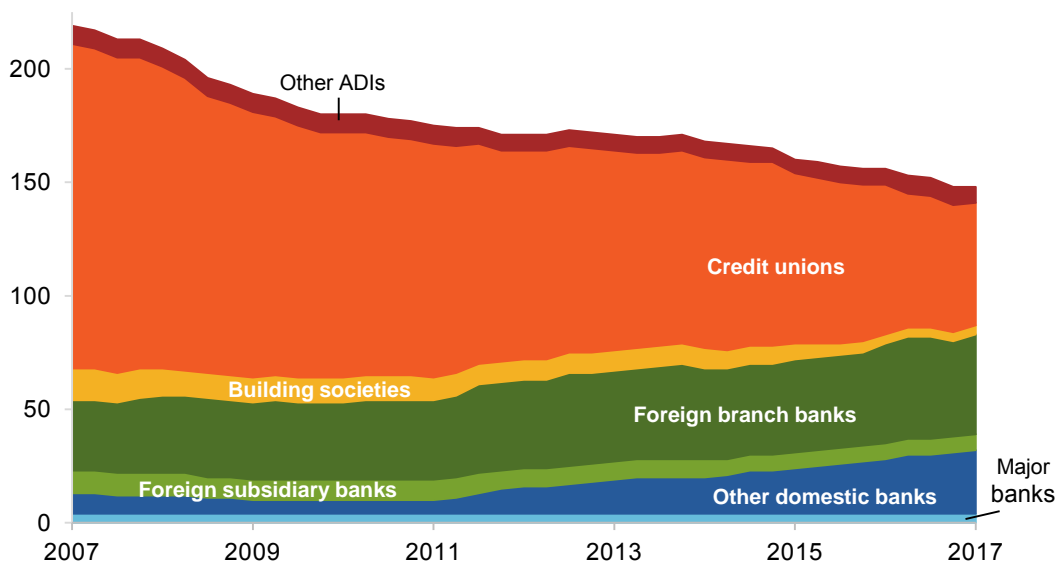
⁸ Some institutions that already had a banking licence have since had them varied over this period. For example, Tyro (2015) (formerly MoneySwitch) received a restricted licence in 2005 and later had their licence varied in 2015.

High barriers to entry and expansion can discourage new institutions from becoming vigorous competitors in the retail banking system. This reduces the pressure on incumbent institutions to compete amongst each other. As discussed below, there are several initiatives underway to reduce regulatory barriers to entry.

The emergence of the financial technology (‘fintech’) sector provides an avenue for competition and change in Australia’s financial system and worldwide. Fintech companies are primarily built around the use innovations in technology and a greater use of data to provide innovative financial services and products.

However, instead of becoming banks, many of these fintechs are focusing on providing services in less-regulated areas of the financial system, such as investment and lending. For example, many non-ADIs, including fintechs, compete to provide loans to businesses, including SMEs. However, the non-ADI share of all lending has declined since the global financial crisis (chapter 9).

Figure 4.1 The net result of ADI entries and exits^a
Total number of ADIs, year end June 2007–2017



^a Some ADIs have switched licence types rather than formally exiting or entering the banking system. For example, several credit unions became ‘mutual banks’ and are included in ‘other domestic banks’.

Source: APRA (2017s); Keane (2016)

DRAFT FINDING 4.1 A CONSOLIDATION IN BANKING

In the past decade, there has been substantial consolidation in Australia’s banking system. The number of organisations with a banking licence reduced by more than 30%. This was largely a result of mergers between institutions, rather than exits.

4.2 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 (chapter 2). 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 (appendix B). For example, the Australian Prudential Regulation Authority (APRA) enforces prudential regulations, such as capital and liquidity requirements, on banks to facilitate financial stability. Further, APRA will soon be able to extend its reach to intervene in the non-ADI sector if it identifies a systemic risk to financial stability (chapter 15).

It is important to strike a balance between barriers necessary to preserve regulatory objectives, such as financial stability, and those that unnecessarily inhibit competition from new entrants (chapter 16). Given the potential for new entrants, such as fintechs, to disrupt and compete in retail banking, unnecessary barriers to entry should be reduced or removed.

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 in part accepted by the Australian Government and APRA, and there are some initiatives in train aimed at reducing these barriers. The removal of such barriers should be high on the regulators' priority list.

Making it easier to apply for a new banking licence

The requirement for an entity to hold a banking licence (or similar) before it can accept deposits from the general public is a common requirement around the world. An entity seeking to operate a banking business in Australia must be authorised by APRA (2008a) and subject to prudential requirements, such as capital, governance, risk management and compliance.

However, there are some concerns that the current authorisation process can be difficult for small entrants to navigate and meet, discouraging entry (HoRSCE 2016d). Indeed, in a survey of Australian start-up fintechs, 80% thought that removing barriers to the creation of new banking licences would be an effective initiative to grow the fintech industry (EY 2017). APRA's (sub. 22, p. 22) process for licensing ADIs has traditionally been 'agnostic to size and business model'. This can make it an onerous process for small innovative entrants.

The [Murray Financial System Inquiry] also noted that regulatory frameworks can impose significant barriers to the entry and growth of new players, especially those with business models that do not fit well within existing regulatory frameworks ...

As observed by the [Murray Financial System Inquiry], the fixed costs of complying with regulation fall more heavily on smaller firms. (COBA, sub. 21, p. 23)

APRA (2017j) is currently reviewing and consulting on its approach to help new entrants navigate the licensing process.

This includes a new centralised licensing team and a phased approach to licensing. The phased approach involves a new restricted banking licence for applicants that allows them to conduct limited activities while they are still developing the resources and capabilities necessary to meet the prudential framework. APRA suggested that this new regime is already garnering interest from potential new entrants.

We are in discussions with a broad range of entities at various different degrees of maturity and readiness. There are some which are very interested and we expect to receive formal applications this year. That is a small number. There are a far larger number who are on some sort of path which may or may not lead to applicants, but we are clearly anticipating more applicants over time. (HoRSCE 2017b, p. 5)

The United Kingdom has already implemented a similar phased application process, which is believed to be largely responsible for increasing the number of new entrants from 1 bank in 2010 to more than 14 from 2014 onwards (Wallace 2016; Woolard 2017). The experience in the United Kingdom indicates that phased licensing may be a way to lower barriers to entry without necessarily compromising on prudential considerations.

While APRA has made significant progress on these reforms, we consider that a phased approach for licensing ADIs should be implemented by end-2018.

Making it easier to be called a ‘bank’

In addition to the requirements to become an ADI, section 66 of the *Banking Act 1959* (Cth) restricts the use of certain terms to institutions regulated by APRA — for example the terms ‘bank’, ‘credit union’ and ‘ADI’. These restrictions are intended to give customers confidence in their financial institutions.

These terms are restricted for use only by authorised deposit-taking institutions (ADIs) regulated by APRA to ensure potential customers are not misled into believing that non-APRA-regulated institutions have the same level of capital adequacy, depositor-priority and other prudential protections that apply to ADIs. (APRA 2015c)

Under the Act, APRA has the power to exempt institutions from this restriction. However, APRA requires that an entity hold over \$50 million in tier one capital if it wants to use the term ‘bank’ (APRA 2013c).

This \$50 million threshold can be 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. This is because a difference in naming conventions can create confusion for some consumers (COBA, sub. 21; Heritage Bank 2017c).

Start-up fintechs can find it difficult to raise this level of capital investment — indeed, Xinja pointed out that the \$50 million capital requirement is a significant barrier for banking start-ups, and may push some to partner with, rather than compete against, existing banks.

The pathways to starting a new bank in Australia are therefore a choice of three problems:

1. Raise over \$50m in capital,
2. Be dependent on and constrained by your competitors, or
3. Raise less capital and operate like a bank without calling yourself a bank.

None of these are particularly commercially attractive, market competitive, or market attractive. In fact, a branch of a foreign bank would most likely find it easier to enter the Australian market, than a local startup under the current regulatory framework. (Xinja, sub. 9, p. 3)

In the 2017-18 Budget, the Australian Government (2017c) stated that it would alleviate the prohibition on the use of the word ‘bank’ by ADIs. Legislation that would allow any ADI to use the term ‘bank’, except in exceptional circumstances determined by APRA, was introduced into parliament in October 2017, but it is yet to pass into law (Australian Government 2017h; The Treasury 2017b).

We consider that this is a useful measure that will make it easier for start-ups to enter and compete in retail banking and should be implemented by mid-2018 at the latest.

Loosening the ownership cap on banks

Under the *Financial Sector (Shareholdings) Act 1998* (Cth) a shareholder or group of associated shareholders cannot hold more than 15% of an ADI’s voting shares. This was a prudential regulation, enacted in response to the 1997 Wallis Financial System Inquiry, to create a diversity of ownership. This would 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 by the Treasurer (on national interest grounds) or APRA if the ADI has less than \$1 billion in residential assets (HoRSCE 2016d).

In its first report of a review of the four major banks, the House of Representatives Standing Committee on Economics (2016d) 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.

In its 2017-18 Budget, the Australian Government (2017c) stated that it would look to relax the ownership cap for innovative *new entrants*, either through existing ministerial discretion or legislative change. However, progress to date has not yet been made public.

Reducing this ownership limitation may be a useful way to encourage small new entrants that would otherwise have difficulty raising capital. The Commission considers that the

Australian Government should expedite its review of the ownership cap with the aim of having new arrangements in place not later than the end of end-2018.

In chapter 16, we query the continued policy attachment to the Four Pillars policy, which we suggest is redundant, removes a discipline on poor management (the threat of takeover), and embeds a market structure.

We consider the ownership cap review should thus not restrict itself to new entrants' share structures. Share ownership in existing ADIs (including the major banks) should also be considered.

DRAFT RECOMMENDATION 4.1 REDUCING REGULATORY BARRIERS TO ENTRY AND EXPANSION

The Australian Prudential Regulation Authority (APRA) and the Australian Government should prioritise reforms that reduce regulatory barriers to entry and expansion in banking.

- APRA should finalise and implement its phased approach for licensing authorised deposit-taking institutions (ADIs) and revise its policies and guidelines for removing restrictions on the use of the term 'bank'.
- The Australian Government should determine revised ownership rules (including a higher threshold on ownership) under the *Financial Sector (Shareholdings) Act 1998* (Cth) to improve access to capital for both new entrants and existing banks. For existing ADIs, share ownership limits should be reviewed, without the presumption of the Four Pillars policy.

These reforms and determinations should be completed no later than end-2018.

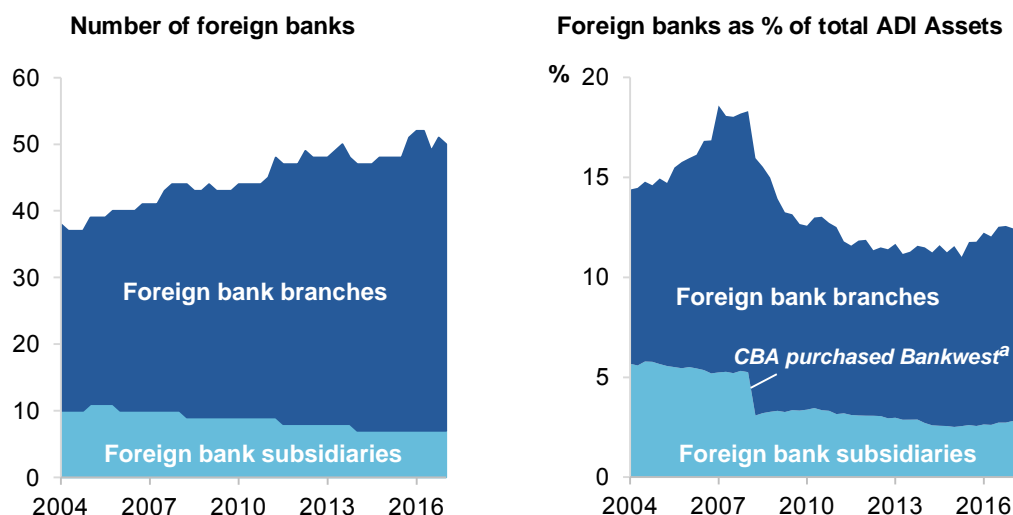
4.3 Foreign bank impacts have been limited to select markets

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 is certainly the case in the markets in which they have chosen to focus, but they have not yet proven a significant source of competition for 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 hold a total of 13% of total ADI assets (figure 4.2). The largest foreign bank in Australia accounts for just under 2% of total resident banking assets and deposits (APRA 2017n).

Figure 4.2 Foreign banks in Australia
2004–2017



^a Bankwest was acquired by the Bank of Scotland in 1995, operating as a foreign subsidiary. In 2008, the Commonwealth Bank of Australia (CBA) purchased Bankwest and its assets were no longer recorded as a foreign bank subsidiary.

Source: APRA (2017t)

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, meaning they face the same prudential requirements as domestic ADIs (table 4.1). APRA’s prudential settings are some of the most risk-averse internationally (chapter 16). 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 cannot accept retail deposits (of less than \$250 000) from Australian residents.

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	43
Representative office ^d	No	No	No	No	13

^a Some foreign banks operate both a branch and subsidiary in Australia. ^b Retail deposits means the bank can accept deposits from Australia residents and non-corporate institutions of less than \$250 000. ^c Number as at 3 November 2017. ^d Foreign banks can also establish representative offices in Australia, for example 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, 2017d, 2017k)

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 4.2). 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. The difference in regulatory treatment between a branch and subsidiary explains why just one foreign bank subsidiary has entered the market 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). It is much simpler for foreign banks to open and operate a branch in Australia than a subsidiary. Indeed, in the past, some foreign banks replaced their subsidiaries with branches (RBA 2012b).

However, given foreign bank branches cannot accept retail deposits, they are clearly not substitutable for the everyday banking needs of most Australians. Instead, branches tend to concentrate on wholesale banking operations because they are less constrained by capital limits in Australia and can access funds globally, including through their parent company. In contrast, subsidiaries tend to focus on the retail market, using local deposits to fund their lending.

Therefore, competition that benefits Australia's households is more likely to come from foreign bank subsidiaries, rather than branches. This may be problematic, as foreign banks are more likely to set up branches and there has been a decline in the number of subsidiaries as potential competitors.

Foreign banks largely specialise in particular market segments

In Australia, foreign banks have exerted competitive pressure in particular market segments, but not more broadly across the financial system.

During the late-1990s, foreign banks, 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 led to a significant increase in the foreign banks' market share for deposits (RBA 2008). Subsequently, Australian banks introduced similar accounts as their market shares began to decline. This is an excellent example of new entrants providing an innovative banking product at a competitive price, and pushing their peers to compete.

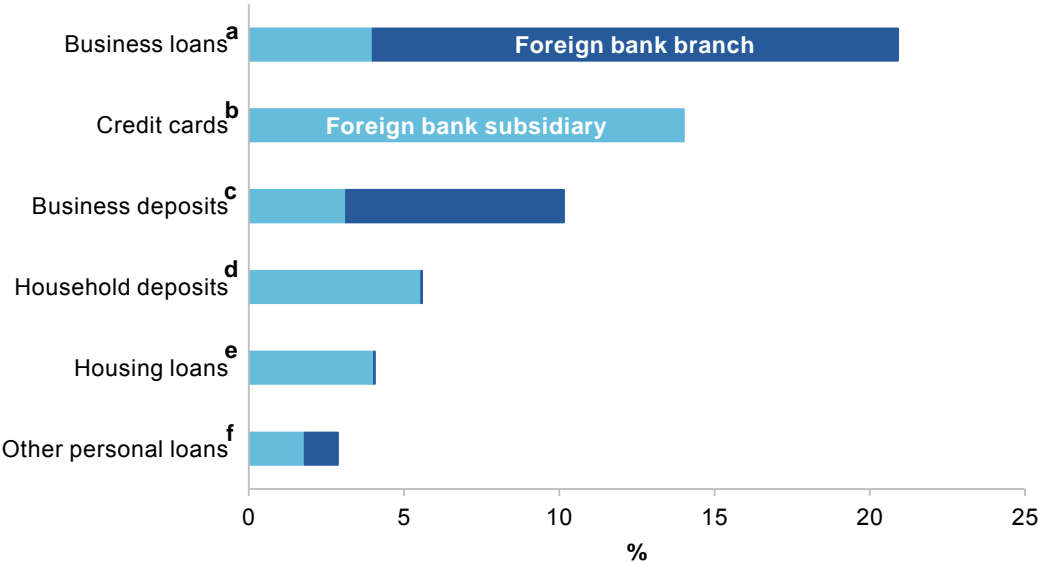
Since the early 2000s, foreign bank lending to businesses has increased (RBA 2014a). For example, prior to the global financial crisis, a number of foreign banks increased property lending to businesses. Following the crisis, some European banks and non-bank lenders have

exited the market as their parent entities sought to scale back their global operations. However, some Asian banks have since expanded their presence in Australian business lending markets.

Foreign banks hold a significant portion of market share in a few key product segments (figure 4.3). Foreign bank branches are more active in business lending and deposits. In contrast, and with some notable exceptions (such as Rabobank in agribusiness lending), foreign bank subsidiaries are the main foreign players in household deposits and lending, but tend to hold much smaller market shares. Indeed, the major banks hold significantly lower market 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)

Figure 4.3 Foreign bank market shares in select product segments
September 2017



^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 (2017m)

The RBA (sub. 29, p. 40) believes ‘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 — such as for businesses owned by dual nationals in Australia.

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).

Credit card issuance is another market where foreign banks are active in Australia. A number of smaller ADIs advised us that they use foreign banks, such as Citibank, to be the issuer of credit cards for their customers.

Are there additional barriers to foreign bank entry and expansion?

In principle, the high profitability of Australia's larger banks, relative to other sectors and countries, has the potential to make the local market attractive to new foreign operators (chapter 3). While the same regulatory barriers (discussed earlier) that face new entrants also face foreign entrants, they have the option of drawing on the resources and the 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.

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, the introduction of online savings accounts gave some foreign banks a foothold in the Australian market. Further, foreign banks may be able to tap into the residential home loan market using an established network of mortgage brokers. For example, ING (sub. 20) (a foreign bank subsidiary) uses a network of mortgage brokers and financial planners to access the market. Finally, 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 suggests 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)

DRAFT FINDING 4.2 FOREIGN BANKS REMAIN PREDOMINANTLY NICHE OPERATORS

Foreign banks have shown that they are willing to enter Australia's banking system — between 2007 and 2017, all 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 most foreign banks thus remain relatively niche operators, offering financial services to subsets of the population, they cannot be relied on to be the primary source of new competition in the retail banking sector.

4.4 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.⁹ This means they can be start-ups, mature companies and even non-financial services entities. Fintech opportunities arise from the operational and process shortcomings of incumbent entities.

There is a strong case for fintechs to enter, grow and compete in Australia's retail banking system. Profits of larger players are generally high (chapter 3), Australians are, for the most part, comparatively quick to take up new technology, and the provision of financial services tends to be 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 2017).

The many faces of fintech

Fintechs offer a broad range of financial services, such as wealth, lending and payments services (figure 4.4). 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).

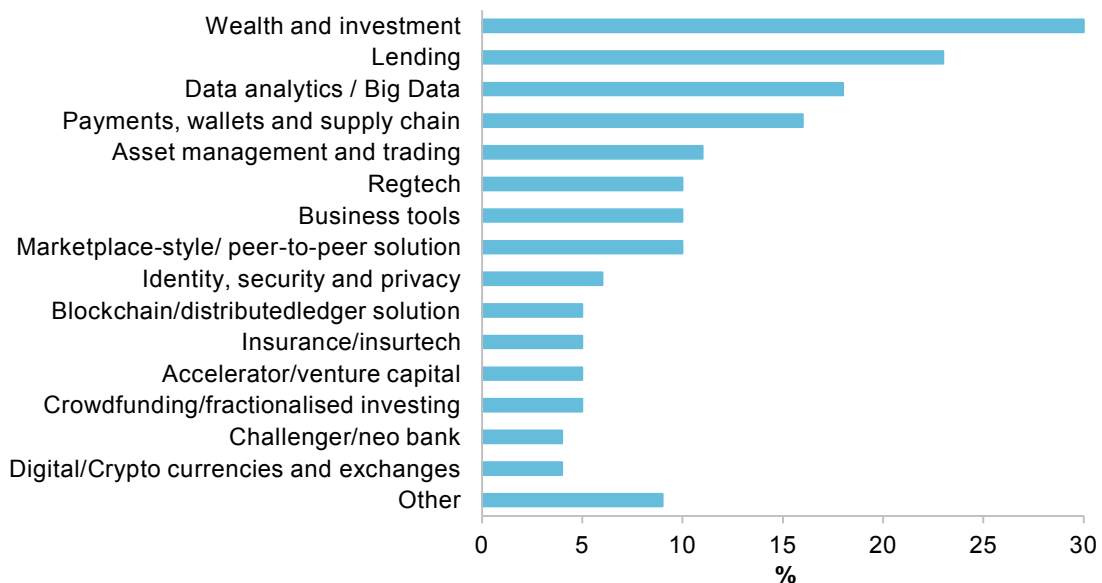
In Australia, the potential for fintechs to compete is supported by broader changes in the community. The underlying technology (such as mobile phones) has become ubiquitous and transformed consumer behaviours and expectations of digital services. For example, Australia has a very high penetration of smart-phones (Deloitte 2016b). Further, younger

⁹ 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 2017j, p. 6).

generations tend to be more tech-savvy and open to alternative providers of financial services (Telstra 2017).

In recent years, the fintech sector in Australia has grown significantly, to nearly 600 start-up companies in 2017, compared with less than 100 in 2014 (KPMG 2017). Investment in start-up fintechs reached \$US 675 million in 2016, increasing from \$US 53 million in 2012.

Figure 4.4 Financial services offered by fintechs in Australia^a
2017



^a Multiple response.

Source: Based on EY (2017)

The Bank for International Settlements classifies two broad ways that fintechs can compete in the banking system (BIS 2017). 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 and mature, 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 4.5).

- Better banks — incumbents may upgrade their existing customer platforms and use innovative technology to provide better services. Many Australian ADIs 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.¹⁰ Xinja (sub. 9) is an example of a neo bank attempting to establish itself in Australia.

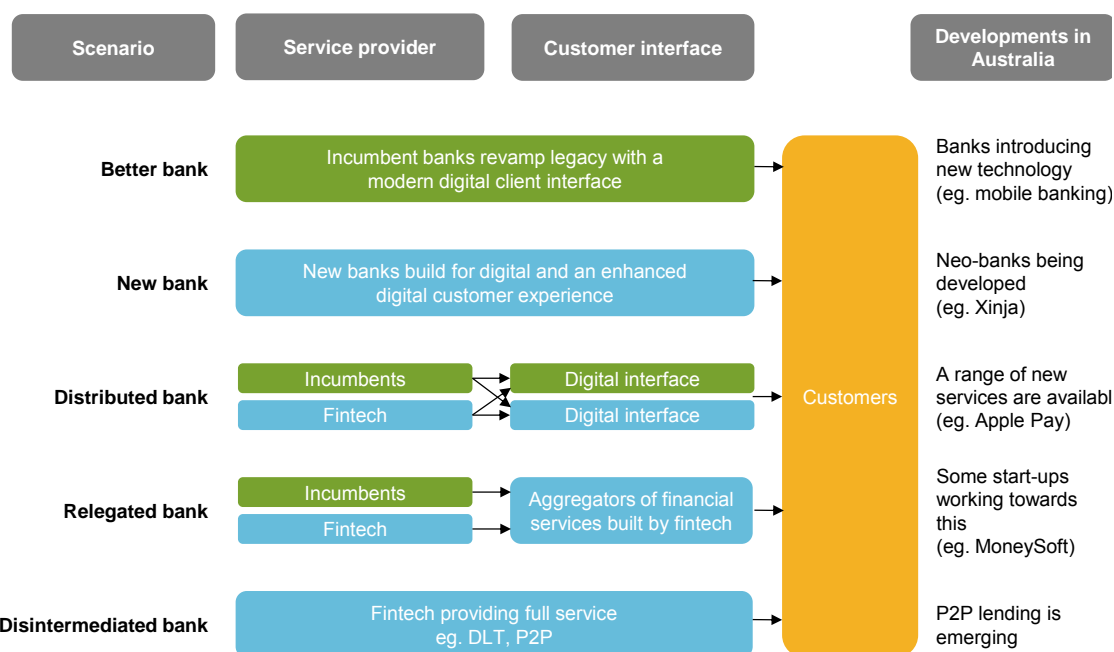
- Distributed banks — banks can co-operate with technology companies, so that each provides the service they specialise in with links or referrals between them. For example, some banks allow customers to use third party digital wallets, such as Apple Pay (chapter 10). In another example, if a customer does not meet an established lender's requirements, the lender may refer the customer onto a peer-to-peer lender.
- 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 wide 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 2017).
- 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.

In Australia, fintechs are working towards each of these scenarios. For example, many fintechs offer consumers automated financial advice, peer-to-peer lending and crowd-sourced property investment (figure 4.4).¹¹ 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').

¹⁰ 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.

¹¹ Peer-to-peer (marketplace) lending matches investors with borrowers.

Figure 4.5 How fintechs can compete in the banking system^a



^a DLT is distributed ledger technology. P2P is peer-to-peer lending.

Source: Adapted from BIS (2017)

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 2017, pp. 17–18). In the United Kingdom, a number of neo banks have gained banking licences (Dunkley 2017) — for example, Atom Bank in 2015 (Wallace 2015). Atom Bank 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.

The United Kingdom’s recent experience with challenger banks demonstrates the potential for these types of competitors to enter and grow 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 struggle to gain market share given barriers to expansion, such as reluctance for customers to switch (BIS 2017; Dunkley 2017; WEF 2017a).

In Australia, most start-up fintechs tend to focus on relatively less-regulated areas of the financial system, such as money management and lending services, rather than the onerous prudential regulation involved with retail deposit-taking (figure 4.4).

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)

Neo banks are yet to make strides in Australia — only a small proportion of Australian fintechs consider themselves to be potential challenger banks (figure 4.4). Xinja (sub. 9) stated it is working to become Australia's first neo bank. However, since 2006, just one entity that was not already associated with a bank has been approved for a new banking licence in Australia (HoRSCE 2016d) — PayPal Australia received a licence in 2006, but does not operate in the retail banking market. In contrast, the United Kingdom has approved at least 14 banking licences since 2014, many of these neo banks and another 20 banks 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 2017). Many of these companies offer payments or lending services in Australia and abroad (chapters 9 and 10). 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).

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).

DRAFT 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 wealth, small-scale lending and payments systems. It remains to be seen if and how global technology companies will compete in banking and the broader financial system.

To compete or to collaborate, that is the question

It is clear that 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. For example, even though there are several fintech lenders targeting the small and medium enterprise (SME) market, their combined market share is about 3%, compared with over 70% held by the major banks (Banjo Loans 2016).

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. For example, in a survey of Australian fintechs, only 36% of fintechs said their biggest competitors were incumbents in 2017 (EY 2017).

... 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. First, fintechs can find it difficult to grow as customers tend to be reluctant to switch financial service providers (chapter 13). Second, fintechs can find it difficult to raise or access capital to fund their entry and growth, although the pool of fintech investment is continually growing and recent tax incentives have been well-received (EY 2017). Finally, partnering with incumbents can reduce barriers to entry, including regulatory barriers.

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. (Capgemini and The University of Sydney Business School 2017, p. 18)

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 or investing in fintechs (ANZ, sub. 49; CBA, sub. 25; NAB, sub. 31; Westpac, sub. 28). This benefits the 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. But it also would likely reduce the potential for these new entrants to be a source of competition.

However, if barriers to entry and expansion continue to fall, and data reforms are pursued effectively by the Australian Government, fintechs will find it easier to compete against incumbents.

DRAFT FINDING 4.4 FINTECH COLLABORATION AND COMPETITION

Many fintechs are attempting to work with and provide services to incumbent banks, rather than compete against them. Incumbent banks are also looking to collaborate with fintechs as a way to innovate and lower the threat of future competitors.

While this is a legitimate and sensible commercial strategy for many, it means that these fintechs are unlikely to provide the basis for vigorous competition against incumbent banks in the near future.

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

Fintechs are slowly overcoming barriers to entry

Only one in three Australian fintech companies see government or regulatory issues as an external impediment to their expansion (EY 2016). More common 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 must be 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. This is because larger banks gain a significant advantage from economies of scale — they can raise funds at lower costs than smaller financial institutions (chapters 3 and 5).

In recent years, the Australian Government introduced initiatives to help start-up fintechs raise investment capital. For example, from July 2016, early stage investors in qualifying companies may be eligible for favourable tax treatment (ATO 2017b). Further, following legislation passed in 2017, in January 2018, the Australian Securities and Investments Commission (ASIC) (2018c) 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.¹² 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 convenience, technology and innovative solutions offered by fintechs, and growing more comfortable with alternatives to traditional financial institutions.

Further, many consumers are open to banking with a 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 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)

Traditional financial institutions also have the advantage of incumbency when it comes to retaining customers. Customers are generally reluctant to switch providers of financial services (chapter 13). Therefore, any new entrants would likely have to offer services that are significantly beneficial to consumers that they outweigh the costs of switching. That said, initiatives to reduce barriers to customer switching, such as the introduction of a consumer data right, may begin to erode some of the barriers to switching and also provide a fertile data-driven environment to encourage new fintechs to thrive (chapter 13).

¹² 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.

Making room in the regulatory sandbox for fintechs to provide their own products

All types of financial service providers are subject to market conduct requirements imposed by the *Corporations Act 2001* (Cth), which are administered by ASIC, including ADIs regulated by APRA (appendix B). These requirements can be difficult for start-up fintechs to understand and become a strain on their already limited resources, such as time, money and access to professional advice (ASIC 2017h). 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). The sandbox 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.¹³ 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 2017u).

However, by the end of 2017, just four businesses had used the fintech licensing exemption (ASIC 2017m). This is likely because the exemption only applies to fintechs that 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 limitations 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.

In October 2017, the Australian Government (2017d) released draft legislation and regulations for an 'enhanced regulatory sandbox' to broaden the scope of activities that can apply for the exemption. 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

¹³ 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 2017ag).

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.

Extending the regulatory sandbox to fintechs that take household deposits and issue financial products could further encourage innovative new entrants in the retail banking system, as well as the *provision* of other financial services. These temporary exemptions from ASIC’s licensing regime could complement APRA’s phased licensing approach for new fintechs that want to become a bank. Importantly, nothing in the sandbox would exempt a fintech from complying with prudential regulations. We are interested in stakeholder views on whether the regulatory sandbox could be extended to those fintechs that want to take retail deposits and issue other eligible financial products, including the merits and necessary consumer protections.

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 a limit between \$2000 and \$25 000.

Source: ASIC (2017w, 2017ag); Australian Government (2017e)

ASIC’s Innovation Hub and regulatory sandbox is aimed at helping start-ups navigate its regulatory system. However, some incumbents claimed that this unnecessarily inhibits innovation and collaboration from established institutions.

... access to ASIC’s Innovation Hub including the recently extended “regulatory sandbox” has only been provided to FinTech competitors, in contrast to markets like Singapore where sandboxes are available to all financial market participants. Commonwealth Bank believes that the “regulatory sandbox” should be extended to be accessible for all market participants, to

encourage further innovation and collaboration between existing participants and new market entrants. (CBA, sub. 25, p. 40)

The challenge for CUA is that established financial institutions like CUA are unable to participate in the sandbox due to the established criteria. This criteria may inhibit the likelihood of established financial institutions collaborating on early stage FinTech opportunities, restricting our ability to innovate and grow. (CUA, sub. 15, p. 5)

We are in favour of reducing barriers to entry for new entrants, by encouraging start-up fintechs to independently innovate, develop their business models and assist them to comply with regulatory requirements, without needing to collaborate with incumbent banks. This is achieved through ASIC's regulatory sandbox and broader measures of ASIC's Innovation Hub, such as providing start-ups with a designated contact to help them understand the regulatory framework.

However, we consider it is not necessary to extend the regulatory sandbox to established financial institutions for several reasons. First, these institutions are already licensed by ASIC and have significantly more experience in dealing with regulators. Second, these institutions can still rely on existing flexibility in the law and individual relief from ASIC. Finally, established institutions have a greater ability to test new products, and invest in and expand their operations, relative to start-up fintechs with limited capital.

In other words, incumbents already have the capacity to innovate and assisting new entrants will give incumbents an incentive to do so, drive competition and support the welfare of retail consumers and the broader community.

INFORMATION REQUEST 4.1 SHOULD ASIC'S REGULATORY SANDBOX BE EXTENDED?

Should the fintech licensing exemption offered under the Australian Securities and Investments Commission's (ASIC's) regulatory sandbox be extended to prudentially regulated fintechs that want to take retail deposits and issue other eligible financial products? If extended, would:

- an extension encourage new fintechs to become banks or providers of financial products*
 - any additional consumer protections be necessary to prevent poor conduct and retain consumer confidence?*
-

5 Funding models and their effect on competition

Key points

- The cost at which banks and non-bank financial institutions 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, in part as a result of the global financial crisis and ensuing regulatory changes. The RBA's cash rate influences the price of deposits, but the major banks' pricing power means they can determine to what extent changes in the cash rate are passed on to depositors. Smaller institutions then tend to follow the major banks.
 - Wholesale funds: Australia's major banks do not have similar pricing power in overseas capital markets. However, they pay less than smaller institutions for wholesale funds because they have higher credit ratings. These ratings reflect in part the expectation of ratings agencies that major banks will receive government support in a crisis (they are seen as 'too big to fail').
 - 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 (back to relatively high historic 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.
- Major banks gain a cost advantage from the structure of prudential regulation, which allows institutions to develop their own risk models to determine how much capital to hold against the loans they make. These models require a very large investment, and must be approved by APRA.
- 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 their own risk weight models must follow APRA's standardised risk weights. APRA's approach to risk weights has increased the cost disadvantage for smaller institutions and reduced price competition, potentially harming consumers.
- Overall, the major banks have lower cost of funds, compared with smaller institutions. This is unsurprising.
- The Australian Government and APRA have taken a range of steps with the *apparent* intent of increasing the cost of funds for major banks to improve competition. These include changes to risk weights for banks using internally developed models, as well as the bank levy. The Commission considers such an objective — lifting the cost of funds — to be misguided and likely to erode, not improve competition.

For all lenders in the Australian financial system, the cost of sourcing funds to provide credit to borrowers is their single largest expense. In the year to September 2017, authorised deposit-taking institutions (ADIs) paid over \$78 billion — more than half their interest income and about three times more than the cost of staff — in interest payments for their funding (APRA 2017t). Therefore, the cost of funds affects institutions' ability to compete in the market; those that face lower costs are in a better position to either attract more customers by charging less for credit, or increase their profits.

The overall cost of funds for institutions depends on the type of funding they use, the cost of each funding source, and the mix of funding sources. Each of these factors is affected both by regulation and market forces.

5.1 Which types of funding?

Australia's lenders can use a range of funding sources (figure 5.1). Their choices are influenced by market conditions as well as regulatory change. For example, since 2008, Australia's banks have increased their reliance on equity (including new issuance, retained earnings and dividend reinvestment plans) in response to prudential standards set by the Australian Prudential Regulation Authority (APRA) (Atkin and Cheung 2017).

The cost of equity has remained fairly unchanged since 2008 (Norman 2017). What has changed, however, is the regulatory environment that requires ADIs to hold more equity. This erodes returns on equity (ROE), and limits the major banks' ability to continue to deliver high profits to their shareholders (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)

In other words, banks that are more reliant on equity — in particular the major banks — have had to find ways to maintain high ROE, despite regulatory change. Their market power has largely allowed them to do this by increasing lending interest rates relative to the cash rate (chapters 3 and 6 discuss this issue in detail).

Not all types of lenders can use the entire range of funding sources (table 5.1) — for example, non-ADIs must fund their operations without taking deposits. Mutually owned institutions (including mutual banks, credit unions and building societies) are restricted in their use of equity. This can possibly affect their ability to compete, for example, if they cannot raise sufficient funds to expand their lending portfolios (COBA, sub. 21).

This limitation is a result of the way 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).¹⁴ 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 2017x).¹⁵

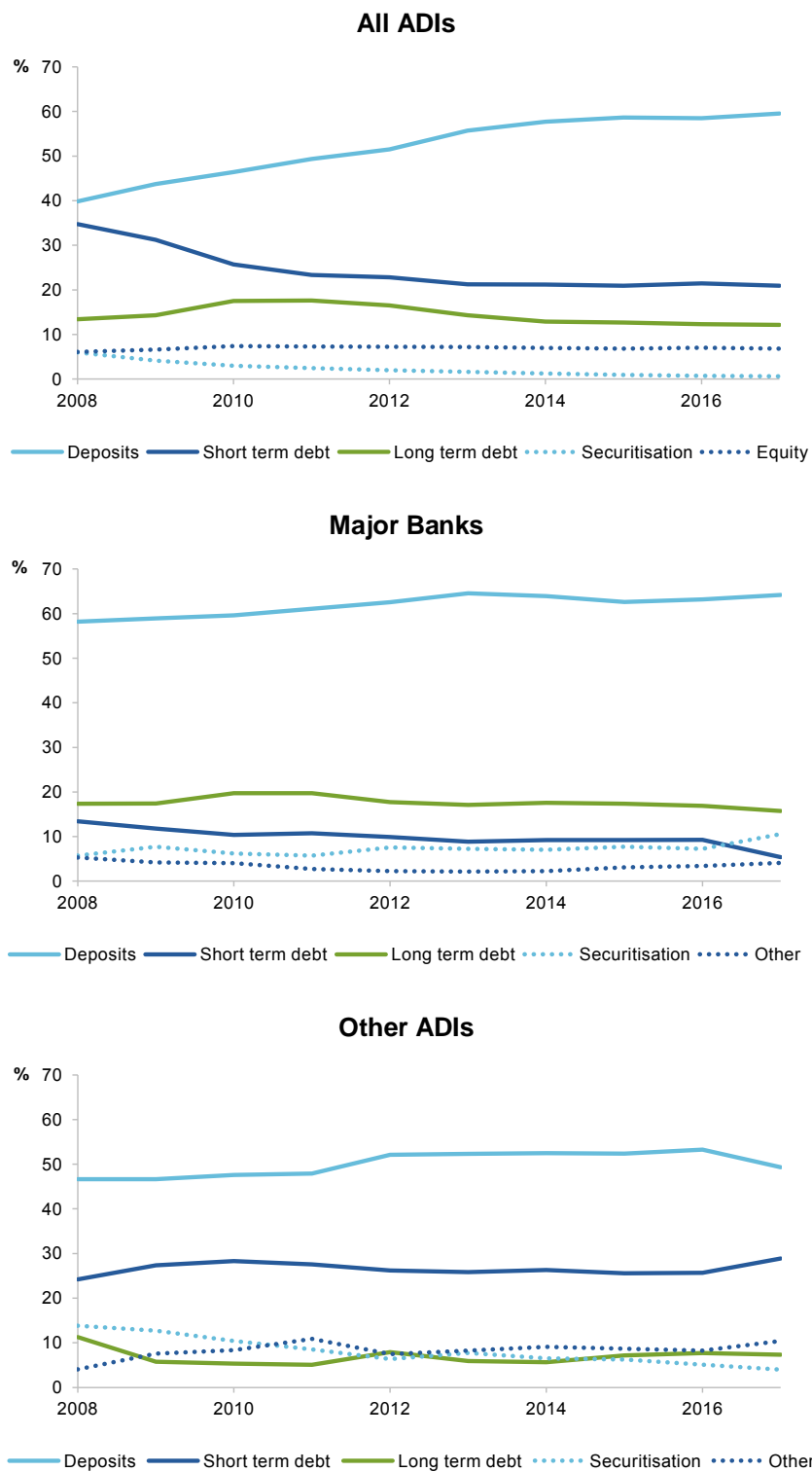
Table 5.1 Sources of funding for lenders

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 CUBS	Non-ADIs	Foreign banks
Deposits	Price affected by cash rate	✓	✓	✓	x	✓ Retail deposits only for foreign bank subsidiaries
Short term wholesale debt	On domestic markets — price driven by cash rate, and influenced by the institution's credit rating.	✓	✓	✓	✓	
Long term wholesale debt	On foreign markets — price determined by supply and demand in foreign markets and influenced by institution's credit rating	✓	✓	✓	✓	Funds are usually raised in the bank's country of origin – using any of these sources
New 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	✓	✓	✓	✓	

¹⁴ Mutual equity interests are a new form of capital available to a mutually owned ADI. The instrument provides no voting rights (other than those required under the Corporations Act) and limits both the claim of holders on any surplus of a failed mutual ADI and the amounts that can be paid by dividends to holders.

¹⁵ APRA requires all ADIs to hold specific proportions of Common Equity Tier 1 (CET1) capital, which include ordinary shares and retained earnings. Mutually owned institutions cannot issue ordinary shares, as this may be inconsistent with the way they are incorporated. Therefore, the main option until recently has been retaining earnings in order to comply with APRA's requirements. From January 2018, APRA's prudential standards allow mutual institutions to issue MEIs, which would count towards their CET1 capital. Following consultation with industry, APRA decided to increase its initial cap on the proportion of MEI that can be issued from 15% to 25% of CET1 (APRA 2017x).

Figure 5.1 Funding composition of Australia's ADIs



Source: Unpublished ADI data; Unpublished RBA data

The Commission recommends that the impacts of APRA interventions be reviewed after implementation, to identify and address any possible unintended effects on competition (chapter 17). As part of this process, the changes to mutual institutions' equity issuance should be evaluated to assess their effects on institutions' ability to compete effectively — focusing on benefits to consumers, rather than to suppliers.

Non-ADIs are precluded by regulation from accepting retail deposits, and they have limited access to wholesale debt funding (Gishkariany et al. 2017). Therefore, they rely primarily on securitisation, issuing securities backed by existing assets such as loans, mortgages, credit card debt, or other assets (OECD 2001). In many cases, non-ADIs use interim funding from major banks (known as 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 (chapter 7 discusses warehouse funding, and its implications for competition, in detail). The most common types of securities issued in Australia are residential mortgage backed securities (RMBS) (Aylmer 2016).

The mix of funding sources used changes over time, depending on cost and availability (figure 5.2). For example, the global financial crisis (GFC) had a dramatic effect on securitisation, with total Australian RMBS issuance dropping about 70% in 2008 (Aylmer 2016). Globally, substantial uncertainty in markets for asset-backed securities, coupled with the failure of a number of mortgage lenders in the US, resulted in very limited access to funds for institutions that relied on short-term debt and securitisation (Ellis 2009). Since then, securitisation volumes have been fluctuating, based on relative cost and market conditions, however they remain far below their levels a decade ago (Aylmer 2016).

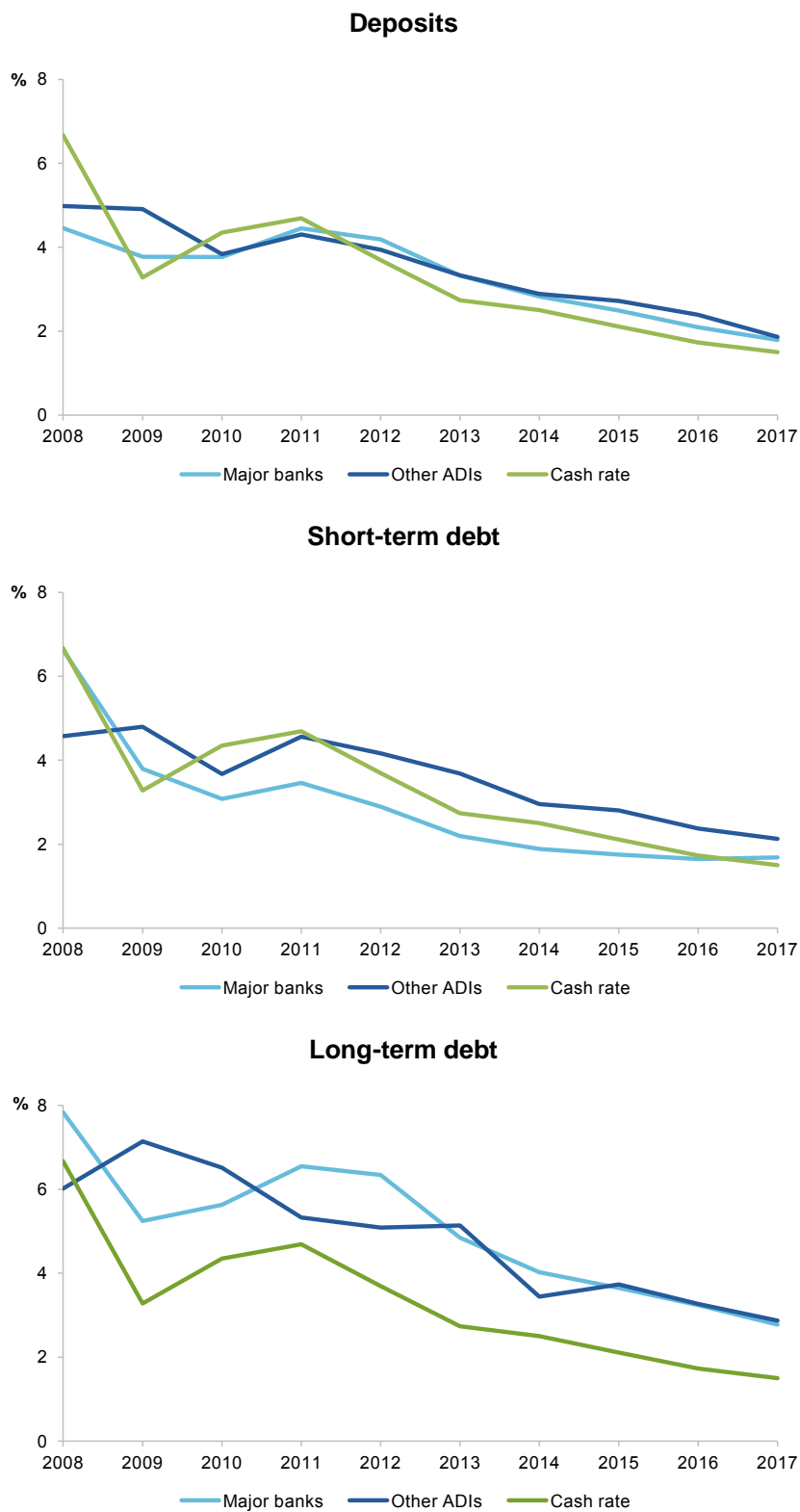
During the GFC, all ADIs had to increase their reliance on deposits as other funding sources became more expensive (see below). Following the crisis, funding markets recovered, but changes to prudential regulation have maintained this increased reliance on deposits, which are considered more stable funding sources (chapter 6).

5.2 At what cost?

The cost of different sources of funding fluctuates, reflecting a range of domestic and global economic factors (figure 5.2). The cash rate set by the RBA is only one of these factors — market conditions and regulation also affect costs. Demand for specific sources of funding is affected by changes to prudential regulation. For example, changes to prudential standards in the past ten years have prompted an increase in demand for deposits, and as a result, the cost of deposits to the ADIs (or, viewed from a different perspective, the interest rates paid to depositors) has increased (chapter 6).

Nonetheless, deposits remain one of the cheapest sources of bank funding. Increasing their share in the overall funding composition benefits ADIs, as it lowers their overall cost of funds (figure 5.2, top panel).

Figure 5.2 Cost of different funding sources



^a The cash rate series is time-weighted to enable comparisons

Source: Unpublished ADI data; RBA (2018a)

There are two important factors that keep the cost of deposits low, relative to other funding sources: the decline in the RBA's cash rate (box 5.1) and the major banks' pricing power (chapter 3).

Unlike domestic markets, where the major banks have substantial pricing power, they have very limited influence over global funding markets. The major banks source about 15% of their funding from overseas (Cheung 2017). 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.

Box 5.1 How the cash rate influences the cost of funds

The cash rate is the interest rate paid by financial institutions on overnight funds. These funds are used by financial institutions to balance their books each day — they borrow money from the RBA and other institutions, and repay them the following day. The cash rate is the interest rate paid on these transactions.

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. 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, the interest rates tend to rise by less than the changes in the cash rate, reflecting the management expenses and profit margins of banks.

Therefore, 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 home 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.

Source: Lowe (1995)

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 believe that the Australian Government will intervene

to support the major banks to prevent them failing and triggering a financial crisis.¹⁶ Therefore, investment in these institutions is considered safer, compared to smaller operators in the financial system, and their ratings are higher. In turn, investors are more likely to accept a lower yield on the debt securities issued by the major banks compared to smaller institutions (chapter 16). The difference in credit ratings means that larger institutions pay less to raise funds — most evident in the cost of short-term debt (figure 5.2, second panel).

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 (chapter 7). The cost of these services raises the overall cost of funds for smaller players, while the major banks have the required skill set available in-house.

Using the services of major banks to raise funds is particularly common among non-ADIs that rely on securitisation. Non-ADIs hold a small share of the market for housing credit, at about 4% (Gishkariany et al. 2017), but they provide an additional source of competition. For ‘non-conforming’ borrowers (for example, those with an impaired credit history), they may provide the only avenue to get credit. They have also expanded their activities in areas where APRA has recently constrained ADI lending (as non-ADIs are not regulated by APRA, they were unaffected by the regulator’s decision to set benchmarks on investor and interest-only lending) (chapter 6).

Non-ADIs often fund their operations using warehousing facilities provided by major banks. Prudential regulation is set to increase the cost of these facilities, and this may have a substantial effect on the ability of some non-ADIs to continue operating. Recently, foreign banks have expanded their activities in warehouse funding, creating additional sources of funds for non-ADIs (chapter 7).

Overall, there is a distinct difference in the cost of funds faced by larger and smaller players. Major banks are able to set the price on deposits, and they benefit from higher credit ratings, which lower the cost of their funds raised overseas. 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 institutions 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.

On the other hand, some small institutions (such as mutuals) can benefit from relatively low cost funds. In their case, however, high operating costs erode profit margins (Byres 2017).

¹⁶ 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.

This makes it difficult for them to lower lending interest rates to attract more customers and compete vigorously against the major banks.

5.3 What determines the funding mix?

Prudential regulation has a very strong influence on the mix of funding sources used by ADIs. This is because APRA requires ADIs to hold regulatory capital, so that possible losses from their loan portfolios (and other assets and activities) can be absorbed without affecting depositors or the government (chapter 16 explains this issue in detail). This affects ADIs' overall cost of funds, as they are unable to optimise their funding mix in response to market conditions.

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.¹⁷

The impact on competition of differences between the standardised and IRB approaches to risk weighting was of most concern to inquiry participants in relation to lending against residential mortgages. 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 (see, for example, BOQ, sub. 35). Alternatively, it can be 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 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 (that are using the standardised approach) need to hold more regulatory capital against these loans than ANZ, CBA, Macquarie Bank, NAB and Westpac (that are authorised to use the IRB approach). The requirement to hold more capital translates to a higher cost of funding residential loans for standardised ADIs compared to the five IRB banks. A similar but separate concern was also raised about lending to small and medium size businesses and that concern is considered in chapter 9.

¹⁷ 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 16 discusses these issues in detail.

Risk weights applied to residential mortgages

Risk weights on residential mortgages were identical across all ADIs before the Basel II reforms introduced the notion of IRB models. 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).

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 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. (2014a, p. 61)

To address the effects of this difference in funding costs, and the resulting consequences for competition, the Murray FSI recommended increasing the minimum risk weights used by IRB banks. It specifically chose not to lower the standardised risk weights — despite the likely competition benefits — as it believed such a move may weaken the stability of the smaller ADIs and reduce their incentive to improve their risk models. Lowering standardised rates also created the risk that Australia would not be compliant with the current Basel framework (chapter 16 explains this issue in further detail) (Murray et al. 2014a).

Following the Murray FSI recommendation, APRA increased the regulatory capital IRB banks are required to hold against their residential mortgage loan portfolios in 2016 (APRA 2015b, 2016c).¹⁸ 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). 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).

IRB risk weights are not always lower than the standards set by APRA. For example, the maximum risk weight applied by an IRB bank for a residential mortgage that is not in default is 137% compared to 100% for a standardised ADI (table 5.2). The difference is more marked for loans in default, where IRB banks are applying risk weights up to almost 220% and standardised ADIs are usually applying a risk weight of 100% (ANZ 2017b; APRA 2012a; CBA 2017b; NAB 2017c; Westpac 2017a).

¹⁸ 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.

Table 5.2 Risk weights for eligible mortgages that are not in default
2017

	Standard eligible mortgages ^a		Non-standard eligible mortgages ^a		IRB banks
	No LMI	LMI covering ≥ 40% of the loan	No LMI	LMI covering ≥ 40% of the loan	
LVR	%	%	%	%	<ul style="list-style-type: none"> • 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	

LMI Lenders mortgage insurance. **LVR** Loan to valuation ratio. ^a 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 (2017c); 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 8). 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 0.15 percentage points in the cost of funding the loan portfolio (table 5.3). This difference translates into an annual funding cost advantage of almost \$750 on a residential mortgage of \$500 000, or about \$20 000 over the 30 year life of a residential mortgage (assuming an average interest rate of 7% over that period).

In addition to the IRB advantage illustrated in table 5.3, major banks benefit from lower costs of debt and deposits, and lower operating costs (as discussed above). Therefore, the overall advantage for the major banks is likely to be higher.

There are, however, costs of using the IRB approach that the standardised ADIs do not face and which reduce the size of the four major banks advantage. For example, the major banks need to hold regulatory capital against the interest rate risk in their banking books (IRRBB)¹⁹ and they need to cover the ongoing expense of monitoring and maintaining their IRB models, capability and accreditation (table 5.4).

¹⁹ 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).

Table 5.3 Composition of the cost advantage from risk weighting

Based on a residential mortgage of \$500 000

	<i>Standardised ADI</i>	<i>IRB ADI</i>
Common equity tier 1 (CET1) required	9%	9%
Risk weight	39%	25%
Equity funding (based on CET1 and risk weight)	\$17 550.00	\$11 250.00
Deposit and debt funding	\$482 450.00	\$488 750.00
Cost of equity	\$2,507.14	\$1,607.14
Cost of deposits and debt	\$12 061.25	\$12 218.75
Total funding cost	\$14 569.39 <i>(or cost of funds of 2.91%)</i>	\$13 825.89 <i>(or cost of funds of 2.77%)</i>

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 (2014c). The same assumptions were applied to the standardised ADI and IRB bank to isolate the cost advantage from different risk weights.

Table 5.4 Factors that affect the cost of funds for IRB and other banks

Factors that lower the cost of funds for IRB banks

	<i>IRB banks</i>	<i>Other ADIs</i>
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

	<i>IRB banks</i>	<i>Other ADIs</i>
CET1 requirement ^b	10.5%	8.5%
Higher capital requirements for domestic systemically important banks (D-SIB)	Yes	No
Capital for IRRBB	Yes	No

^a A negative number indicates a reduction in funding costs. The figure 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 2017b).

Even after allowing for these factors, 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 (APRA 2017y).²⁰

²⁰ This estimate assumes the cost differentials demonstrated in table 5.3 apply across the residential mortgage portfolio. This refers only to the costs advantages created through the use of IRB models.

5.4 Should regulation target the cost of funds?

While the major banks receive an advantage in their funding costs from certain regulations and the ratings agencies believe they will receive government support in a crisis, they have also recently faced regulation (and related costs) that increases their funding costs relative to rivals.

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 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 2017b).
- As noted above, 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).
- The major banks are also subject to the major bank levy whereas other ADIs (aside from Macquarie Bank) are not. This further erodes the cost advantage of the major banks (chapter 16 discusses these policies in detail).

Regardless of any regulatory intervention, funding costs will naturally vary across ADIs due to a number of factors, including strength of balance sheet, profitability and competence in managing risk. These factors work in favour of the four major banks and, to a degree, Macquarie Bank. This cost advantage becomes particularly important in times of crisis, but is a reflection of markets at work — it does not mean government action is required to address any competitive advantage the major banks (or other ADIs) have in funding markets because of these traits.

Well designed and implemented regulation, including prudential regulation and other government interventions, should not affect markets (and, as a result, harm competition and consumers) more than it needs to. Ideally, neither would affect competition both among and between regulated and unregulated firms. Some recent policy shifts have been characterised as being more about reducing the reasonable competitive advantages of larger banks rather than redressing regulatory misjudgements (for example, if APRA had approved risk weights that were incorrectly calculated by the IRB banks). The bank levy has reinforced the impression that actions are now squarely aimed at lifting major banks' costs. That simply seems unwise. It certainly offers no benefit to consumers — it may ultimately cost them something — and it does nothing to improve competition.

Further, as observed by the RBA, the increase in the capital base of the major banks has not led investors to expect a lower return on their shares (as could be expected in theory, given

that the risk of loss has diminished) (Atkin and Cheung 2017). As a result, major banks have used their market power to support high returns — by increasing their lending interest rates.

In other words, the cost of more stability is paid by the community.

DRAFT FINDING 5.1 COST OF FUNDS FOR DIFFERENT SIZE BANKS

Larger authorised deposit-taking institutions (ADIs) benefit from lower costs of funding, compared with smaller institutions, as they can access funding markets overseas more easily and have higher credit ratings, which in part reflect an expectation of government support.

In addition, larger institutions gain a cost advantage from being allowed to use risk weights that are lower than the Australian Prudential Regulation Authority's standard requirements.

These lower costs of funds are not fully passed on to borrowers in the form of lower interest rates.

Attempts to artificially raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and harm consumers.

6 Banks' responses to pervasive regulation

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.
 - ADIs' willingness and ability to compete on price is constrained significantly by regulatory price-setting (the cash rate and prudential risk weights) and macroprudential interventions.
- 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.
- Recent macroprudential intervention has resulted in a higher than necessary cost (up to \$500 million a year) on investors and taxpayers via tax deductible interest payments. Regulators targeted only new loan growth, but *all* investor loans were re-priced upwards.
- 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 the anti-competitive activities (up to and including tacit collusion) that they may unintentionally authorise.
- 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, both the individual and the collective impact on scope for exercise of increased market power by larger ADIs is actively minimised.
- Markets reasonably assume that governments will assist banks that are considered too big to fail if they encounter serious trouble. 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 Australia's big four 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.
- Some initiatives are squarely aimed at reducing competition. Regulators should pay more attention to the question of 'who pays' and at 'what price' in designing intervention.

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) has tightened the capital and liquidity requirements that all ADIs must comply with, and in many cases, chosen to take a conservative approach to the global guidelines (chapter 16). At the same time, the Australian Government and the Reserve Bank have put in place various measures to support the banks in their new operating environment.

Alongside macroprudential policies, 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 changing the way ADIs operate in the medium term (APRA 2017w).

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, pp. 11–12).

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 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. Therefore, the discussion will concentrate on prudential regulation, including the broad requirements that apply to capital and liquidity and the more targeted interventions in specific markets.

6.1 The prudential regulatory landscape is changing — and ADIs are changing along with it

In recent years, APRA has been working towards redefining the prudential regulatory landscape. In keeping with global trends, it has been implementing the Basel III regulatory

framework, which has mandated an increase in the amount and quality of capital held by ADIs in developed countries (Atkin and Cheung 2017).

In addition, it has been putting in place prudential standards that are unique to Australia. The Murray Financial System Inquiry (FSI) recommended adjustments in the 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 2020 and other aspects still being developed (APRA 2017z) (for additional detail on the regulatory changes, see chapter 16 and appendix B).

The objective of these reforms is to 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 are seen by regulators 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).

But not all ADIs are affected by prudential regulations in the same way. Australia's major banks are all 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.²¹ This is likely to place the smaller banks at a pricing disadvantage (chapters 5 and 16 discuss risk weights in detail).

This new regulatory environment has had substantial implications for competition across the banking system. Increasing the amounts of capital ADIs must hold as well as their reliance on equity as a source of funding has raised their costs.²² 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 to customers (table 6.1).

ADIs and market analysts primarily use two measures to assess bank profitability: net interest margins (NIM) and return on equity (ROE). From a managerial and shareholders' perspective, an ongoing erosion in these measures would be of concern. In response to lower profitability, ADIs currently tend to increase interest rates to borrowers and exit product areas that offer lower returns, such as wealth management (Norman 2017) (the effects on ADIs' vertical and horizontal integration is discussed in more detail in chapter 7).

²¹ For example, in the case of home loans, an IRB bank holds 25-29% of capital — whereas for a standardised bank this is set at 39% (chapter 5).

²² ADIs can use a range of sources to fund their operations: deposits, short-term and long-term debt (raised on wholesale bond markets), equity and securitisation. Chapter 5 discusses this issue in detail.

Table 6.1 How ADIs have responded to the shifting prudential regulatory environment

All ADIs are required to hold more high quality capital	
<i>Steps taken by the ADIs</i>	<i>Effects on ADIs' profitability</i>
Increase their capital base through: <ul style="list-style-type: none"> • 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	
<i>Steps taken by the ADIs</i>	<i>Effects on ADIs' profitability</i>
Increase the use of funding from stable sources – deposits, equity and long term wholesale debt, leading to <ul style="list-style-type: none"> • 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

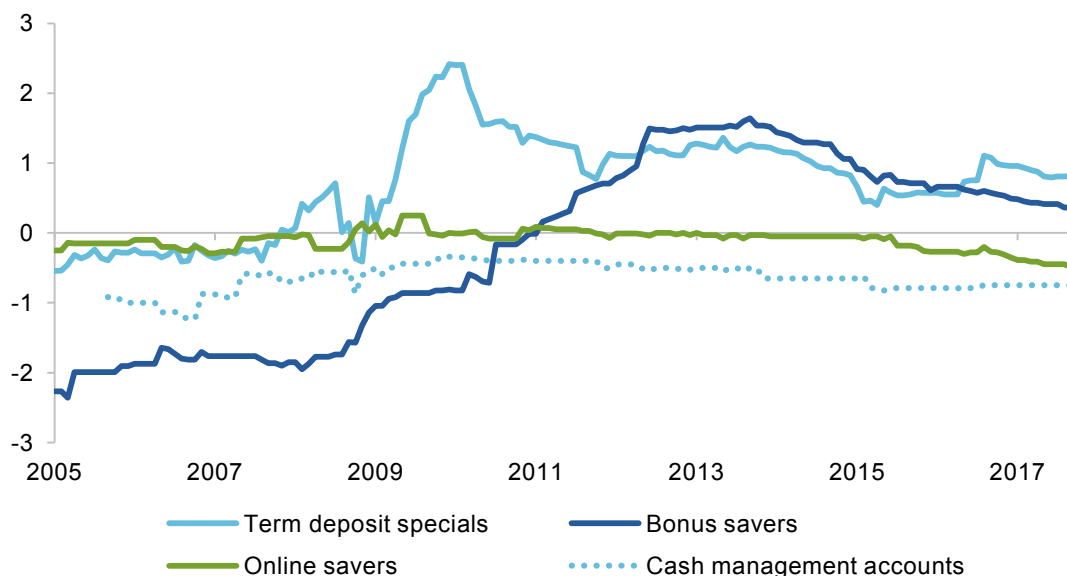
^a Prudential regulation assigns a risk weighting to each type of lending activity, and this weighting determines the amount of capital an ADI has to hold against its lending activity. Residential mortgages, for example, are considered less risky than small and medium enterprise (SME) term loans, and 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 2016e). ^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 SME who have multiple products with the same bank (Atkin and Cheung 2017).

Source: Atkin and Cheung (2017)

Effects on deposit rates — is competition increasing?

In the immediate aftermath of the GFC, credit markets stopped operating — investors were unwilling to lend money to banks (regardless of their direct exposure to the risky assets implicated in the crisis), and securitisation deals declined significantly. All ADIs required more deposits in order to continue operating — and competition increased significantly, as institutions increased deposit rates to attract more consumers and larger amounts of funds (figure 6.1). Banks also reduced fees to attract additional deposits (RBA, sub. 29).

Figure 6.1 Banks' 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

The regulatory shift that followed the GFC supported the demand for deposits, and therefore is likely to have prompted additional competition. More recently, competitive pressures driven by regulation are likely to have eased, as banks reached the capital ratios required by regulation. The GFC saw an increase in major banks' share of deposits (figure 6.2), and they were able to comply with the new regulation with relative ease. Further, as funding markets have recovered from the GFC, banks no longer needed to compete as strongly for deposits, as they could access alternative sources of funding — therefore interest rates offered to consumers have been relatively stable, or declining (figure 6.1).

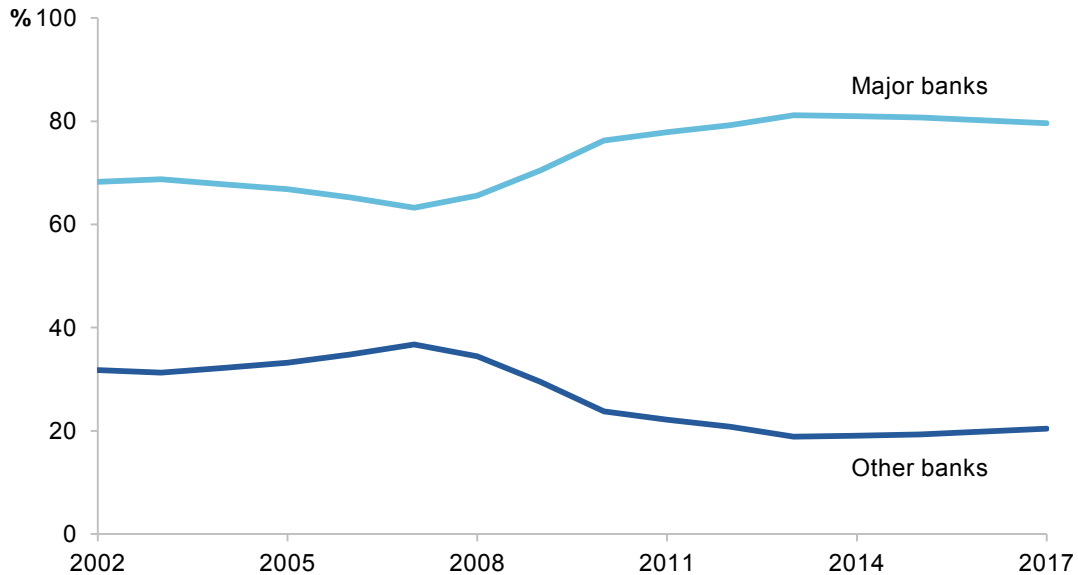
Regulation has had a stronger effect on some segments of the deposit market in recent times:

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)

While there is differentiation between products, there is little difference in the interest rates paid on similar types of deposits by major institutions (see, for example, Davies 2016). Some smaller institutions do offer better rates (COBA, sub. 21), but their ability to attract more

deposits is hampered by the major banks' market dominance and the generally low levels of customer switching (chapters 3, 13).

Figure 6.2 Share of deposits



Source: APRA (2017b)

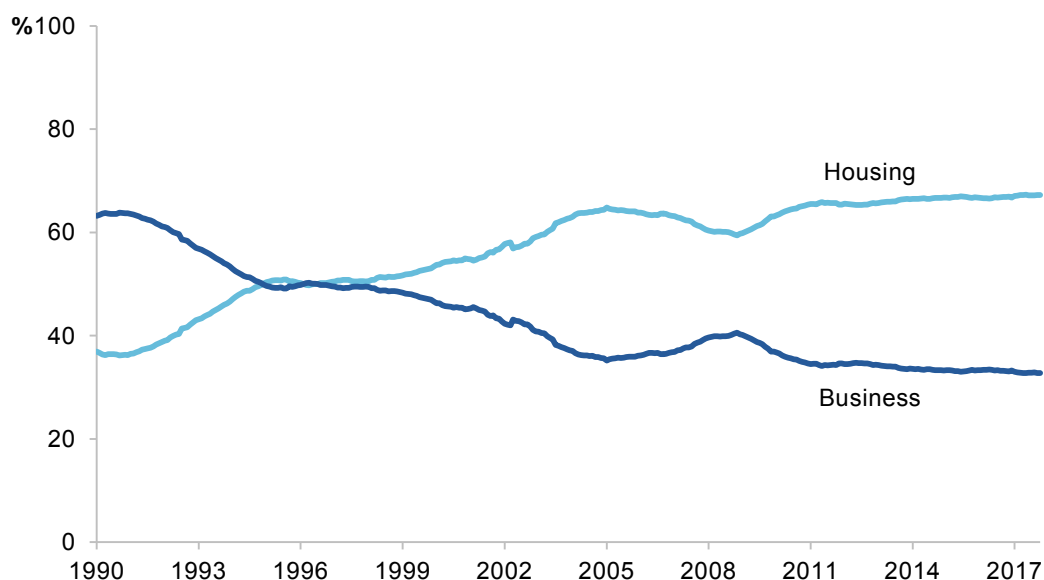
Banks are already exceeding the capital ratios required by regulation (Atkin and Cheung 2017). In view of this excess, any further increases in capital requirements (for example, as a result of the net stable funding ratio and the 'unquestionably strong' ratio, due to come into effect in 2018 and 2020 respectively) may not require active competition by banks in the deposit market.

Effect on lending rates — who pays for regulation?

As regulators raised capital and liquidity requirements for ADIs, they anticipated that institutions may increase lending rates in order to offset their higher funding costs (see, for example, APRA 2012). And indeed, lending rates have been rising, although not all institutions have increased their rates to the same extent.

In addition, the composition of banks' lending portfolios has changed. Over time, housing lending has become the key component of ADIs' credit activities, at the expense of business lending (figure 6.3).

Figure 6.3 Australian credit components



Source: RBA (2017d)

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, competition from foreign banks has contributed to lowering the share of domestically-owned banks in the market for large business lending, leading many of them to concentrate on housing. Finally, 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 2017ae).

ADIs are concentrating on home loans — but price competition remains constrained

In principle, ADIs can compete on home loan price and service to borrowers to expand their market shares. Margins are healthy and if competition was 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 towards a thin mean.

A number of stakeholders suggest that recent years have seen significant competition in the home loan market (chapter 8). Such competition could be expected to lead to lower prices, innovative products, and reduced profits over time.

But innovation has been limited. 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 loyalty (consumers are less likely to switch if they hold multiple products (chapter 13)) and offer institutions opportunities to cross-subsidise (chapter 7). However, 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. Attempts to introduce such 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). Most recently, one of the big four banks revealed that it had also 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, and the required funding is likely to be available. In addition, banks *do* raise funds via bond issues that track the cash rate plus a margin. 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 2016c; HoRSCE 2016a). This regulatory ambiguity has the potential to stifle innovation in the market.

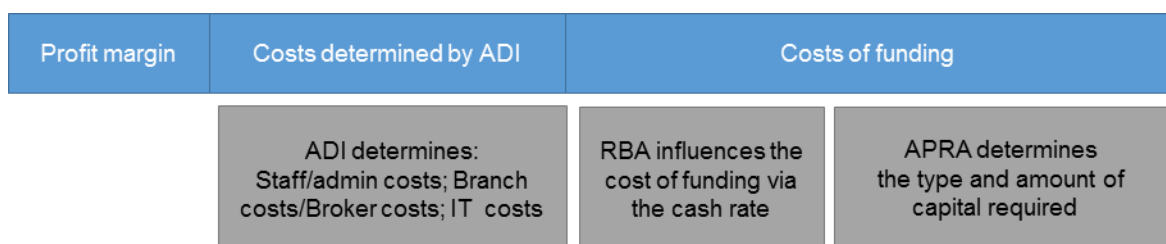
Is price competition possible?

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, but it is behaviour that should induce better quality managerial decisions and reward well-judged risk-taking. However, 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.

ADIs' ability to set home loan prices competitively is constrained significantly by regulatory limitations and interventions, and their effect on the cost of funds (chapter 5).²³ The RBA influences interest rates through its cash rate decisions, which affect funding costs (although the relationship is far from direct, and the responsiveness of the market to the cash rate changes over time (Atkin and La Cava 2017)). The effect on prices of APRA 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. The cost of this capital and its maturity rate must be 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 (chapter 16).

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 — or grow — its market share (figure 6.4). These numbers are mostly well known to all competitors and in the case of cost of funds powerfully broadcast and deeply analysed by regulators and analysts alike. Thus a form of price leading is, to a degree not evident in many industries, managed by the regulators.

Figure 6.4 Components of home loan pricing — illustrative example



²³ Home loan pricing encompasses interest rates and all related fees, similar to the comparison rate advertised by lenders.

In a competitive market, profit margins would be slim at sustainable levels, as no provider would have sufficient market power to keep its margins thick without losing market share (chapter 2). However, based on the available data in the Australian banking system, ADIs appear to have sufficient market power to allow them to maintain profit margins even when costs shift suddenly (chapter 3). The shock of the GFC saw barely a blip in the NIM of major institutions.

In this environment of regulated price signals, deeper concern in the past for 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.

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 6.5). They have also abandoned the long-observed practice of changing their interest rates only when the RBA adjusts its cash rate (SERC 2011).

Changes to prudential regulation have undoubtedly increased ADIs costs. But although APRA (2017z) suggests that competitive pressures can prevent lenders from passing on increased costs that result from regulatory change, this does not seem to have eventuated. The bulk of these costs *have* been passed on to new and existing borrowers. So while individual lenders may jostle to attract new borrowers with hints of slightly different 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.

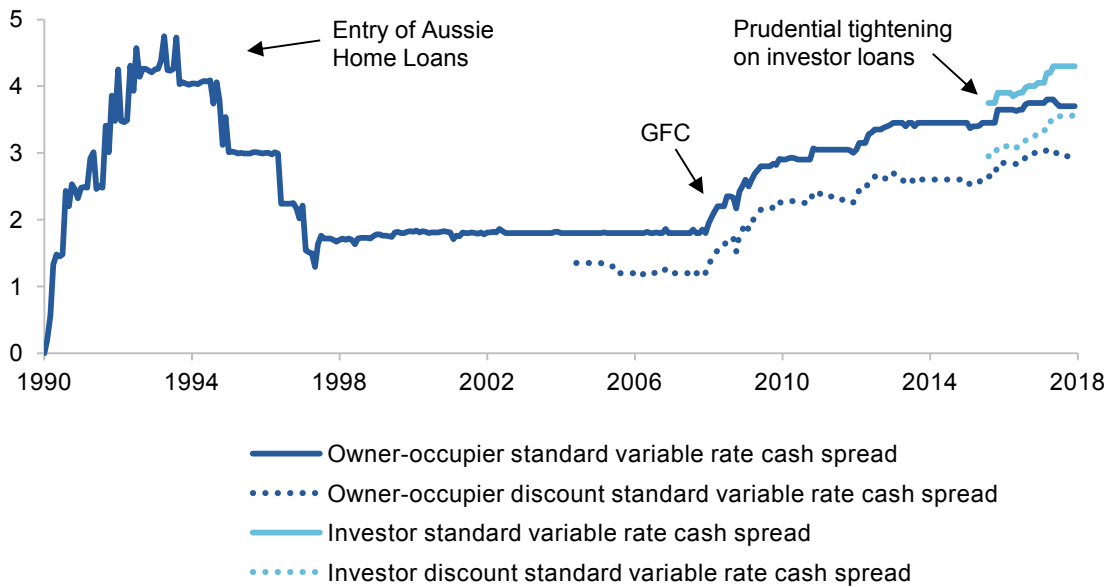
ADIs tend to follow each other's lead in setting interest rates:

Since 2000, at least one of the major banks has increased their [standard variable rate] out-of-cycle nine times. On five of these occasions, each of the other major banks has followed in the same month (HoRSCE 2016d, p. 31).

The data shows generally that smaller institutions in turn tend to follow the rate decisions of the major banks.

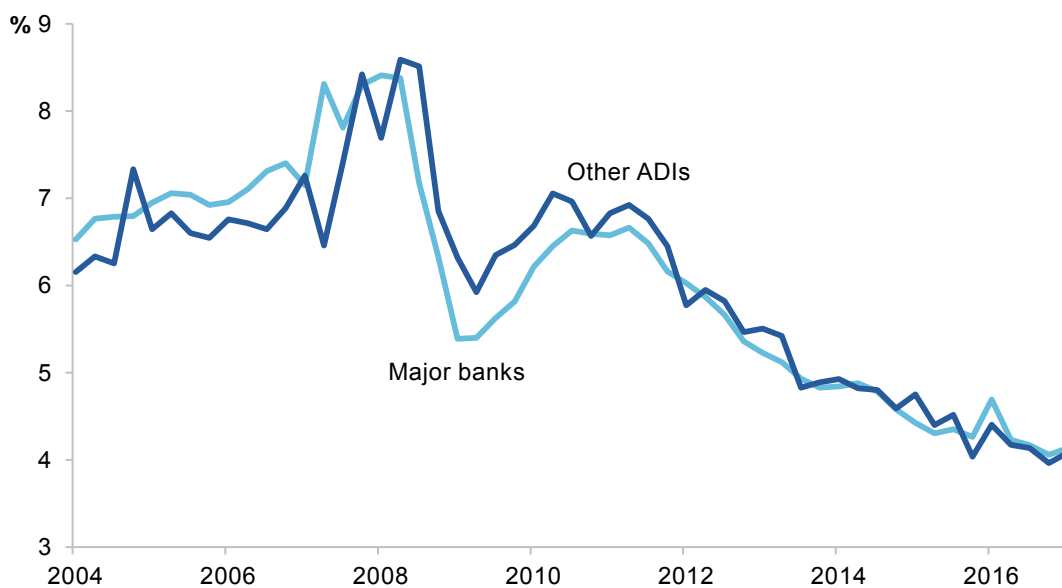
Therefore, over time there has been little variation in housing interest rates across the system (figure 6.6). Limited price variation in itself does not necessarily mean there is no competition, if the price is set at the marginal cost of provision. However, this is not the case in housing lending.

Figure 6.5 Banks' housing lending rates
Percentage point spread relative to the cash rate



Source: RBA (2017v)

Figure 6.6 There is limited variation in housing interest rates between different types of institutions



Source: APRA (2017t)

6.2 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 forces. 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 16).

We remain in an environment of high house prices, high and rising household indebtedness, low interest rates, and subdued income growth. That environment has existed for quite a few years now, and one might expect a prudent banker to tighten lending standards in the face of higher risk. But for some years standards had, absent regulatory intervention, been drifting the other way. Indeed, if we look back at standards that the industry thought important a decade ago, we see aspects of prudent practice that we are trying to re-establish today.

The erosion in 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 2017, emphasis added)

In its submission to this inquiry, APRA (sub. 22, p. 22) stated that these targeted actions can deliver competitive benefits in the long run:

APRA's interventions are designed to result in more favourable long-term competitive outcomes for consumers, by ensuring that competition will occur on a more sustainable basis.

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 can be delivered in more informal ways.

The decision to set a benchmark of 10% growth on investor lending in late 2014 was communicated by letter to ADIs, which stated:

Fast or accelerating credit growth can also be a key indicator of a build-up in risk, both at an individual ADI and at an aggregate system level. For an individual ADI, excessive housing credit growth can generate a rapid shift in risk profile, especially if new borrowers are increasingly stretched to compete in a quickly rising property market. Given the currently very strong growth in investor lending, supervisors will be particularly alert to plans for rapid growth in this part of the portfolio. *For example, annual investor credit growth materially above a benchmark of 10 per cent will be an important risk indicator that supervisors will take into account when reviewing ADIs' residential mortgage risk profile and considering supervisory actions.* The

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 2014d, p. 2, emphasis added).

The suggested benchmark was stated to not be a hard limit, but it was clear that growth beyond it would induce adverse consequences for the relevant ADI. 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. 9).²⁴

ADIs, not surprisingly, thus treated the suggested benchmark as a hard limit on investor 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; National Australia Bank, sub. 31; Regional Banks, sub. 37).

In order to implement the APRA 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.²⁵ While this would limit demand, it offers banks the benefit of increasing interest income across their entire portfolio of investment lending.

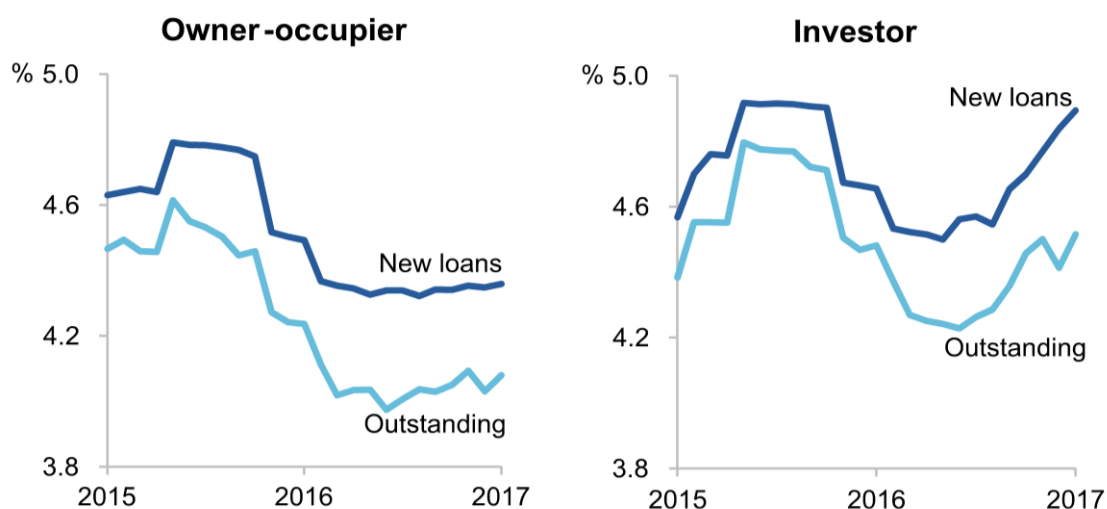
The overwhelming response from ADIs has been to increase standard variable interest rates for investor loans and interest only loans, as well as review lending standards (Wayne Byres, Chairman, Australian Prudential Regulation Authority 2017, sec. Standing Committee on Economics). Interest rates for investor loans increased markedly; and in response demand for investor loans dropped — the amount of new investor credit remained unchanged in 2015, after expanding by 24% in the previous year (APRA 2017r) .

At the same time, because interest rates increased across *all* investor loans, this has had a positive effect on NIM for institutions (RBA, sub. 29).

²⁴ All CFR agencies (ASIC, APRA and the RBA) held discussions on expanding their 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).

²⁵ 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).

Figure 6.7 **APRA's intervention in investor loans led to higher interest rates**
Balance-weighted average rate on securitised housing loans^a



^a New loans originated over the past three months

Source: RBA, Securitisation System

In 2017, APRA intervened at a product level, using stronger language in its letter to ADIs:

As detailed in this letter, APRA *expects* ADIs to:

- limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending, and within that:
 - place strict internal limits on the volume of interest-only lending at loan-to-valuation ratios (LVRs) above 80 per cent; and
 - ensure there is strong scrutiny and justification of any instances of interest-only lending at an LVR above 90 per cent;
- manage lending to investors in such a manner so as to comfortably remain below the previously advised benchmark of 10 per cent growth;
- review and ensure that serviceability metrics, including interest rate and net income buffers, are set at appropriate levels for current conditions; and
- continue to restrain lending growth in higher risk segments of the portfolio (e.g. high loan-to-income loans, high LVR loans and loans for very long terms)....

...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 2017e, pp. 1–2, emphasis added)

Again, ADIs interpreted APRA’s expectations as hard limits. Rates on investment loans and interest-only loans increased — while at the same time, rates for owner occupiers remained unchanged (figure 6.7). Rates increased for existing and new loans, although APRA specifically stated that it intended to influence the flow of credit, not the stock (unlike its 2014 letter, where it referred to ‘credit growth’). This was not a requirement of the regulator, although we understand it was discussed with the regulator prior to being implemented by ADIs.

According to APRA, ADIs have also taken other steps, such as changing eligibility criteria, but the overwhelming result of the intervention has been higher rates:

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 (Wayne Byres, Chairman, Australian Prudential Regulation Authority 2017, p. 3).

The effect on profits and competition

In responding to APRA’s benchmarks, ADIs, seemingly almost in unison, chose the path that would ensure their compliance while also boosting their profits. Unsurprising as this is, the serious question is whether a more targeted intervention could have avoided creating such a windfall profit opportunity.

The changes to interest rates have drawn criticism, in particular from members of Parliament (HoRSCE 2017c). 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 2017e).

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 a rise in some prices. The limited ability for existing interest-only borrowers to move to an alternative supplier while preserving interest-only status under the regulatory intervention meant that ADIs would have additional market power over these existing borrowers.

The anti-competitive consequences reflect the structure of the Australian banking market. If there were more diversity of 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 (as all rates *need not* have risen); yet investor growth still would have cooled (as new loans would have been constrained); and competitive alternative strategies could have emerged. Instead, the outcome was as close as possible to one where the traditional mechanism — a rise in the cash rate, but only for one class of customer — was applied by ADIs.

Higher levels of competition simply by having more banks are unlikely to have prevented this outcome. While APRA did not specify which steps ADIs should take to ensure they comply with the growth benchmarks (Wayne Byres, Chairman, Australian Prudential Regulation Authority 2017, sec. Standing Committee on Economics), 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 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. Further, the RBA (sub. 29, p. 24) suggests that this change presents an opportunity for other lenders:

The major banks ..., and other lenders, have tightened their lending criteria, raised interest rates and pulled back from higher-risk lending. As they have done so, some smaller lenders (some of which have a lower risk appetite than the major banks), have regained market share, supported by strong ongoing demand for housing credit.

This may leave the impression of equating improvement in smaller banks’ market share with a competitive outcome. But in fact it is a response to a risk-rebalancing, which is another regulator objective. Competition — be it 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.

Despite the RBA’s observation, some smaller ADIs decided to temporarily stop offering investor loans (Heritage Bank 2017b; 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 of interest-only loans. 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 2017ae, p. 50).

Second, non-ADIs are, to a significant extent, dependent on ADIs to participate in warehouse funding as a source of funds. 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.

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.²⁶

The cost to the tax payer would be offset to some extent by the tax ADIs pay on their income; however, it is unlikely that the entire cost of tax deductions would have been recovered.

DRAFT FINDING 6.1 COST OF APRA INTERVENTIONS ON HOME LOANS

The Australian Prudential Regulation Authority’s (APRA’s) actions to slow interest-only lending on residential property in early 2017 resulted in higher interest rates on both new and existing residential investment loans, despite the regulatory objective being to slow 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.

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

6.3 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, such interventions can affect competition, by giving certain institutions a competitive

²⁶ 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.

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 imposed 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 16). 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 16). However, in its submission to this inquiry, 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 16). The scheme 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, and 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, p. 47). Under legislation, foreign banks branches must inform depositors that their funds will not be covered by the depositor protections contained in the Banking Act.²⁷

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 barrier to entry, compared to other segments of the market. This does in principle affect the competitive landscape, and may have constrained the ability of foreign banks to continue competing for deposits as strongly as they had before the GFC. 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's 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 2012d).²⁸ Only 15 institutions in the banking system have been deemed large and complex enough to require LCR compliance (APRA 2016e).

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).²⁹ 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 2016b). 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 15).

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,

²⁷ Foreign bank branches are also precluded from accepting deposits of less than \$250 000 (chapter 4).

²⁸ 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 2012d).

²⁹ Only deposits held with the RBA, Commonwealth Government securities and semi-government securities are designated as HQLA (APRA 2012d).

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 total size of the CLF was \$193 billion, and the fee income received by the RBA was \$347 million (RBA 2017f).

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. This has the potential to influence the prices they charge in areas where they hold market power as an offset to lower profitability. But other regulatory changes since the GFC have potentially worked in the other direction too (chapter 16).

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. This has been acknowledged by regulators and bankers alike:

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 'too big to fail' advantage in Australia are, to some or a total degree, 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 5 discusses this issue in detail). 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 their lower funding rates (RBA 2016b) (chapter 16 discussed these issues in detail).

A range of policy responses have been put in place to address this issue.

- Australia's four major banks have been designated as domestically significant banks by APRA, which increases their capital requirements over and above those imposed on other banks (APRA 2013b).
- 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 2016b).
- The recently introduced 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 \$1.5 billion each year (Hawkins 2017).

Policy makers expect that these policies may erode some of the major banks' market power. Cost advantage is one source of the major banks' market power, but it can be tempting to respond to that *by lifting costs* for them. But as we have shown in other chapters, this does not benefit consumers nor the economy.

For example, in the review of the four major banks, the House of Representatives Standing Committee on Economics ((2016d, 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 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 as a margin above publicly-signalled rises in the costs of funds. 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 competition is unlikely to be positive for the purposes of *price* competition. 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 needs to 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. In our assessment, they can.

7 Dominance through integration?

Key points

- Internationally, and at some points in Australia's financial market history, concerns have arisen that integration in the financial system can increase systemic risk. However, internationally integration has only been associated with excessive risk-taking when there is also poor regulatory and prudential oversight.
- In Australia, the major banks have been able to leverage their incumbency and integrate across various financial system market segments.
 - Major banks have entered multiple market segments, integrating horizontally and bundling products (such as credit cards, insurance and home loans).
 - The financial system has also vertically integrated (up and down the supply chain), particularly in retail banking (residential mortgages), wealth management and insurance, and in terms of providing funding to smaller lenders.
- At present, while integration in the Australian financial system is a matter of fact, it is not a problem in and of itself.
- Nevertheless, the results of integration in Australia have been mixed — with consumers sometimes benefiting from greater choice but facing greater complexity and the possibility of exploitation.
- In some areas where competition has been impeded by integration, firms are now winding integration back and the market is working towards enhanced competition.
 - There is a current trend of major banks divesting from wealth management and add-ons such as life insurance as they pursue relatively higher returns in their other product arms.
 - Older platforms in asset management are under attack from digital disruptors and direct investment (both in and outside superannuation).
- Regulation may distort competitive outcomes in integrated settings.
 - Future of Financial Advice reforms may have focused on improving consumer protection through increased regulatory requirements on financial advisers, but have likely reduced contestability.
 - Integration occurs in sourcing of funds, where smaller banks and non-ADIs are dependent on larger ADIs for wholesale funds. APRA should be more attuned to the effects on competition as it captures non-ADI funds under Prudential Standard APS 120 and diminishes smaller lenders' ability to pose a credible competitive threat.
- Given major banks' ability to dial up or down integration readily, there is scope and need for the ACCC to proactively monitor and publicly report on the extent of integration. But policy responses should not penalise the efficiency gains from integration that inevitably also offer market advantage.

7.1 Integration can reinforce market power

Banks and financial institutions have integrated through mergers and acquisitions to increase profitability either because they believe that it is more efficient (economies of scale or scope), or will decrease long-run competition. Institutions in the financial system integrate horizontally (acquire a business in the same part of the supply chain to increase size or diversify product offerings) and/or vertically (acquire a business along the supply chain to control or capture profits along distribution channels).

Institutions that integrate may be able to reduce costs of delivering a product or increase market share by providing more diverse product offerings. Consumers can benefit where competition is strong enough to ensure that any efficiencies are passed through to them in the form of lower prices or increased product choice.

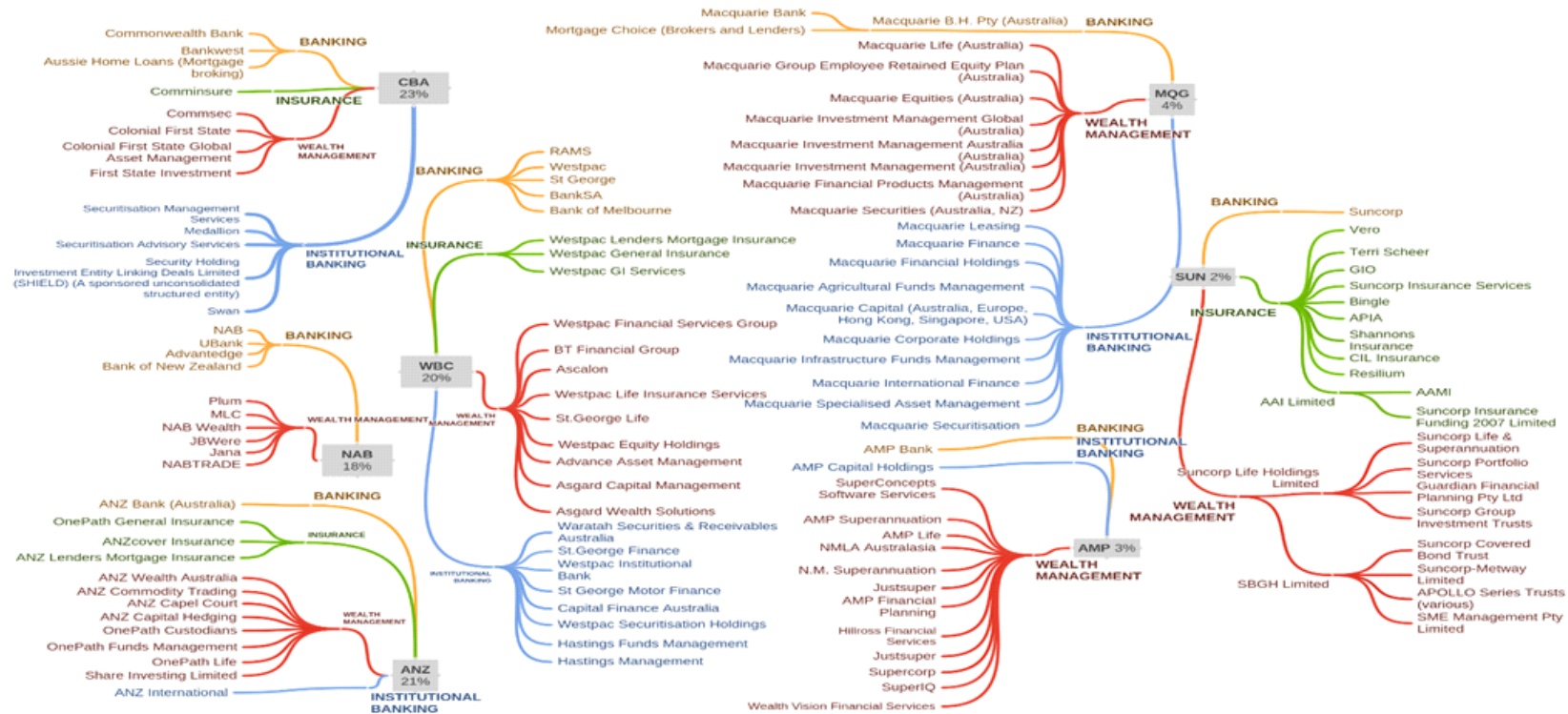
Integration poses a problem where it allows providers to use their integrated services or product offerings to impose barriers to entry against competitors. This thereby diminishes market contestability and the competitive pressure on firms to drive efficiencies, and ultimately to benefit consumers.

There is an argument that integration can also create larger and more complex institutions, generating additional risks as well as making it more difficult for management, boards and regulators to monitor and assess those risks (Hoenig and Morris, 2013). But there is also evidence that the diversification that comes with integration makes institutions more resilient to negative shocks (Hsieh, Chen and Yang 2013).

Integration in the Australian financial system is not a problem in and of itself. If integration leads to efficiency gains then this is beneficial for society and should be encouraged, not prevented, by policy. But integration, even when leading to efficiency gains, can also raise market power. If competition is inadequate to moderate this market power, then regulatory intervention may be called for (for example, through the merger provisions of the *Competition and Consumer Act 2010* (Cth)). Regulations that restrict integration may, however, impose competitive distortions, particularly if mis-targeted or if they fail to address the real causes of risky behaviour.

This chapter evaluates the extent to which both horizontal and vertical integration have occurred in Australia's financial system, its impact on competition, and the need for any policy intervention. The focus here is on the integration activities of larger banks (with residential mortgages covered in chapter 8), and the role of regulators.

Figure 7.1 **Networks 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 Australian financial institutions.

^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 (2017); ANZ (2017c); CBA (2017a); Macquarie Group (2017); NAB (2017a); RBA (2017g); Suncorp Banking Group (2017); WBC (2017)

7.2 Major banks have led the integration charge

As noted in earlier chapters and appendix C, banks dominate the Australian financial system, starting with retail banking and leveraging this into other financial product markets (figure 7.1).

Within retail banking markets, the major banks have maintained a level of control over funding supply chains by their dominance in retail deposit markets (as at June 2017, the major banks accounted for 80% of total household deposits and 77% of all deposits) (APRA 2017o). Access to retail deposits in particular has allowed them more flexibility in how they fund their activities compared with options open to smaller banks and non-banks. The major banks have also been able to exert pricing power by virtue of their size, being able to pass through the increased costs of wholesale funding, capital and liquidity to borrowers, with smaller banks following suit (Moody's 2017a).³⁰

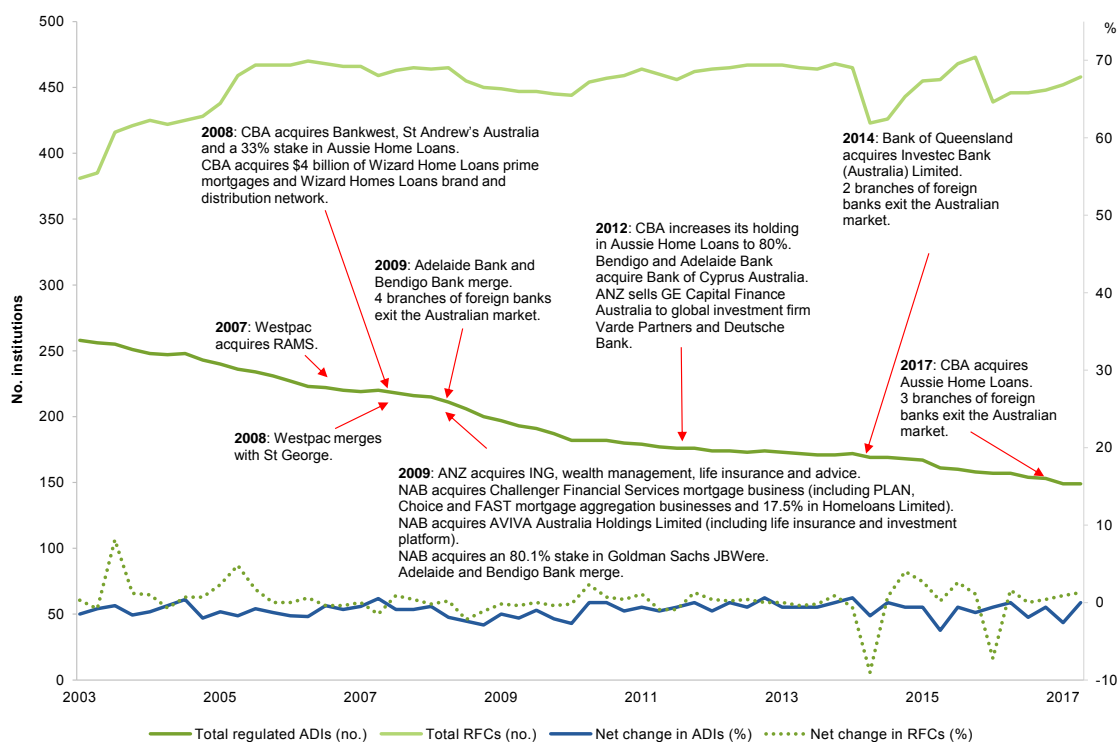
Australia's major banks have also augmented their presence within the broader financial system by extending their distribution channels (such as through the acquisition of financial advisory firms and mortgage brokers) and acquiring what might otherwise have been external sources of competition.

Reflecting these developments (and despite a number of conversions to bank status within the sector), mergers and acquisitions combined with exits from the financial system have led to an overall decline in the number of institutions (figure 7.2).

Credit unions and building societies — institutions that grew strongly in earlier decades — have declined in market share in recent years and have been merged with other minor ADIs (APRA 2017t; Deloitte 2012). Between 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 (APRA 2017, Productivity Commission research). In comparison, 7 banks merged, and 11 banks exited the market during the same period, which included the exit of 6 foreign bank branches. Consolidation between credit unions and building societies continues, with more ADIs exiting the market than entering (chapter 4).

³⁰ As an example of pricing power, the Australian Securities and Investments Commission alleged that NAB, ANZ and Westpac engaged in unconscionable conduct and market manipulation for their involvement in setting the bank bill swap reference rate (BBSW) between 2010 and 2012. In November 2017, ASIC accepted enforceable undertakings from ANZ and NAB (not Westpac) to address their alleged conduct. The issue involving Westpac remains before the courts. The BBSW is the wholesale interbank rate within Australia (in addition to the cash rate) — it is used to provide benchmark interest rates for the pricing and revaluation of Australian dollar derivatives and securities (ASIC 2017a; ASX 2017).

Figure 7.2 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).

Source: APRA (Entries and exits, unpublished), APRA (2017s), ASIC (sub. 40)

...into new market segments, such as wealth management

The major banks' dominance in their traditional bank product markets has provided them a strong capacity to move into other related markets over the past two decades. Advancement into the wealth management and insurance markets has resulted in a relatively high degree of market concentration in the provision of some of these products as well.

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 (appendix D).³¹ This triggered a number of mergers and acquisitions. Historically, wealth management services were largely provided by independent fund managers and life insurers such as AMP Limited (AMP), Colonial Group, BT Financial

³¹ An employer-funded superannuation benefit in industry awards was introduced in 1986, followed by the introduction of compulsory superannuation in 1992.

Group (BT) and MLC. 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 big four banks now hold approximately 21% of superannuation and fund manager assets under management, and about 30% of the 25 379 financial advisers listed on the financial advisers register work for one of the big four banks (ASIC 2017f).

These acquisitions resulted in the major banks' assets under management increasing from the equivalent of 13% of the Australian total in the late 1990s to about 20% (or \$530 billion) in 2016 (Golat 2016).

The superannuation 'pot of gold' that banks sought to capture has now seen at least two of the major banks rank among the top five superannuation funds by assets under management (SuperGuide 2017).

Banks are like 'financial supermarkets' as they advance into new market segments ...

Mergers and acquisitions have been a means for increasing the product range that major banks offer. Major banks have ventured into virtually every part of the financial system; they have essentially operated like 'financial supermarkets', offering various financial products and services that can be bundled together and sold under one roof (sub. 40). 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 the major banks can make it harder for other players to compete on a product-by-product basis.

What's in a bundle?

Product bundling has occurred across the retail banking, wealth management and financial advice and insurance sectors (chapters 11 to 14).

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 2015h). For example, according to CHOICE (sub. 42, p. 15, chapter 13), a survey of consumers found that around half of respondents had a transaction account and a credit card with their home loan provider. Similarly, data collected by the Productivity Commission 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 (chapter 13).

In life insurance, while most policies can be purchased as stand-alone products, they are often bundled. As at May 2017, there were approximately 209 products in the life insurance market — 158 stand-alone and 51 rider (add-on) products. Add-on products bundled with life insurance include total permanent disability, trauma, income protection, accidental death and injury, and funeral insurance products (ASIC 2017x).

What's in bundling for consumers and providers?

Bundling can bring consumers benefits in the form of choice, lower cost and convenience. It may mean that consumers can access new and more tailored products or access a broader class of products perhaps at a lower cost (for example, where fixed costs such as credit card and transaction account fees are waived when provided with a home loan). Many consumers have also come to view products within bundles as 'features' of the one product and expect products to be offered as a bundle (chapters 12 and 13).

Bundling can also benefit providers by increasing opportunities to cross-sell products and lowering costs of provision through economies of scope, facilitate product testing, and enable innovation and product improvements.

For example, a provider may redesign policies with revised definitions and promote them to their distribution channels to win market share or attract a new segment of the market. These new products may benefit the provider by replacing high-cost legacy policies or products, which may have been poorly designed or underwritten (in the case of insurance) or had unsustainably broad definitions or conditions (ASIC 2016a).

Bundling can also reduce consumer incentives to move to an alternative provider, thus also helping to gain market share. Smaller players with niche offerings may in turn be affected in their ability to compete against larger more integrated players.

Similarly, for new market entrants, developing sufficient scale can be difficult and requires significant investment to attract customers and gain market share (by building brand loyalty and consumer trust). On the other hand, major banks may have been able to take advantage of economies of scale, lowering their long-run average costs by consolidating their funding and operating costs, for example.

... and control supply chains, such as in wealth management

Australia's major banks have led the charge in increasing vertical integration, competing for distribution channels as a way of increasing customers, in addition to directly offering alternative products and prices. This in turn could have affected smaller players' market access (ACCC 2017f).

This chapter considers two specific examples of vertical integration — in the asset management sector and in terms of warehouse financing — with vertical integration in the residential mortgage and insurance markets covered elsewhere (chapters 8, 11 and 14).

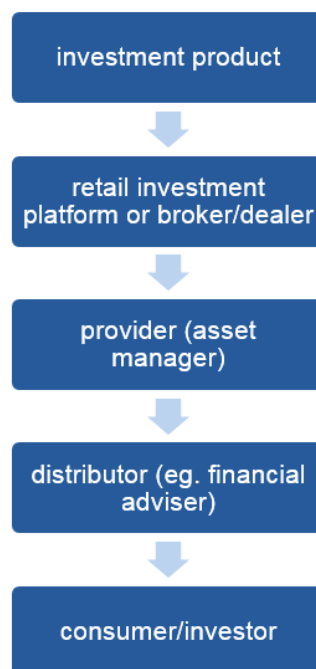
Concentration in asset management

This chapter focuses on asset management and financial advice within the wealth management sector, and should be read in conjunction with appendix D. While superannuation is the largest component of the wealth management sector (Murray et al. 2014b), it is out of scope of this inquiry as the Productivity Commission is conducting a parallel inquiry into superannuation (chapter 1).

Asset management services are a major part of the Australia’s financial system. For the June 2017 quarter, the assets under management of managed funds institutions were close to \$2.4 trillion (more than the value of GDP in that quarter — see appendix D). The assets under management have rapidly increased over the past three decades, growing at an average rate about 10% per year, mainly due to superannuation. (Australian Trade and Investment Commission 2017).

The asset management sector is highly vertically integrated (see figure 7.3 for a simplified supply chain). The combination of advice, platforms and funds management into a single business in an already concentrated industry potentially presents high barriers to entry. This ultimately reinforces the market power of incumbents.

Figure 7.3 **A simplified wealth management supply chain**



Source: Adapted from FCA (2015a); Oxera (2016)

Concentration is high at two levels along the banks' asset management supply chain: retail investment platforms and financial advisers. These are essential links that ultimately control the investment choices available to, and the flow of funds from, retail investors.

Australia's top asset managers are mostly big banks (table 7.1). The major banks including Macquarie, and AMP, and other wealth managers such as IOOF and Perpetual, provide services including funds management, retail investment platforms and financial advice (explained briefly here and in detail at appendix D).

Macquarie, AMP, Commonwealth Bank and Westpac together control about 43% of the market by assets under management (table 7.1, appendix D). Despite this, foreign fund managers and specialised fund managers have a relatively significant presence in the wealth management market (appendix D, and discussed later).

Vertical integration through retail investment platforms

Retail investment platforms provide the central link in the chain between investment product providers, financial advisers and planners and retail investors, and play a similar role to mortgage aggregators (appendix D). They are typically online services used by intermediaries and consumers, to allow investors to buy funds from different asset managers, and hold them together in one account or portfolio.

In general, there are two main types of platforms: master trusts (sometimes known as 'fund supermarkets'), and wraps (detailed further at appendix D).

To achieve sufficient assets under management (fund flows), a retail investment platform provider requires the support of investment product providers, financial planners, technology, and continued investment to maintain and develop the platform (appendix D).

As at March 2017, there were \$748 billion in platform assets under management. While the platforms market itself does not comprise the majority of the entire asset management market at over \$2 trillion, the high levels of vertical integration in the platforms market may give rise to competition and consumer issues in the platform market specifically.

The largest Australian financial service licensee groups (those with licences to provide financial products, henceforth 'licensee groups') are Commonwealth Bank, Westpac, ANZ, NAB and AMP (ASIC 2017f, 2018d). These and other licensee groups own 'approved product lists' (APLs) which are used to list the various wealth management products, including retail investment platforms, that each group has authorised its network of aligned advisers and brokers specifically to distribute and advise upon. APLs will often include deposit products, investment and superannuation products, and life insurance products. Thus for smaller providers of financial products, getting on an APL is an important way of competing for that consumer assets (Kell 2017c).

The products on the APLs can be either 'in-house' (manufactured by a related party) or from an unrelated product provider ('external' — manufactured by an unrelated third party).

While APLs inevitably contain in-house products, the degree to which the product list represents the full diversity of products is today a major factor in whether this market can be said to be competitive (ASIC 2017r). Depending on the institution, unrelated product providers may have to pay ‘shelf-space fees’ to appear on an APL, although volume-based shelf space fees are now banned (ss. 964-964A, Corporations Act).

Licensee groups which have branch networks have the added flexibility of choosing which platforms are offered to consumers directly and which are made available through financial advisers via their APLs. Licensee groups argue that the list is a means of ensuring the quality and security of the investment products they advocate by virtue of the ‘vetting process’ (ASIC 2017d; Padley 2014; The Dover Group 2015).

But recent evidence from ASIC suggests that the selectivity of APLs has granted a clear competitive advantage to the largest licensee groups in terms of them promoting their own in-house platforms (ASIC 2018d).

Table 7.1 Australia’s top 10 asset managers are mostly big banks
31 December 2016

<i>Australian rank</i>	<i>Global rank</i>	<i>Manager</i>	<i>AUM (\$US mil)</i>
1	52	Macquarie Group	362 511
2	102	Colonial First State (CBA)	147 154
3	120	AMP Capital	119 976
4	182	BT Investment Management (WBC)	60 699
5	193	QIC	57 453
6	203	IFM Investors	54 486
7	227	Challenger	47 230
8	269	Westpac Banking	34 974
9	275	Magellan Asset Management	33 612
10	318	Goodman Group	25 147

Source: Willis Towers Watson (2017)

The platform to control competition

Platforms can be in-house or external to the licensee group, and a parent entity may own more than one in-house platform. Competition between existing platforms includes competing for a wider financial planner and adviser network than is available in-house, as well as on the products then offered on these platforms.

Vertical integration and concentration are currently high in the platforms market (figures 7.4 and 7.5). This is partly due to the high level of investment required to operate a successful platform, and possibly partly due to the sequence of mergers and acquisitions between

emerging platform providers and large incumbents in the 2000s (for example, AMP's 2010 acquisition of the emerging competition, AXA's North platform; Colonial, MLC and BT are other examples). Platforms are by their nature major commitments, creating an investment ecosystem that is expensive to maintain and not necessarily flexible in the face of change:

- there are significant IT infrastructure investments;
- regulatory and licensing costs; and
- constant investment in marketing to gain access to distribution channels (ASIC 2016j).

The top five master fund administrators accounted for approximately 76% of the total \$748 billion in platform assets under management. This high level of concentration has largely remained stable between 2014 and 2017 (Plan For Life 2015; Strategic Insight 2017, appendix D). The vertical integration that platforms enable can increase efficiencies through economies of scale and scope and can also keep prices low by integrating the supply chain. But the evidence (below) suggests the concentration in platform ownership has led to a disproportionate preference for in-house product sales.

While the ability of smaller financial product providers to compete is undoubtedly affected, this is not the crucial issue. The competition issue is whether consumers are made aware of more relevant competing products, their ability to exert demand-side pressure in the market, and the conflict of interest that may arise.

Between 2015 and 2017, ASIC conducted research into Australia's largest licensee groups, collecting data on the number and value of in-house and external financial products were listed on these licensee groups' approved product lists. ASIC collected data from the two largest advice licensees controlled by each of the five institutions over two periods: from 1 July 2014 to 28 February 2015 and from 1 January 2017 and 31 March 2017 (ASIC 2018d).

The ASIC data shows that the overwhelming majority (90%) of total funds invested through platforms during the 2017 period were invested in in-house products, with this being higher for new customers (96%). Yet as a point of comparison, these same in-house products comprised only 23% of the total number of products on approved product lists at that time (ASIC 2018d).³²

Data provided to the Productivity Commission by ADIs also suggest that the major banks hold an estimated market share of more than 90% by number of platform customers (appendix D). Platform customer retention also appears to be increasing, especially at the major banks (appendix D).

As per the ASIC data, the proportion of customers invested in in-house products increased (to 79% in 2017 from 68% in 2015), but the number of new customers invested in in-house

³² ASIC removed products from its analysis where there were missing values or 'not applicable' responses provided by the licensees for the 2017 period. This means that not all the products on a licensee's APL are represented in the proportional analysis, only those with funds invested.

products slightly reduced (to 64% in 2017 from 75% in 2015) even as the proportion of funds that new customers are investing has remained unchanged (ASIC 2018d).³³

This could indicate that platform managers and financial advisers are retaining high-value new customers in in-house investments while pushing lower value customers to external products. But equally it could indicate that awareness of better quality products is rising. However, ASIC's previous research on the quality of personal financial advice provided suggests otherwise (ASIC 2016e).

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. Not only are APLs a means of controlling exit and entry, the control over APLs gives dominant firms an information advantage (that is, ability to exploit the information asymmetry) which they can put to use in designing their product offerings and price differentiating, potentially at consumers' expense.

ASIC has also flagged that vertical integration by banks into the insurance sector restricts competition to the consumer's detriment, particularly in life insurance. ASIC has found there is a tendency towards the sale of in-house life insurance even when banks have included other products on their APLs. This may be explained by the fact that banks, until recently, have been able to pay commissions to advisers for the sale of in-house life insurance products. These costs have to date been passed through to consumers and as a result, life insurance commissions have risen as high as 130% of the first year's premium in some cases, and 10% in subsequent years (CHOICE 2016).³⁴

Financial advice reforms may affect competition in the near term

The Future of Financial Advice (FOFA) reforms have sought to address some of the issues associated with vertical integration in the asset management market at the consumer end, such as poor conduct and conflicts of interest (appendix D, chapter 12). But the reforms were not designed to improve contestability in the sector.

³³ Certain caveats apply to the comparison between the 2015 and 2017 data ASIC collected that limit the ability to compare across periods conclusively. The data was collected over two different periods of time (eight and three months respectively), may be affected by seasonal and structural factors, and may be affected by the data provided to the licensee groups by third parties. The Commission is also informed that the advice licensees did not use a consistent methodology to provide the data across the two time periods. Notwithstanding these caveats, some inferences from comparison can be made given that it is data on stock measures that is collected.

³⁴ Starting from 1 January 2018, upfront commissions in life insurance are capped at 80%, then will reduce to 70% from 1 January 2019, before settling at 60% from 1 January 2020. Commission levels for policy applications submitted prior to 1 January 2018 will be maintained at their previous levels. New retention clawback provisions commenced on 1 January 2018, starting with 100% of the commission in year one and 60% in year two (no clawback in year three) of the policy, with some exemptions (FPA 2017).

The advice industry is still in the process of adjusting business models to respond to these regulatory changes, along with a suite of other regulatory changes that have taken place over the last few years. Many of these are reshaping the advice market (subs. 16, 24, 26, 38, chapter 12).

Since the regulatory changes, a trend has emerged for financial advisers and planners to merge with, or move in-house, to work directly for wealth management institutions, thereby making the sector more vertically integrated and concentrated (Murray et al. 2014a). As at June 2017, there were 25 379 financial advisers listed on the financial advisers register (ASIC 2017f). The four major banks, AMP and IOOF account for over 50% of the advice market measured by the number of aligned advisers (operating under a licence they control), and the largest 10 entities control about 60% of aligned advisers (appendix D).

How have the FOFA reforms affected competition?

Regulation can indeed shape the way the marketplace evolves, and the choices firms may make to integrate or divest. Businesses organise their models around regulatory structures, an observable trend in the asset management and financial advice market.

And even though the FOFA changes may be helping to increase consumer protection against poor financial advice, the majority of customers' funds in vertically integrated institutions remain invested in related-party products, as discussed earlier.

Some 80% of advice licensees operate with fewer than 10 advisers (perhaps reflecting the relative ease, pre-FOFA, of obtaining a licence), but the market share of the major banks in providing financial advice has increased (appendix D). The major banks, which have the largest number of financial advisers working for them, control multiple licences held by their controlled entities (appendix D). For example, NAB controls five licences, with close to 70% of its advisers operating in related entities under licences controlled by NAB.

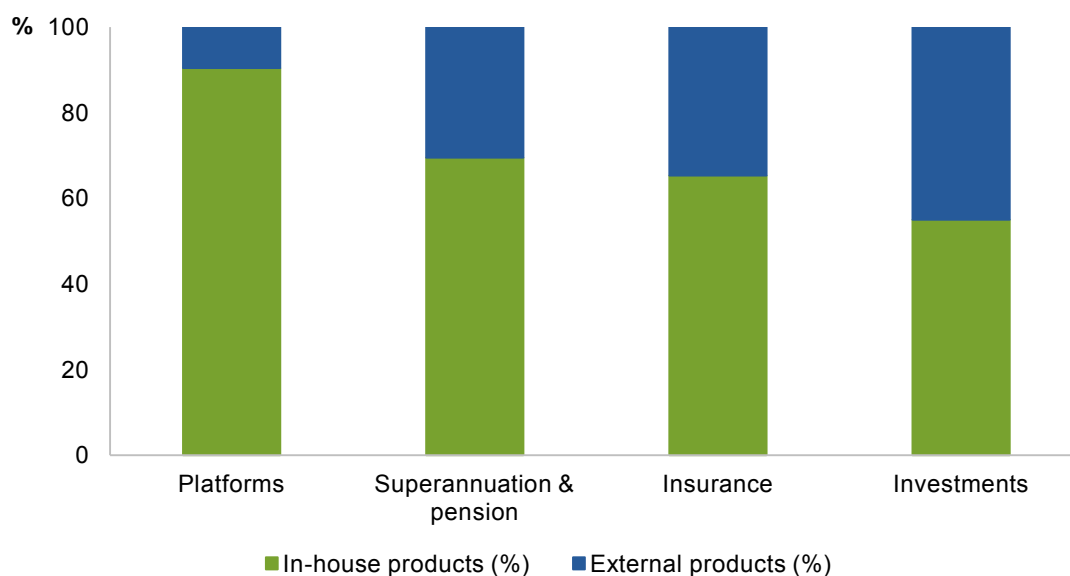
Some consolidation and restructuring would be expected in the advice and platforms market as an efficient response to increased costs imposed by regulatory requirements and significant changes in remuneration structures, and it appears that this has occurred since the FOFA reforms were introduced.

In ASIC's 2014 review of the early effects of FOFA, some small licensees stated that complying with the reforms was more challenging for them as they did not have the scale that the large bank-type organisations had (ASIC 2014f) (figure 7.4). Similarly, the Financial Planning Association of Australia has explained that the cumulative burden of complex regulatory changes over the last five years has increased consumer fees and consolidation in the market:

An increase in the regulatory burden placed on both financial planners and licensees, particularly over the past 5 years, has seen an increase in fees charged to consumers, changing adviser numbers, and many sole traders, small licensees and medium licensees forced to move to a general advice only model, reduce client numbers or turn in their license altogether and join a large licensee (sub. 26).

Figure 7.4 Proportion of major financial service licensees' total assets under management by product type^a

As at March 2017



^a Proportion of total assets managed by AMP Financial Planning Pty Limited (AMP), Charter Financial Planning Limited (AMP), Commonwealth Financial Planning Limited (CBA), Count Financial Limited (CBA) National Australia Bank Limited (NAB), GWM Adviser Services Limited (NAB), Westpac Banking Corporation (Westpac), Securitor Financial Group Ltd (Westpac), Australia and New Zealand Banking Group Limited (ANZ), Millenium 3 Financial Services Pty Ltd (ANZ).

Source: ASIC (2018d)

This suggests that larger institutions are in a position to take advantage of scale and bear the regulatory costs through integration that smaller advice providers cannot, therefore reducing the contestability of financial advice — were it not for market developments (appendix D, and described later).

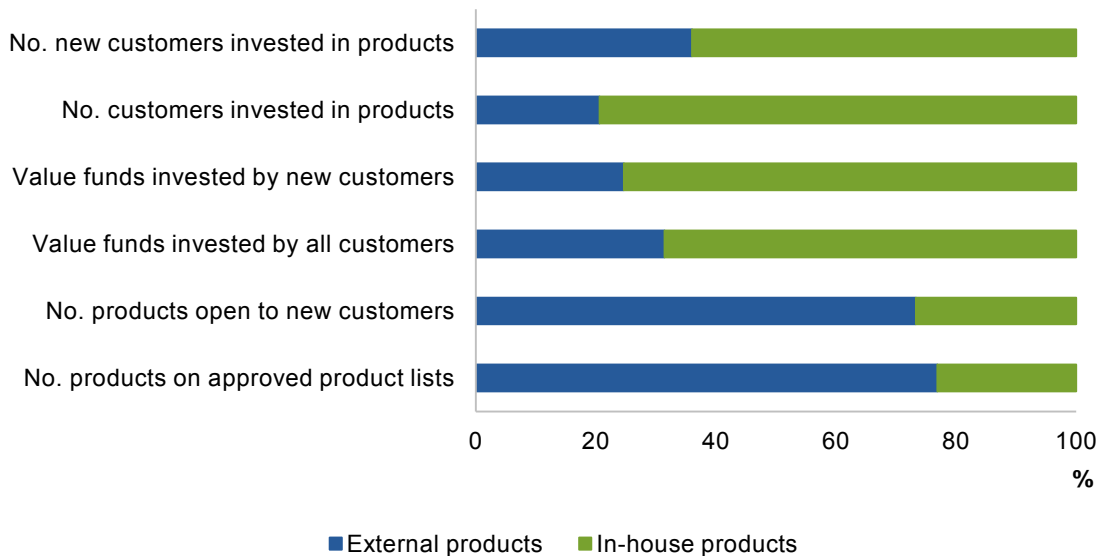
By banning conflicted remuneration structures and introducing stronger consumer protections, the FOFA reforms continue to shape the financial advice market. Similarly, design and distribution obligations proposed by the Murray FSI to apply to issuers or distributors of financial products — not just advisers — may well impact on the structure of the platform market going forward (figure 7.5). Currently before Parliament, these obligations (if passed) would be imposed at the stage of product design and distribution, and after the sale of the product (The Treasury 2016b).

Under the proposed policies, 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). These changes may influence

broader incentives to integrate in the asset management market going forward and the competitive landscape overall.

Figure 7.5 Number and value of major financial service licensees' in-house versus external products ^a

Across product lists and by customers as at March 2017



^a Number of products and value of funds by AMP Financial Planning Pty Limited (AMP), Charter Financial Planning Limited (AMP), Commonwealth Financial Planning Limited (CBA), Count Financial Limited (CBA), National Australia Bank Limited (NAB), GWM Adviser Services Limited (NAB), Westpac Banking Corporation (Westpac), Securitior Financial Group Ltd (Westpac), Australia and New Zealand Banking Group Limited (ANZ), Millenium 3 Financial Services Pty Ltd (ANZ).

Source: ASIC (2018d)

DRAFT FINDING 7.1 CONSOLIDATION IN ASSET MANAGEMENT AND FINANCIAL ADVICE

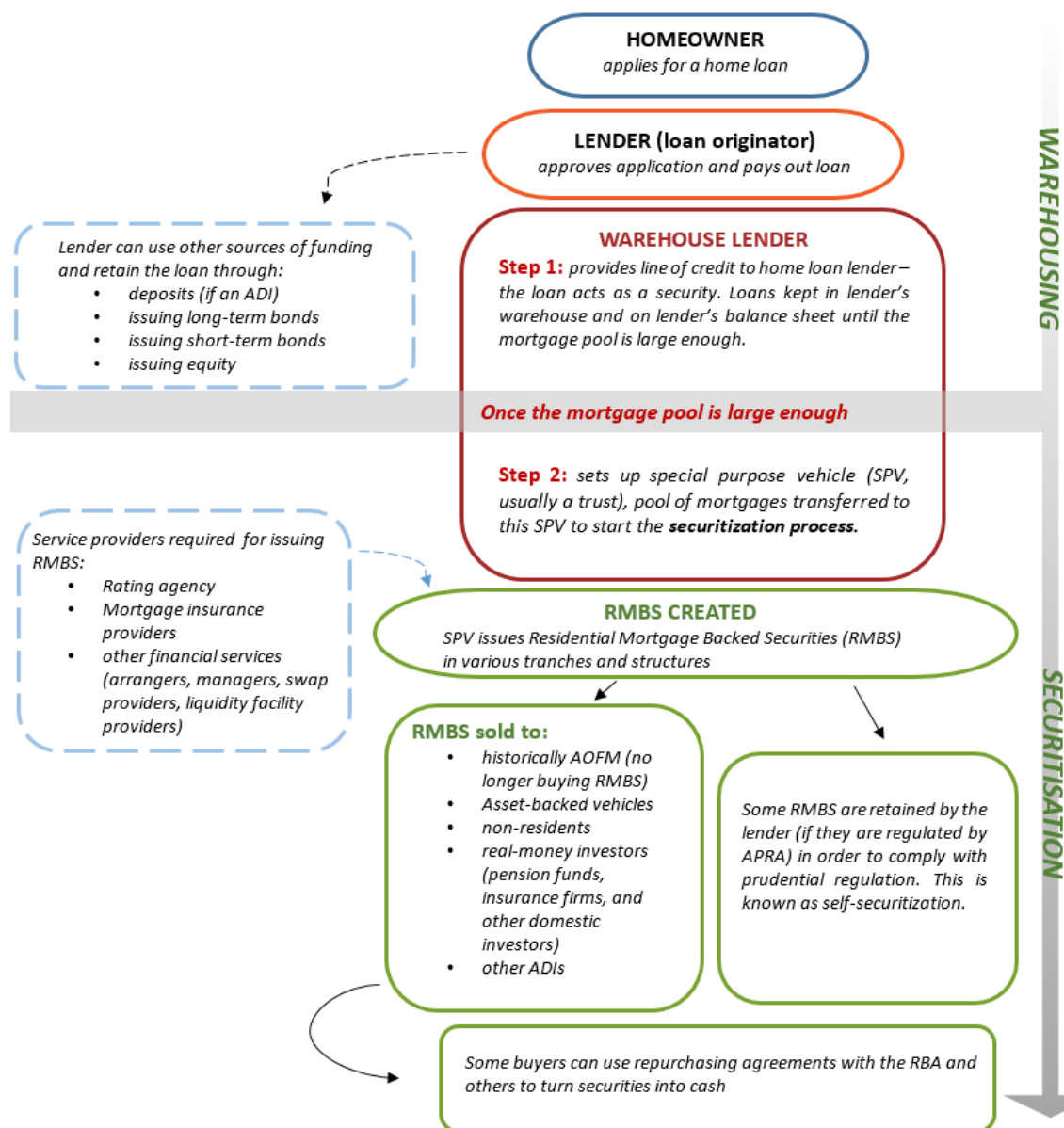
The Future of Financial Advice reforms appear to have contributed to consolidation in the asset management and financial advice markets. Consumers may be better protected against poor advice, but be offered a narrower range of in-house products.

... and providing warehouse funding to competitors

Another form of vertical integration allows major banks to exercise control over the provision of funding to smaller and non-bank lenders through warehouse funding arrangements (figure 7.6).

Figure 7.6 The warehousing process^a

A stylised supply chain



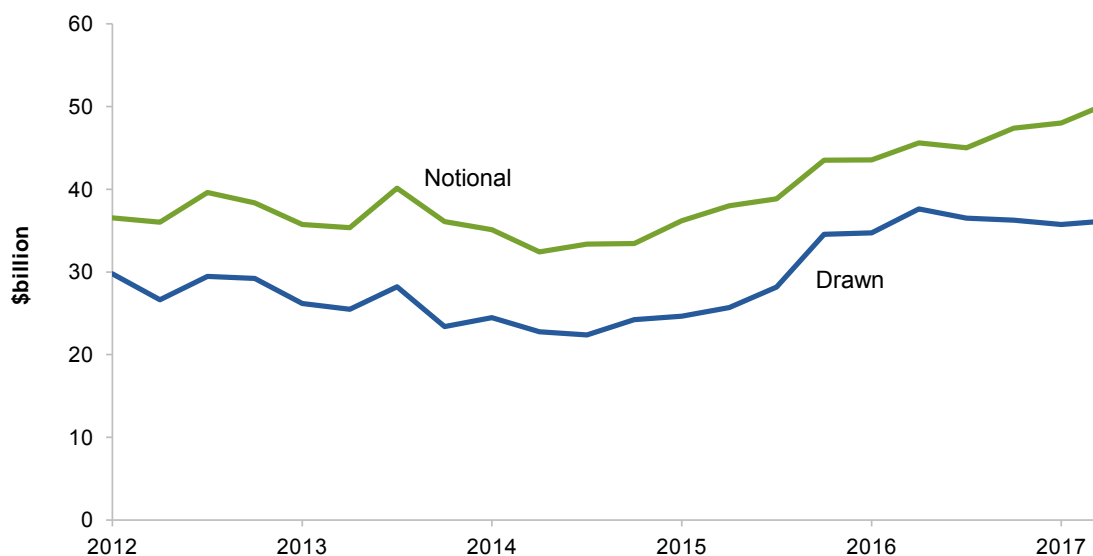
^a Select acronyms: RMBS — residential mortgage backed security; SPV — special purpose vehicle; AOFM — Australian Office of Financial Management

Warehouse facilities are temporary, or in practice revolving, lines of credit provided to (usually smaller) lenders. All major banks (including Macquarie) provide warehouse funds to smaller lenders along with other securitisation facilities (figure 7.7).³⁵

³⁵ Securitisation is the process of taking a group of illiquid assets and through financial engineering changing them into a security (a bundle of assets).

Figure 7.7 **Securitisation facilities provided by all ADIs to other financial institutions^a**

As at March 2017



^a Captures arrangements where provider of warehouse loan is not the originator of the underlying mortgage. Includes 'liquidity', 'funding', 'warehouse', 'lending', 'credit enhancement', 'underwriting' and 'other' facilities, but excludes derivatives arrangements

Source: RBA (2017ab)

For smaller lenders (that are either ADIs or non-ADIs), warehouse facilities are an important means for accessing wholesale funding in secondary markets through accumulating enough loans to eventually securitise. Domestic warehouse facilities represent close to a quarter of these lenders' assets in aggregate, and facilitate what is estimated to be about half of non-banks' lending through securitisation (Gishkariany et al. 2017; RBA 2017t, 2017ab).³⁶ The non-banks currently have access to about \$16 billion in warehouse facilities from major banks (although alternative sources estimate this to be \$22 billion), of which \$11 billion was drawn as at June 2017 (RBA 2017ab). We understand this \$16 billion comprises 95% of total warehouse funding made available to smaller lenders.

In effect, for some lenders their largest competitors may be the source of funding via warehousing (thus pricing their input) and also a prospective buyer of their final product (via securitisation).

³⁶ Evidence on the extent of warehousing activity in Australia is currently 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 2017ab). We understand that APRA has recently issued notices to ADIs to collect quarterly data on the extent of warehousing activity.

How could the lines of warehouse funding affect competition?

The implications of having the major banks being the providers of ‘wholesale funds’ to their competitors raises competition issues at least in theory. Specifically, controlling the supply of funds provides the major banks with the ability to influence the input costs of their competitors. This inquiry is seeking further data to demonstrate how the pricing of warehouse funds potentially may control market structures and limit competitiveness.

The non-bank sector has failed to grow in Australia since the global financial crisis (GFC). This is largely due to the fact that it does not have access to retail deposits and the securitisation market’s near-collapse during the GFC (chapter 5).

While non-bank lending to the domestic property market, for example, is estimated to be small (RBA 2017t), the lending activities of non-banks, along with those of smaller banks, have in the past grown rapidly at times and could in the future add competitive pressure on major bank lending. As an example, when mortgage broker Aussie Home Loans entered the Australian home loan market in 1992, it challenged the incumbents’ market dominance through its access to warehouse finance and securitisation.³⁷

Smaller lenders in Australia face capacity constraints because of their reliance on the availability of warehouse funding, and are beholden to any terms and conditions in accessing it. For example, non-bank lender Pepper Money funded 100% of its Australian loan book from warehouse funding and Heritage Bank funded 38% (Heritage Bank 2017a; Pepper Group 2017).

There is however the risk of lower quality lending through warehousing. This was highlighted in the Australian context in the lead-up to the GFC where the non-bank lending sector grew to fill a gap in the market for ‘riskier’ lending — for loans that traditional banks could not provide at effective rates, such as to those with irregular incomes or tainted credit histories (Financial Stability Board 2017, APRA 2017) Indeed, ASIC’s mortgage broker remuneration dataset shows that some non-bank lenders in the dataset have a higher mean loan-to-value ratio (LVR) than the smaller ADIs (ASIC 2017ac).

Recent changes have been made to prudential standards around securitisation, which will require the banks providing warehouse funding to hold additional capital and may ultimately affect the competitive dynamics between the larger banks, smaller banks and non-ADI lenders. The potential impact of these regulatory changes on smaller and non-banks is discussed later.

³⁷ At the time Aussie Home Loans entered the Australian home loan market, securitisation was new, with Macquarie Bank providing most of the warehouse funding to Aussie Home Loans.

7.3 Integration isn't an ongoing threat to competition

Banks divesting in some areas is a market response

Despite the high concentration and vertical integration in the asset management platform and advice markets, the 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 reducing 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.
- NAB sold its 80% stake in MLC Life Insurance to Nippon Life in 2016.
- 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, and the sale agreement also included a 20-year partnership with AIA for providing life insurance products to its customers.

The banks' wealth management operations have been sold to global as well as local financial institutions, with the global institutions possibly more responsive to a global clientele (Nippon Life and OCBC Bank, for example).

The retreat from wealth management

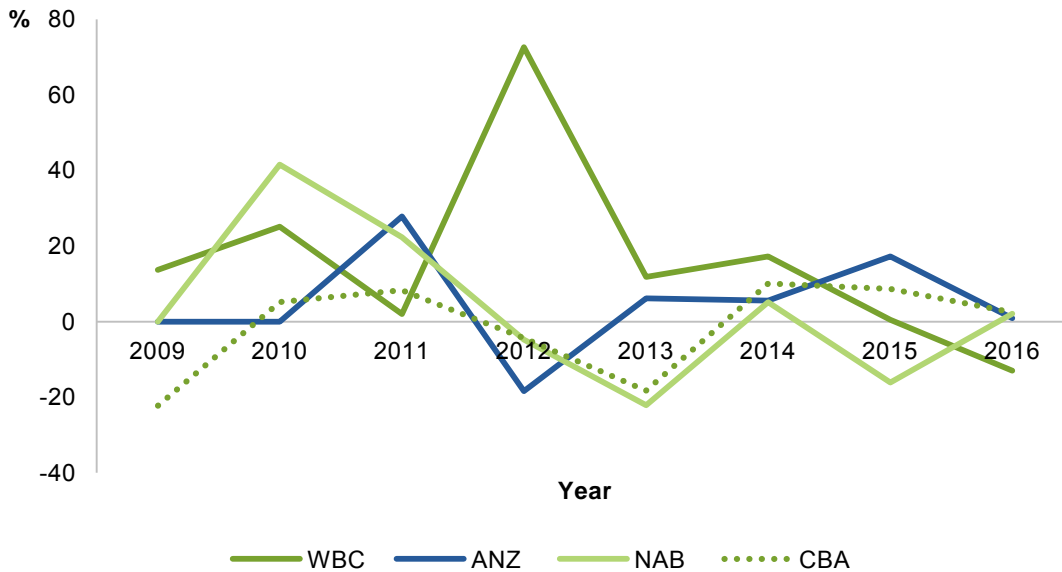
Divestment across the industry has been undertaken largely for commercial reasons (RBA 2017, Moody's 2017, ADI data). The retreat from wealth management reflects a return by banks to the most profitable and efficient businesses where they dominate the market: retail and commercial banking.

Overall, the major banks' wealth management performance is relatively weak and sluggish, especially when compared to the specialised fund managers (figure 7.8 and 7.9, appendix D).

Revenue from asset management has grown more slowly than revenue from other activities since 2007 (figure 7.8, appendix D). Margins have been narrowed and subject to downward pressure by competition from other funds and investment options, and from new platforms that disrupt traditional supply chains and are capturing market share (appendix D). For example, new platform NetWealth, floated in late 2017, took 18% of net flows (of assets under management) in the previous financial year (Strategic Insight 2017).

According to the data provided by ADIs to the Commission, there also appears to be significant variation in efficiency among the major banks in providing wealth management services (appendix D). This is shown in their ‘asset turnover ratio’.³⁸

Figure 7.8 Major banks’ wealth management revenue growth^a
2008-09 to 2015-16



^a Funds 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 funds 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: Annual reports, NAB (2016)

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.

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.

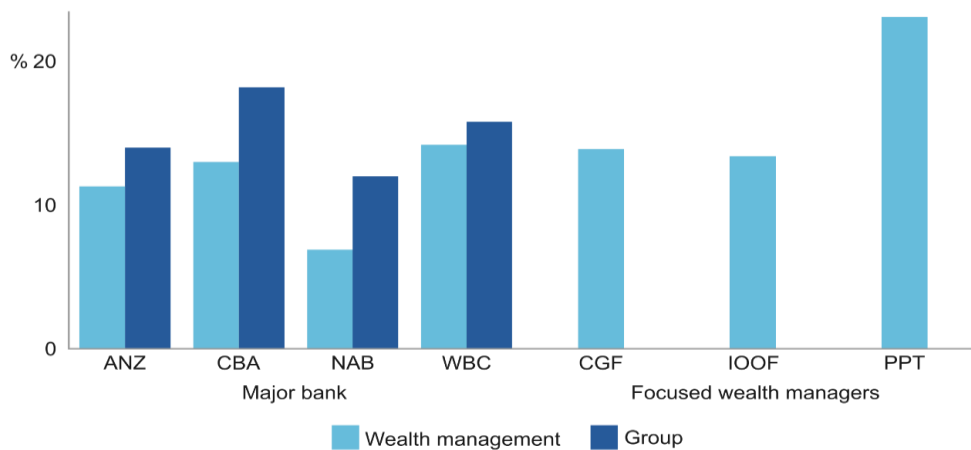
³⁸ The ‘asset turnover ratio’ (measured by revenue as a proportion of AUM) indicates how efficient the banks are in using their assets to generate revenue from their wealth management activities. The higher the ratio, the better the performance.

While these programs come at a cost to the banks, the need for them reflects an accrual of past practices where pursuit of commissions, fees and profits were put above a proper consideration of customers' needs. Commonwealth Bank's profitability, which fell by 18% from financial year 2014 to financial year 2015, was affected in part by the costs of its Open Advice Review program at that time (CBA 2015). To date, the program has cost \$29 million in compensation.

ANZ, on a slightly smaller scale, provided remediation for customers who failed to receive the Prime Access service as part of their financial advice. This cost the bank an estimated \$30 million (RiskInfo 2015). ASIC has also worked with Macquarie Investment Management to remediate clients affected by systems errors (ASIC 2017c).

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 7.9). According to data received from some ADIs, the ROE for wealth management was around 10-11% at June 2017, down from around 17% in 2010 (unpublished ADI data).

Figure 7.9 Major banks' and funds managers' return on equity ^{a,b}
2014-15



^a Cash return on equity (RoE). ^b Focused wealth managers include Challenger (CGF), IOOF and Perpetual (PPT).

Source: Golat (2016)

Asset management supply chains are ripe for disruption

Older platforms and traditional models of financial advice in wealth management are under attack from digital disruptors, and direct investment choices (both in and outside of superannuation).

Disruption in wealth management and financial advice

Industry observers have characterised supply chains in Australian banks' wealth management businesses as being 'considerably behind other industries' and particularly so in the wealth management space (Stevens 2015). Historically, the Australian platform market has been considered difficult to enter because of the hold that major banks have had (Stevens 2015). Furthermore, complex and continuously changing regulations (which may have shifted the attention of incumbent providers from innovation to compliance) have equally served as a deterrent to new entrants in the market (Lansiti and Lakhani 2017).

The retail investment platforms based within the major banks continue to rely on complex webs of legacy technology, stifling their ability to adapt to changing technology and consumer expectations (Stevens 2015). 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. And investments that incumbents have made in platforms (for example, ANZ's investments in its former wrap platform, Oasis) risk obsolescence as they are taken over by newer technological developments and direct-to-consumer channels (for example, NAB trade and Commsec).

This has presented an opportunity to disrupt currently embedded supply chains by those who incorporate more sophisticated analytics and personalisation into the provision of wealth management options and financial advice.

Thus incumbents no longer have the same exclusive claim to economies of scale as the costs of technology fall. 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.

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. As mentioned earlier, 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. While specialist or independent platform providers (as new entrants) have a relatively small market share by assets under management, they appear to attract a sizeable proportion of annual net inflows of the industry (appendix D). 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.

Market studies also point to consumers now wanting one-stop-shop wealth management offerings (subs. 26, 40). This includes the provision of personal financial advice. To this end, digital and more scaled advice may improve the affordability of, and meet the demand for, financial advice by lowering its cost. Digital advice (also known as ‘robo-advice’ or ‘automated advice’ — chapter 12 and appendix D) is automated financial product advice provided using algorithms and technology without the direct involvement of a human adviser. Australian licensees are now actively developing their own digital advice models, having observed its growing popularity in the United States and Europe since 2012 (sub.40).

Digital advice has the potential to increase competition in the financial advice industry and disrupt current supply chains. New advice providers are entering the financial advice market, including overseas digital advice providers in the coming years. And the costs associated with starting a digital advice business in comparison with a traditional advice business are relatively low, reducing barriers to entry — typically, a digital advice business will require fewer staff and will not require a large physical presence.

Since 2014, start-up licensees and existing licensees have been developing or launching digital advice models. ASIC (sub. 40) expects this growth to continue given the number of start-up businesses that have approached ASIC through its Innovation Hub.

Regulation is the potential competition issue for warehousing

The Commission’s discussions with smaller banks and non-banks indicate that it is not so much the banks’ control over the funding supply chain that will affect competition but the costs associated with revised APRA regulations.

Recent regulatory action could affect prices and competition

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 will now need to hold more capital against their securities than they had previously, driving up warehouse costs (box 7.1).

Box 7.1 APRA's Prudential Standard APS 120 and warehousing

ADIs are required to hold regulatory capital so that losses can be absorbed without impacting depositors (chapter 16). These capital standards include Prudential Standard APS 120 Securitisation (APS 120), which covers securitisation activity.

Securitisation is taking a bundle of illiquid assets and financially engineering them into a security. The GFC revealed that securitisation had become complex and opaque, and that its prudential regulation had become similarly complex. The regulator consensus has been that the GFC also revealed the capital requirements on certain types of securitisation exposures were too low (under the Basel II securitisation framework). In December 2014, the Basel Committee released its updated securitisation framework (Basel III securitisation framework), which APS 120 follows.

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).

How did APS 120 change?

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 introduces higher regulatory capital requirements for some types of securitisation exposures (table below). Now, securities will either need to be 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.

Where does warehousing come in?

Securitisation often involves the first step of frequent settlements of new loans into warehouses - in order to then create the securities (figure 7.6). This means that the 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. Moving to the external ratings-based or standardised approaches is likely to increase funding costs that are passed onto those accessing the warehouse facilities.

Capital costs of securitisation exposures under the previous and new regime

Exposure	Risk weight – previous	Risk weight – new
AAA (senior)	20%* (7%**)	15-20% +
AAA (non-senior)	20%* (12%**)	15%-70% +
AA (non-senior)	20%* (15%**)	30%-120% +
A (non-senior)	50%* (20%**)	CET1 deduction
BBB (non-senior)	100%* (75%**)	CET1 deduction
Unrated (non-senior)	1250%	CET1 deduction

* Using the external ratings-based approach under the previous APS 120 (January 2015)
** Using the IRB approach under the previous APS 120 (January 2015)
+ Using the external ratings-based approach under the Basel III securitisation framework

Source: APRA (2017q, 2018d)

For the warehouse providers ...

Major banks that provide a warehouse are required to calculate the regulatory capital to put behind the warehouse line of credit, which then drives the return that they must make (see chapter 16 for a discussion on regulatory capital). For warehouse funding providers, the capital that they will be required to hold against securities will likely more than double under the new rules (see box 7.1).³⁹ 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, and one that will ‘restrict [the banks’] ability to facilitate growth in the non-ADI residential mortgage sector’ (ADI responses 2017, de-identified).

For the warehouse funded institutions ...

A number of non-banks and some smaller banks advised APRA (at the time APS120 was being developed) that warehouse funding costs would be increased significantly as a result of the regulatory changes (ASF 2016).

One small bank with an externally rated warehouse estimates the subordinated debt it would have to hold for accessing a warehouse (debt which ranks after other debts if a company falls into liquidation or bankruptcy) would increase from about 20% to 27% (from \$125 million to \$185 million assuming a \$500 million warehouse limit) (unpublished ADI data).

Similarly, one non-bank that has not sought external credit ratings on its warehouses estimates that the regulatory changes will on average increase home lending rates by 10 basis points and auto and equipment finance rates by 40 basis points.

The Commission was advised that some smaller lenders and non-banks may be wearing the higher costs of warehouse funding in the short-term by trying to attract borrowers with more competitive rates, recouping these costs over the life of the loans.

Some smaller lenders will be required to turn to alternative funding sources (such as private equity, and deposits for smaller ADIs) to varying degrees. For example, some larger non-banks can, and currently do, raise capital directly on global capital markets (Pepper Group 2017; RBA 2017t). It has also been suggested that there may be scope for alternative sources of non-bank finance to emerge, including funding from either the local or international managed funds industry (RBA 2017t).⁴⁰

³⁹ 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 2017q). For warehouses that do not have an external credit rating, the risk weighting will increase from around 7% to at least 15% as per the standardised risk weighting formula.

⁴⁰ Other jurisdictions have also utilised innovative financing arrangements to attract more funding from these sources. For example, in some European countries, most notably the Netherlands, stricter capital requirements for banks have contributed to a rise in the share of mortgages originated by pension funds and insurers over the past six years (ECB 2017, RBA 2017).

Even so, non-bank lenders have limited access to short-term wholesale markets in reality and no access to deposit funding, unlike ADIs.⁴¹ Moreover, their cost of funds is higher not just because they must rely on more expensive funding sources, but also because of the generally lower credit ratings they are assigned, which increase their cost of wholesale finance (chapter 5). Any slowdown in the provision of warehouse lending would therefore further restrict small and particularly non-bank lenders' already more limited funding options, and diminish their capacity to pose a competitive threat in the Australian retail banking market.

Market consequences

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 2017q, 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. The non-ADIs do not appear to have the ability to create a systemic threat. The regulator's efforts to lift the cost of warehouse funds raises the question of whether all competition must be constrained when macro prudential intervention is undertaken (chapter 16).

The regulations could be better targeted

There is a risk that the revised APS120 rules apply a blanket 'one-size-fits-all' approach to all lenders accessing warehouse funding.

Under the revised rules, smaller ADIs subject to the standard approach to risk weights can no longer access funds through a major bank warehouse and have those credit exposures subject to a lower capital requirement under the major banks' internal risk models (box 1.1).

The APS120 changes not only ensure standard ADIs still face standardised risk weights on warehouse loans, but go further in targeting non-banks. Non-banks — reliant primarily on warehousing from the majors for their Australian lending portfolios — are now indirectly subject to the standardised risk weighting model. This is despite not having a banking licence and no access to retail funding. This reduces their ability to compete with the major banks. If the target of APRA's intervention was the 'regulatory arbitrage' by standard ADIs — that is, a compliance issue — there was and is no need to also apply this standard to all warehouses. It may be convenient, but it restricts competition.

⁴¹ Despite not being subject to the prudential standards ADIs must meet, under APRA's recently announced reserve powers, non-banks will fall within the scope of APRA's regulatory oversight (chapter 3). Non-banks are also regulated by ASIC's licensing regime, so fall under the responsible lending requirements as per the *National Consumer Credit Protection Act 2009* (Cth).

As such, it is possible that the new APS120 rules go too far insofar as they restore compliance by smaller ADIs, but at the same time impose disproportionate costs on non-banks.

Second, the standardised risk weighting formula that applies to smaller and non-banks does not distinguish between the risks that different types of loans pose, such as loans with different LVRs and to small business (chapters 6, 9 and 16).

Setting risk weights is a balancing act that represents a trade-off between a tailored approach with more complexity and a standardised, simpler approach (European Central Bank 2017). The simplest approach is to acknowledge risk but refrain from measuring it, but this has its shortcomings. Banks with low risks would have to hold the same amount of capital as banks with high risks. That the standardised approach to risk weighting fails to capture such diverse and changing risks within asset classes is one of its weaknesses. To address this, regulators may consider applying some risk differentials in the standardised model (as discussed in chapter 16).

Non-banks are concerned that APRA takes an overly risk-averse approach to their market segment, which is now facing higher regulatory costs (ASF 2016). While non-ADIs may be able to access alternative finance, this is not the point. There is an obligation already on regulators to balance competition with system stability — and where stability is clearly unthreatened by non-ADI behaviour the presumption in the current policy objectives should favour maintaining competitive sourcing of funds.

To this end, changes at the margin to the new APS120 rules to make the regime more targeted could maintain certainty while providing more flexibility in funding for non-banks. Moreover, the new reserve powers that APRA has to oversee the non-banking sector may further reduce the need for APS120 to apply to this sector.

DRAFT FINDING 7.2 NEW 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 between smaller authorised deposit-taking institutions (ADIs) and non-ADIs. This will increase the costs of warehousing and reduce the competitiveness of those institutions that rely on warehouse funding.

INFORMATION REQUEST 7.1 HOW WILL PRUDENTIAL STANDARD APS 120 AFFECT YOU?

We are seeking detailed estimates or hypothetical scenarios of how revised APS120 will affect warehouse costs for standard ADIs and non-ADIs.

We are also seeking estimates of the costs of obtaining similar levels of finance to that obtained through warehousing, such as through commercial loans in retail markets.

DRAFT RECOMMENDATION 7.1 A PROPORTIONATE APPROACH TO RISKS NON-ADIs POSE

The implementation of the revised Prudential Standard APS 120 that came into effect on 1 January 2018 should be revised and limited in its effect, in the first instance, to warehouse funds provided to authorised deposit-taking institutions (ADIs). Prior to any later extension of the standard funds provided to non-ADIs, the costs to non-ADIs of changes to regulatory capital requirements for the provision of warehouse facilities should be subject to a public cost-benefit analysis that includes calculation of regulatory capital costs and any pass-through.

Stopping integration doesn't reduce risk-taking

There have been concerns that integration in the financial system can increase 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 7.2). This is reflective of the experience of the GFC in these jurisdictions

In the Australian context, the major banks' market dominance has meant that most financial operations have been subject to 'unquestionably strong' prudential oversight and capital requirements (chapter 16). Capital and liquidity requirements 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; Reserve Bank of Australia, 2015b).

Similarly, the ability to grow through integration hasn't necessarily contributed to recent crises as much as poor regulatory and prudential oversight (box 7.2). For example, the collapse of HIH Insurance — considered Australia's largest corporate collapse — was not due to an integrated business model as much as it was to do with under-pricing risk, not holding sufficient 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 such as implicit government support persist and give rise to 'moral hazard' (King 2013; Murray et al. 2014a; Wallach 2012).

The strong prudential settings applied to Australia's banks and insurers negate the need for regulations that ban (for reasons of stability concerns) integration in Australia. What measures might be needed to better assess integration from a market competition perspective, are discussed below.

**Box 7.2 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 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. 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.

In some early research on the effects of the Volcker Rule, Keppo and Korte found evidence that banks’ overall risk levels did not decline with the Volcker Rule restrictions (Keppo and Korte 2016). They found 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. Keppo and Korte stated, ‘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).

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.’

But others, like former United States Treasury Secretary Tim Geithner, have said the focus on being able to integrate 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 securitization 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).

7.4 The need to assess integration impacts on competition

The integration lever remains viable

Scope remains for the major banks to draw upon their significant market power to dial their level of integration up or down depending on the commercial opportunities.

The major banks have the financial strength to deal with any new players or developments in the market by buying them out (chapter 4).

‘Creeping acquisitions’ have been a feature of integration in the Australian financial system for some time. These typically involve a series of smaller mergers and acquisitions that in isolation have little impact on competition, but where the cumulative effect of these mergers and acquisitions overtime may have a less benign impact on competition.

Even so, market power in and of itself is not the issue — competitive advantages that regulatory settings afford should be the focus of any policy or regulatory intervention.

There is opportunity to make full use of the existing regulator powers to identify and address where integration might substantially lessen competition and efficiency, or impose unnecessary barriers to entry, for example through creeping acquisitions. By the same token, any regulatory interventions would need to provide commercial certainty to the market in such a way that regulators do not disrupt integration activities that would be beneficial overall.

Regulator scope to assess potential integration issues

Australia has a well-developed and strong regulatory framework for dealing with anti-competitive behaviour (chapters 15 and 16).

There are strong legislative powers to this end, which allow the ACCC to intervene in instances of anticompetitive behaviour or substantial lessening of competition, particularly with recent changes to section 46 of the *Competition and Consumer Act 2010* (Cth). But, despite the breadth of these powers, it is not clear that the regulatory tools have kept up with the pace of change in the Australian financial system, and the nature of integration in particular.

Some specific limitations of the ACCC’s powers and potential options are discussed in chapter 15; here the discussion focuses on integration.

A paucity of evidence makes assessing integration difficult

When considering creeping acquisitions, the Harper Review (Harper et al. 2015) noted that it was a legitimate question whether in assessing a proposed merger, the merger provisions of the Competition and Consumer Act should also take into account the aggregate effect of the company’s previous acquisitions over a certain period of time (for example, three years). The complicating factor was that market conditions may have changed substantially over the period of time chosen and such a change would impose additional costs to merger reviews. The Harper Review concluded that on balance, in the absence of evidence of harmful acquisitions occurring because of a gap in the legislative framework, a strong case for change had not been made (Harper et al. 2015).

But regulators need a strong evidence base for there to be effective assessment of the impacts of integration on market outcomes over time. There is opportunity to collect information from the biggest market players on a more regular basis on the effects of and basis for integration.

The Commission's own efforts to detail the ownership structures of various financial platforms and subsidiaries have been difficult due to the lack of available data.

As an example, the Commission has found that there is little consistent data on: the extent of integration in the asset management space, as an example; on the type of investors; prices, quality and costs (such as if price clustering occurs); the extent of pass-through (such as whether cost savings are passed through to consumers as a result of integrating business models); and also the relative profitability of different business arms (as measured by return on equity, return on assets or proxy measures).

Just as some concentration measures are calculated, so too could basic indicators of integration be devised (with relevant data collected on a regular basis), even if only as partial indicators.

Integration for efficiency reasons (economies of scale and scope) would improve productivity and should only be restricted if these benefits are likely to be offset by other detrimental community outcomes. Integration for anti-competitive reasons (for example, price fixing or increased barriers to other market participants) would be to the long term detriment of the community and may justify regulatory intervention.

Understanding which situation is behind a given integration activity would necessitate more data than is currently collected by financial system regulators. Otherwise, there is a risk of the economies of scale or scope argument for integration being taken for granted or not being subject to sufficient testing.

ASIC currently collects data on an ad-hoc basis on instances of horizontal and vertical integration, and this tells part of the integration story. As the regulator of financial service licences, its databases could also provide some visibility on which financial institutions have acquired additional licences over time.

To reduce the costs of assessing how creeping acquisitions have impacted on a market over time, financial institutions that are undertaking mergers or acquisitions — including banks, insurers and other financial services firms — should notify the ACCC and ASIC of the acquisitions and their size — not just in terms of market capitalisation but total assets. This should occur not just in the context of the mergers approval process under the Competition and Consumer Act, but on an ongoing basis. The gradual shifts and fluctuations in market integration could be assessed based on total assets or revenue per reporting period.

DRAFT RECOMMENDATION 7.2 BUILDING AN EVIDENCE BASE ON INTEGRATION

Firms that are undertaking mergers or acquisitions within the financial system — including banks, insurers and other financial services firms — should notify the Australian Competition and Consumer Commission and the Australian Securities and Investments Commission (ASIC) on the nature and size of these acquisitions as they undertake them.

ASIC should maintain a publicly accessible database of the relationships between parent and subsidiary companies, and report annually on all notifications received.

8 The residential home loan market

Key points

- The choice of a home loan is, in many cases, the biggest financial decision that people make. It is therefore important that the home loan market is competitive, efficient and fair.
- Mortgage brokers are now the dominant channel for obtaining a home loan. Other options collectively account for less than 50% of the market. Brokers are not a low-cost option, potentially adding 16 basis points in cost to interest rates.
 - However, surprisingly for such a major cost item, *most lenders were unable to provide the information* required to evaluate whether brokers are a lower-cost distribution network. Cost data appears to be a black box for this industry.
 - Brokers benefit lenders by allowing them to avoid the fixed costs of branches.
- Brokers are clearly beneficial for smaller lenders looking to diversify. On average, we calculate that each would have needed to open 118 new branches to generate the equivalent market shares.
- Preliminary analysis suggests that brokers do obtain slightly lower interest rates, but it is not clear if this is attributable to brokers' ability to negotiate with lenders, or to other factors such as the characteristics of borrowers who use direct channels to source their loan.
- Mortgage brokers face conflicts of interest arising from the payment of commissions. Ownership by banks of aggregators — the businesses under which brokers often work — adds to this conflict. In December 2015, about 70% broker-originated loans came from lender-owned aggregators. To overcome these conflicts, lender-owned aggregators and the brokers who operate through them must be required to act in consumers' best interests.
- Information about whether a broker has accredited access to all the loan products on their aggregator's panel, how brokers are paid (and how much), and who owns their aggregator, is not exposed in full to consumers. Better information on all these would enable consumers to evaluate if they are getting the loan that best meets their needs.
- Lenders' advertised standard variable rates are not an accurate indicator of actual home loan interest rates — the vast majority of consumers pay less.
- Consumers cannot readily compare different products before approaching a broker or branch, and so are ill-prepared to bargain. This must change.
- Lenders mortgage insurance (LMI) provides a mechanism for people with fewer resources or poorer credit ratings to obtain a home loan, and can help smaller lenders manage their risks. Approximately 23% of owner-occupier loans are supported by LMI.
- For consumers who capitalise the value of LMI fees into their loan and switch providers while remaining over the 80% loan-to-value threshold, refundable premiums would desirably reduce the cost of switching.

Many households in Australia require a home loan when purchasing residential property. In 2016, approximately 35% of dwellings in Australia were owned with a mortgage, more than the proportion owned outright or rented (approximately 31% each) (ABS 2017d).

Home loans are a significant financial commitment, and are, in many cases, the biggest financial decision that people make. The average home loan written in December 2016 was approximately \$376 000, about seven times the average annual household disposable income of \$53 000 (ABS 2017f, 2017e)⁴². Home loans can also be a long-term commitment, with most loans having 25- or 30- year terms (although many are repaid sooner). Further, home loans can act as ‘anchors’, with many consumers holding other banking products such as deposit accounts and credit cards with their home loan provider (chapter 13).

Given the importance of home loans in the lives of Australians, it is imperative that the home loan market is competitive, efficient and fair. However, consumers may not always be able to place any competitive pressure on lenders and other participants in the supply chain (such as mortgage brokers) because product proliferation and complexity of jargon make it difficult to make informed decisions. Remedies that help increase transparency, and obligations on participants (including lenders and brokers) to provide consumers with information or act in their best interests, can increase competition in the home loan market.

This chapter discusses competition within the residential home loan market, focusing on:

- the role of mortgage brokers
- price transparency and the use of the standard variable rate (SVR)
- lenders mortgage insurance (LMI).

Appendix C provides some background on the residential home loan market.

8.1 Are mortgage brokers a force for competition?

From a relatively small industry in the 1990s, mortgage brokers have grown to become a significant channel for distributing home loans. Approximately 54% of new residential home loans are now written through brokers, compared to only about a quarter in 2003 (MFAA 2017; RBA 2004). Some lenders believe that the share of home loans written through brokers will ultimately increase to 60% (EY 2015).

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)

⁴² According to the ABS (2017e), mean equivalised household income in 2015-16 was \$1009 per week, which is equivalent to approximately \$52 600 per year.

Mortgage brokers act as intermediaries between lenders and consumers, and can bring benefits to both (discussed below). In particular, brokers can benefit consumers by being more effective at selecting the best loan and negotiating with lenders because they are more familiar with the home loan market. This can also increase competition among home loan providers.

However, nothing *obliges* brokers to act in a client's best interests — under the *National Consumer Credit Protection Act 2009* (Cth), brokers are only required not to suggest unsuitable loans to consumers, rather than act in their best interests (although they must also have arrangements in place to manage conflicts of interest). Undesirably for the dominant form of home loan origination, the financial incentives of brokers are skewed in favour of the banks that pay them.

- Mortgage brokers are paid by lenders via commissions, and can face conflicts of interest when the most suitable loan for a consumer is not the one that pays the highest commission.
- Consumers do not have information about how much brokers are paid by different lenders, making them unable to question when brokers may not be acting in their interests.
- Broker commissions are high relative to fees for financial advice (the providers of which *do* face obligations to act in clients' best interests).
- Many of the large mortgage aggregators (Aussie Home Loans is a well-known example) are owned by lenders, and this can exacerbate conflicts of interest (aggregators are discussed in further detail below). Further, where an owner of an aggregator also funds a white-label loan, it tends to achieve a higher market share within that aggregator compared to its overall market share within the broker channel.

Consumers may therefore not be getting the full competitive benefits of using a broker. This is not to say that brokers do not provide some benefits, or that brokers provide questionable services.

Rather, the structure of the mortgage broking market does not resemble one that is fully competitive, as it once did in the 1990s, and recommendations to ensure that poor behaviour does not adversely affect borrowers is preferable to waiting until the system is self-evidently broken.

Players in the mortgage broking industry

The main players in the mortgage broking industry are lenders, aggregators and brokers.

Lenders are authorised deposit-taking institutions (ADIs) and non-ADIs that provide the funds for a home loan. Lenders usually assess and approve loan applications, and also employ business development managers to liaise with brokers regarding potential borrowers.

In the case of white-label loans (discussed later), business development managers may be provided by the aggregator instead.

Aggregators are intermediaries that act between lenders and brokers. Aggregators enter into contractual relationships with multiple lenders, and those lenders form the aggregator's 'panel'. Brokers then enter into contractual relationships with aggregators, which enables them to submit loan applications to lenders on the aggregator's panel. Commissions on successful loans are paid by lenders to aggregators, who take a fee before passing on the remainder to brokers.

Aggregators benefit brokers by allowing them to combine the volume of loans they originate with those of other brokers to achieve the minimum volumes set by lenders. Aggregators also provide brokers with IT infrastructure and support, professional development training and marketing materials. Lenders benefit from aggregators by avoiding the need to have contractual relationships with many hundreds (or thousands) of individual brokers.

Many aggregators are 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 Home Loans 2017). The National Australia Bank (NAB) has full ownership of three aggregators — Choice, FAST and PLAN. CBA also has a 20% share in Mortgage Choice (Roddan 2016), while Macquarie has minority stakes in Connective, Vow Financial and Yellow Brick Road (ASIC 2017ac). Using data obtained from the Australian Securities and Investments Commission (ASIC), the Commission estimates that the combined market share of these aggregators was just under 70% as at December 2015. NAB (sub. 31, p. 14) also submitted that the aggregators it owns collectively represent about 30% of mortgage brokers in Australia.

Brokers are individuals or (typically) small businesses that interact with consumers and suggest loans to them. Once a consumer selects a loan, brokers can assist with the application process and submit the loan to the lender on the consumer's behalf. In 2017, there were approximately 16 000 mortgage brokers in Australia (MFAA 2017).

How do consumers use brokers?

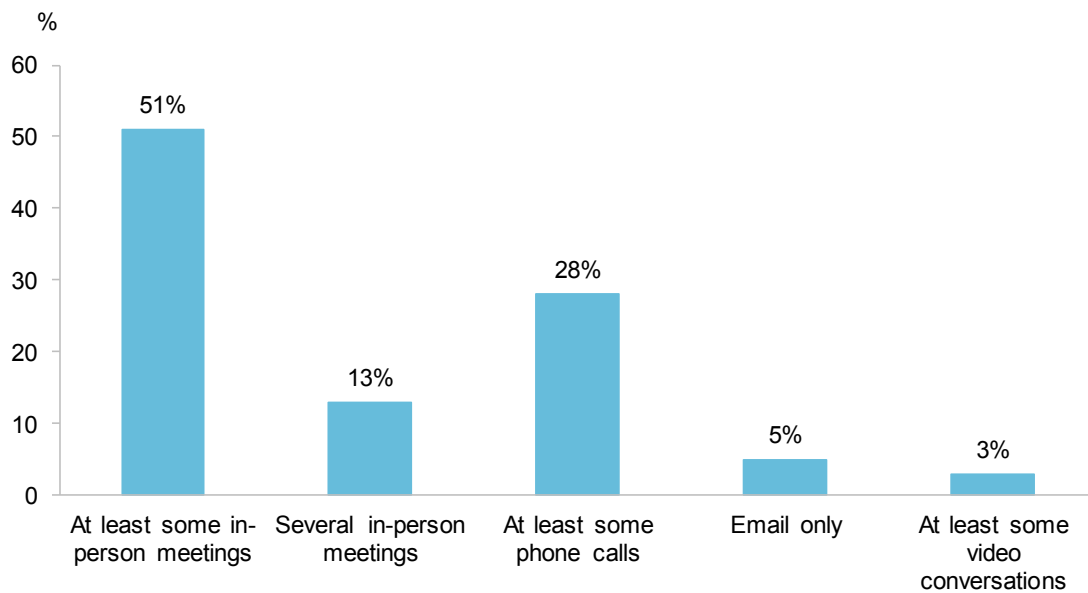
Brokers primarily trade on relationship — most people choose their broker either because of recommendations by family and friends, or because they had previously sourced a home loan through them (Deloitte 2016a; RFI 2009). Once a customer had established a relationship with a broker, they were highly likely to return to them for future home loan needs (Deloitte 2016a). Brokers also tended to provide ongoing advice once a loan had been settled (Deloitte 2016a). Customers were unlikely to turn to other brokers when refinancing (RFI 2009).

Consumers also rely heavily on brokers as a source of information. Deloitte found that a larger proportion of broker customers compared to direct customers had done no prior

research — 22% compared to 12% (Deloitte 2016a). Broker customers also felt less confident, and saw brokers as a trusted adviser (Deloitte 2016a).

Consumers interacted with brokers through a variety of channels, however many still valued face-to-face interactions. Mortgage Professional Australia (2017) found that approximately half of all customers expected at least some in-person meetings (figure 8.1).

Figure 8.1 Channels of communication with brokers
'When using a broker, how would you like to deal with them?'



Source: Adapted from Mortgage Professional Australia (2017)

The benefits of brokers to consumers

Brokers as way to access a wider range of loans

Surveys consistently showed that one of the main reasons consumers used brokers was to access a wider range of loans (ASIC 2017ac; EY 2015; RFI 2009). Unlike lenders' staff (who can only recommend their employer's products), brokers can recommend loans from many different lenders. Large and mid-tier aggregators generally had between 22 and 55 lenders on their panels, however this may overstate the level of choice available to consumers as individual brokers are not necessarily accredited by all lenders on an aggregator's panel. ASIC (2017ac) found that only about 20% of aggregators required brokers operating under them to be accredited by all lenders on their panel. This means that a customer, observing the brands that an aggregator may list in its promotional material, maybe unaware that *their* broker may not be able to access all the promoted products.

Brokers as a source of advice and expertise

The reasons that consumers gave for going to brokers related to brokers as a source of advice and expertise — these included ‘help in understanding the documentation required’, ‘support through the process’, ‘more likely to get a loan approved’, and ‘I wanted independent advice’ (ASIC 2017ac; Deloitte 2016a; RFI 2009). First home buyers in particular valued the help that brokers provide (MPA 2017). Deloitte Access Economics (2016a) found that, compared to direct-to-lender customers, a greater proportion of broker customers felt that their confidence had grown as a result of their experience of obtaining a home loan.

Brokers as negotiators

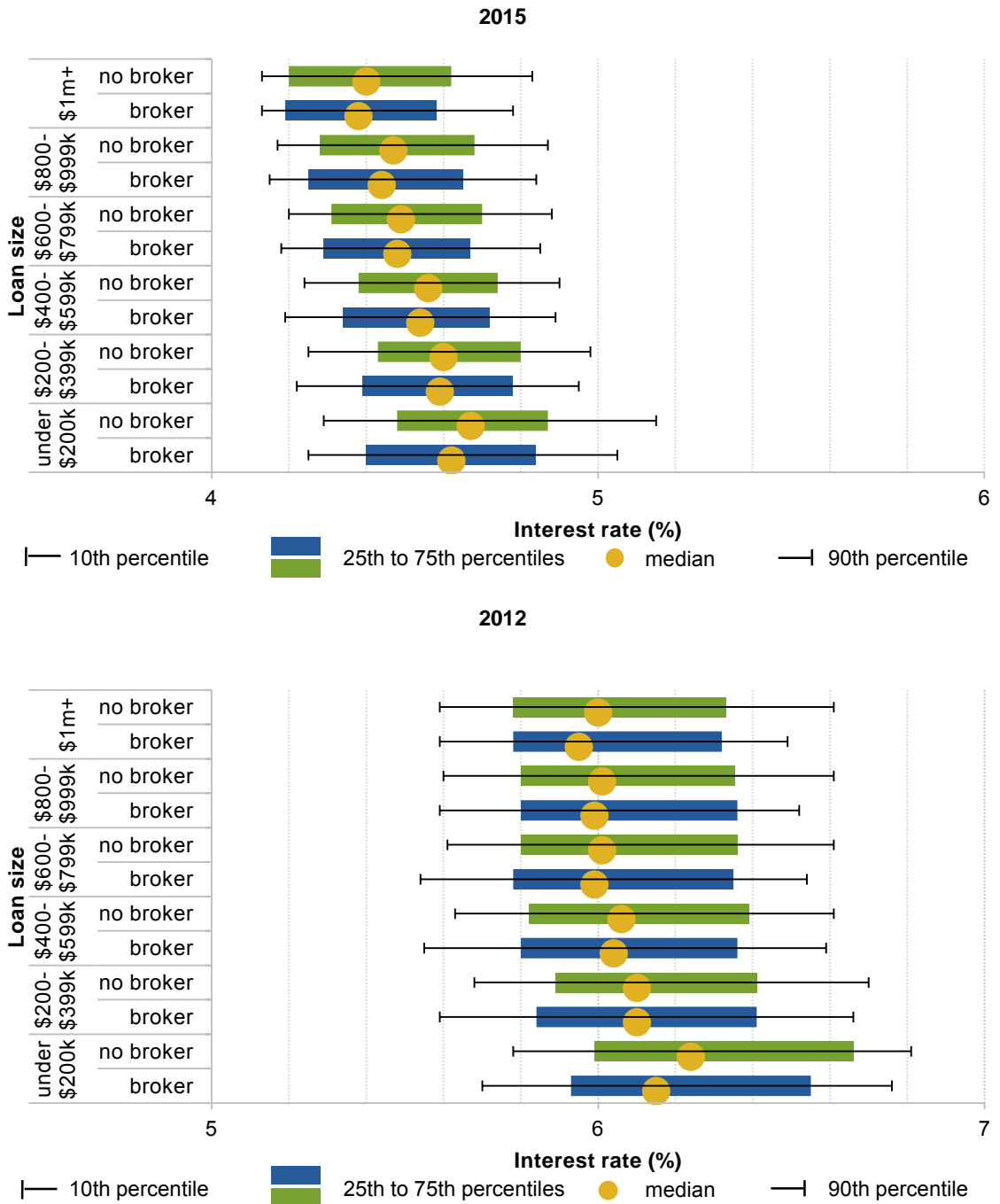
Many consumers felt that brokers were better able to negotiate lower interest rates on home loans, and chose to use a broker ‘to get a better deal’ (ASIC 2017ac; Genworth Financial 2009; MPA 2017). Data obtained from ASIC suggested that loans obtained through brokers generally had lower interest rates compared to those obtained through non-broker channels, although the differences were small. For example, loans obtained through brokers had *slightly* lower interest rates for all categories of loan size, but this difference was more pronounced in 2012 than 2015, and for lower loan sizes in both years (figure 8.2).

Similarly, brokers obtained slightly lower interest rates regardless of borrower income, but the difference was more pronounced in 2012 than 2015, and for borrowers with lower incomes (figure 8.3). Further analysis is needed to inform the Commission’s view of whether these differences are evidence of brokers’ ability to negotiate a better deal or whether they are the result of different types of consumers using brokers compared to direct channels. The Commission will conduct this analysis in preparation for the final report.

DRAFT FINDING 8.1 INTEREST RATES FROM BROKERS VS OTHER CHANNELS

Home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels. Further analysis is needed to inform the Commission’s view of the sources of such differences and whether they are significant.

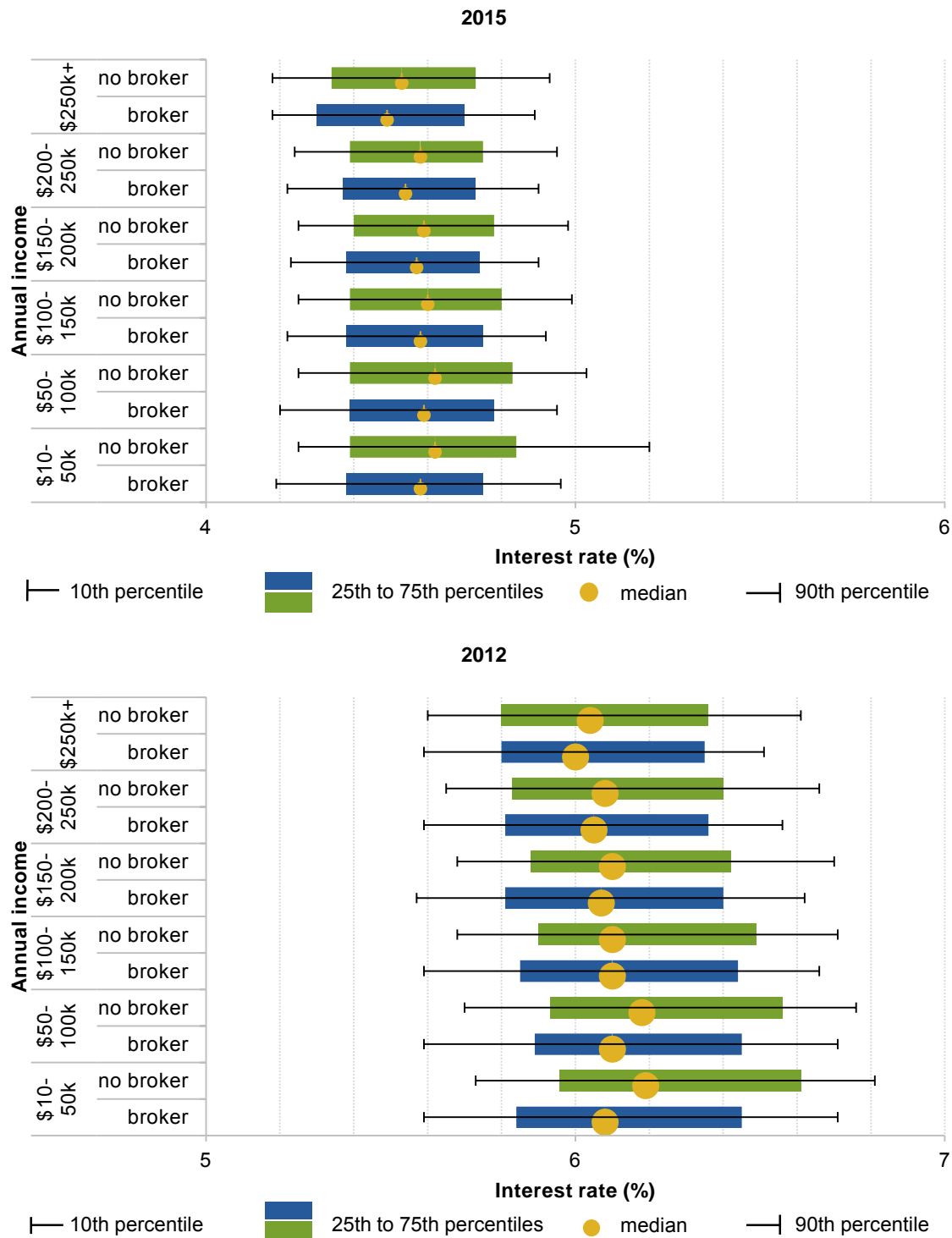
Figure 8.2 Loans obtained through brokers have slightly lower interest rates, but the difference is smaller on larger loans
 Distribution of interest rates for broker and non-broker channels



Source: Unpublished ASIC data

Figure 8.3 The difference in interest rates is also smaller for higher income borrowers^a

Distribution of interest rates for broker and non-broker channels



^a Income represents the net combined income of borrowers.

Source: Unpublished ASIC data

How do brokers benefit lenders?

Brokers as an alternative distribution channel

Many lenders — particularly smaller lenders — considered brokers to be an effective way of distributing home loans. For example, Regional Banks (AMP, Bendigo Bank, BOQ, ME, Suncorp) (sub. 37, p. 63) said that ‘smaller banks are typically dependent on unbiased distribution networks to overcome the disadvantage of smaller physical branch networks and marketing budgets’. Analysis conducted by the Commission using data obtained from ASIC showed that distributing loans through brokers has, on average, increased smaller lenders’ market shares by 1.55% points. If mortgage broker services were not available, these lenders would, on average, need to have an additional 118 branches each in order to maintain their current market shares in the home loan market.

Brokers as a cost saving

Some lenders chose to use brokers because they considered it to be a lower-cost distribution channel compared to branches. For example, ING 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)

The Reserve Bank of Australia (sub. 29, p. 23) also 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’.

In comparing the costs of brokers and branches, the differing nature of these costs must be considered. Brokers are largely a variable cost, whereas branches are largely a fixed cost. In addition, branches usually serve multiple purposes, such as servicing local businesses and allowing customers to deposit cheques. Whether brokers are considered a lower-cost distribution channel than branches depends on the way that the costs of a branch are apportioned between its different activities.

The Commission asked a number of ADI lenders for data on their costs of writing loans through branches and brokers. Of the responses received, some showed that the costs of writing loans through brokers were lower than through branches, whereas others showed the opposite. It was difficult to draw general conclusions due to the small number of responses. We find it of significant concern, given the dominance of the broker channel and the decisions of some lenders to own mortgage aggregators, that many lenders were unable to provide evidence on how they assess the costs and benefits of using brokers rather than branches.

Of the data provided to the Commission, it is apparent that there can be large differences in the costs of different mortgage channels. This differs to Ernst & Young’s finding in a study prepared for the Mortgage & Finance Association of Australia that the costs of acquiring loans through brokers were:

... considered to be comparable to that of proprietary channels. On the one hand there is a measurable upfront commission that is paid to brokers that increases the cost. On the other hand, as brokers invest more time to screen customers and match them to the right lender, the conversion rate of customers in the buying process is measurably better and therefore less costly from a credit checking and valuations perspective. (2015, p. 8)

Nevertheless, the apparent lack of data held by large institutions on the matter is both surprising and appears to be a serious issue for business entities heavily dependent on this form of distribution.

DRAFT FINDING 8.2 COST OF HOME LOANS THROUGH BROKERS VS BRANCHES

Mortgage brokers enable smaller lenders to gain wider reach, increasing product variety in the home loan market. Whether brokers are an efficient, lower-cost distribution channel for lenders depends in large part on the way lender branch costs are apportioned between different activities.

That the providers of half of Australia’s home loans were unable to give evidence on how they assess the costs and benefits of using brokers rather than branches to source home loans is surprising.

Lenders pay commissions to brokers, and the costs are relatively high

Mortgage brokers are usually paid via commissions from lenders, rather than fees-for-service from consumers (ASIC 2017ac). Commissions can include:

- upfront and trail commissions, which are paid on each loan originated through the broker channel
- volume-based commissions, which are paid on the total number of loans written by an aggregator
- campaign-based commissions, which are paid for limited periods of time at higher rates than usual.

Brokers can also receive soft-dollar benefits from lenders such as access to courses and conferences, competitions and hospitality.

Lenders have spent large amounts of money remunerating brokers.

- ASIC (2017ac) found that the average rate of upfront commission paid by lenders to aggregators across the industry was 0.62%, and the average annual rate of trail

commission was 0.18%. On an average new home loan of \$369 000, this amounts to an upfront commission of \$2289 and a trail commission of \$665 per year.⁴³

- ASIC (2017ac) also found that, in 2015, each of the major banks made sponsorship payments of approximately \$1.3 million on average to aggregators for conferences or prizes in competitions run by aggregators. By comparison, customer-owned banking institutions reported paying little in the way of sponsorship. Total sponsorship payments across the industry amounted to approximately \$13.7 million.
- UBS (2017) estimated that in 2015, broker commissions cost \$4623 per loan on average. It also noted that this was relatively high when compared to ‘simple financial advice’, which ASIC (2017p) advised should cost between \$200 and \$700.

The Commission sought data from ADIs regarding schedules of commissions paid to brokers over time, but again very few ADIs were able to provide this information. Broker data appears to be a black box for this industry.

Other data obtained by the Commission show that broker commission rates increased in the period to 2007, decreased between 2007 and 2012, and have since increased slightly (figure 8.4). Ms Rigoni also submitted that:

Around 2007, with Westpac being the first mover, aggregator upfront and trail payments were slashed by more than 30%. (sub. 46, p. 4)

Broker commission rates are currently slightly lower than prior to 2007.

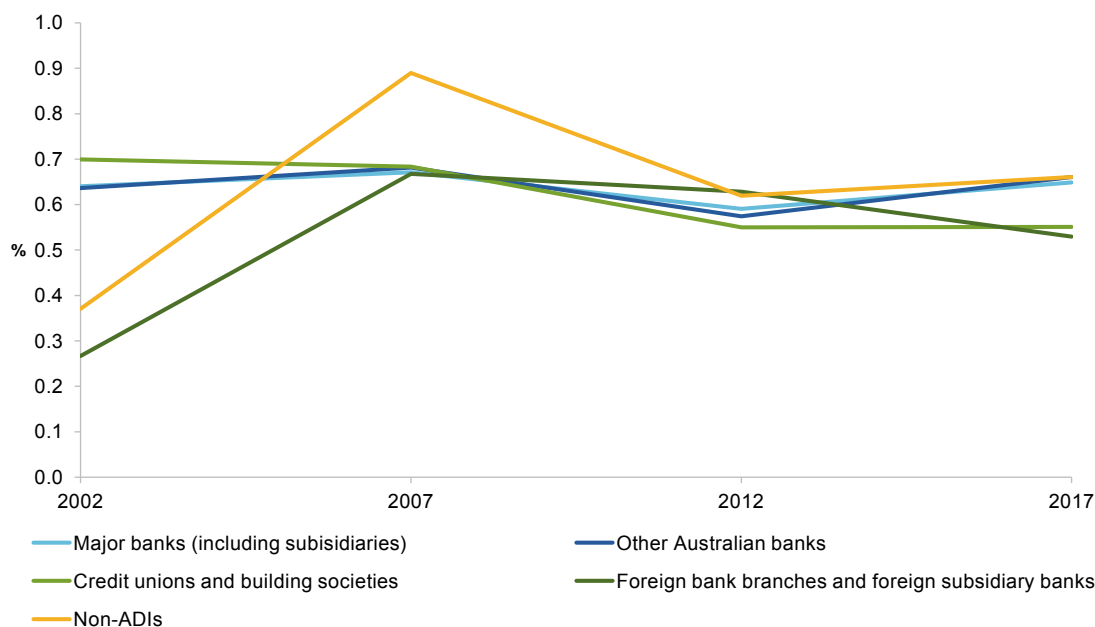
The industry has recently committed to changing or removing some types of commissions and soft-dollar benefits, in particular volume-based and campaign-based commissions (box 8.1).

Consumers ultimately pay for brokers

Because brokers receive commissions from lenders rather than fees from consumers, they can appear to provide consumers with a service that is free. However, brokers are ultimately paid for — lenders must increase interest rates charged to borrowers (to cover this cost), or reduce the interest rates paid to depositors. UBS (2017) estimated that, in 2015, the cost of commissions increased home loan interest rates by 16 basis points per year (however, this does not include any cost savings that may arise if brokers are substituted for, and cheaper than, branches. As noted above, data on the cost of brokers and other channels was not available).

⁴³ 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 2017ac) (chapter 13).

Figure 8.4 Commission rates over time^{a,b}
Average upfront commission rates paid by lenders



^a Data are for the years 2002, 2007, 2012 and 2017 only. ^b The lenders included within some categories change over time, for example as some banks were acquired by major banks.

Source: Unpublished industry data

Who are brokers working for?

In contrast to a fee-for-service model, brokers receive different levels of commission depending on the size of the loan and the lender the consumer ultimately selects. This has the potential to lead brokers to recommend larger loans or loans from particular lenders — ASIC (2017ac) called these ‘product strategy conflict’ and ‘lender choice conflict’. The extent to which these conflicts occur in practice is difficult to ascertain, as consumers are only given information about the commission the broker will receive on the loan they select, not on all potential loans. Although most consumers feel that brokers generally acted in their interests, many also recognise the potential for conflicts of interest (though the concern was much less for consumers with recent experience of using a broker, and the relevant surveys are small) (figure 8.5 and figure 8.6).

Box 8.1 **The Combined Industry Forum’s proposed reforms**

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 the 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, including for:

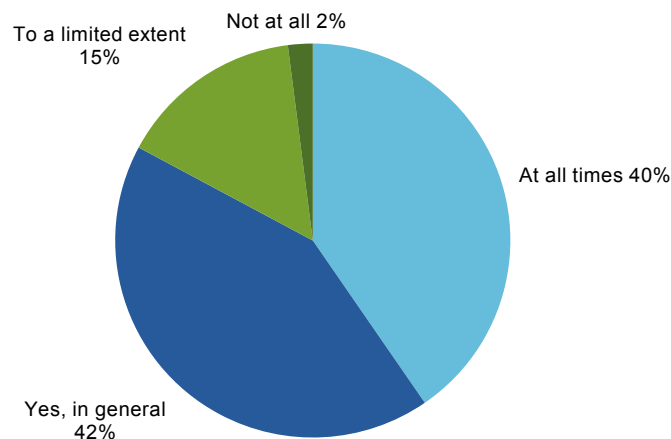
- upfront and trail commissions to be paid on the funds limit drawn down by customers net offset account balances, instead of the limit of the loan facility
- the industry to cease the practice of offering volume-based commissions, campaign-based commissions and volume-based payments (recognising that many in the industry have already ceased such payments)
- 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 in marketing material and at all distribution points
- 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.

The CIF has committed to implementing most of these reforms by the end of 2018. Bonus commissions were removed by the end of 2017. The improved governance framework is proposed to be implemented by the end of 2020.

Source: ASIC (2017ac, sub. 40); ABA et al. (2017)

Figure 8.5 Consumers generally consider brokers act in their best interests^a

‘To what extent did you feel your broker acted in your best interests?’

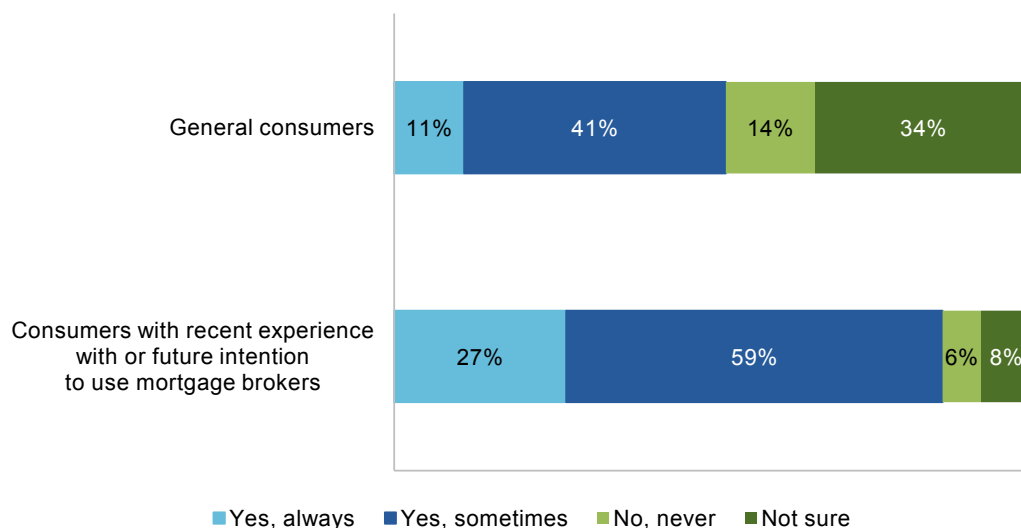


^a Based on a sample size of 474 consumers who had taken out a home loan through a broker in the two years to September 2016.

Source: Adapted from Deloitte (2016a)

Figure 8.6 Yet consumers recognise the potential for conflicts of interest^a

‘Do you think a mortgage broker would put your needs first?’



^a Based on a sample of 1000 general consumers and 490 consumers with recent experience with or future intention to use a mortgage broker.

Source: ASIC (2017ac)

White-label arrangements — another layer of complexity

White-label loans are loans that carry an aggregator’s brand, but are funded by another financial institution (box 8.2). White-label loans have experienced dramatic growth in recent years (figure 8.7), and are one of the fastest-growing categories of home loans (MFAA 2017). They are usually simpler, lower-cost products compared to those offered under lenders’ own brands, and can therefore cater to a different consumer segment and fulfil a market need.

Box 8.2 **How do white-label loans work?**

White-label loans are loans that carry an aggregator’s brand, but are funded by another financial institution. In many cases, the funding institution has an ownership stake in the aggregator.

An agreement between a lender and aggregator will usually stipulate the roles and responsibilities of each party in offering the white-label loan. In some cases, aggregators determine the pricing and design of white-label products. However, in other cases, the lender takes on these tasks.

Aggregators generally provide the necessary services and support for brokers for white-label loans, including business development managers. They may receive a manufacturing margin from the lender for carrying out these tasks. As with non-white-label loans, aggregators also receive upfront and trail commissions from lenders when they successfully obtain a loan on a consumer’s behalf.

However, white-label loans also alter competitive dynamics in the home loan market. In contrast to lender-branded loans that are usually available directly from lenders as well as through multiple aggregators, white-label loans are usually only available from the aggregator whose brand they carry. Consumers therefore do not have a choice of aggregator if they wish to obtain a particular white-label loan, and must also maintain their relationship with that aggregator in order to receive services regarding their loan (in contrast to lender-branded loans where consumers can approach other brokers or lenders to receive loan services).

Aggregators and brokers consider this exclusivity to be one of the main benefits of white-label loans. For example, John Tindall from Choice Home Loans Wattle Grove said that:

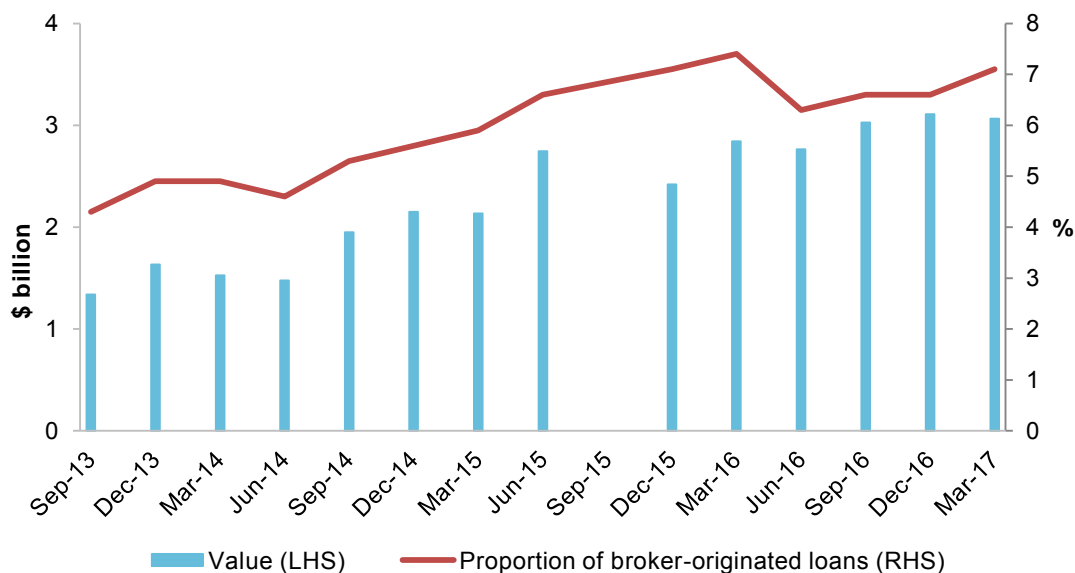
White label means my client can’t go directly to a branch for a loan — I provide exclusive access to the loan, and can take ownership of it, which removes any channel conflict. (Advantagedge 2016, p. 4)

Andrew Rasby, Group Lending Manager at aggregator Yellow Brick Road, also said that:

The harsh reality when another bank loan is sold is that clients may approach the bank directly for future financing needs or other services. The main benefit [of white-label loans] is that clients are directed back to our branches and the cross-sale opportunity is preserved within the group. (Bendel 2017)

Figure 8.7 **There has been rapid growth in white-label lending^{a,b}**

White label loans written through brokers



^a No data were available for July to September 2015. ^b Data is only for white-label loans that were consistently offered over the time period. As such, they under-represent the value and share of white-label loans.

Source: MFAA (2017)

White-label loans can also alter the focus of aggregators from aggregating loans to selling their white-label products. As Ms Rigoni 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)

To the extent that white-label loans transform the role of aggregators from solely intermediaries to quasi-lenders, conflicts of interest would be heightened with incentives for aggregators to attempt to increase their sales of white-label products. ASIC (2017ac) has indicated that it expects aggregators that offer white-label loans to carefully understand and assess whether they have arrangements that result in good consumer outcomes. Whether this is sufficient guidance where transactions are very large and can be intimidating for many consumers is an open question for this inquiry.

Vertical integration exacerbates conflicts of interest

As noted above, there is a high degree of vertical integration in the mortgage broking market. Vertical integration can create conflicts of interest for brokers through a lender's position as both a member of an aggregator's panel and a shareholder with significant influence over the aggregator's activities. Lender-owned aggregators therefore face greater conflicts of interest than independent aggregators, and are of greater concern to the Commission. (Although conflicts of interest arising through the payment of commissions are also of concern to the Commission, as discussed above. Such conflicts apply to both owned and independent aggregators).

Conflicts of interest that arise from ownership are especially apparent where owner-lenders also fund a white-label product. ASIC (2017ac) found that where lenders had both an ownership relationship and a white-label arrangement with an aggregator, they achieved a greater market share within the aggregator compared to their overall market share. This difference was substantial in some cases — in 2015, for example, CBA had a 21% overall market share within the broker channel, but its market share within Aussie Home Loans (in which it had an 80% ownership stake at the time) was 37%. Such evidence of outsized market shares is worrying.

The mortgage broking industry has recently committed to more clearly disclosing ownership structures to reduce the impact of vertical integration on competition in the home loan market (box 8.2). Ownership structures will be disclosed where an owner is deemed to have 'significant influence' over an aggregator, as guided by the definition of 'significant influence' under Australian Accounting Standard 128 (ABA et al. 2017). This means that disclosure will occur where, for example, ownership is 20% or greater, or ownership is less than 20% but a board seat is held by the owner-lender or a white-label product is offered.

Disclosure can highlight potential conflicts of interest, but does not necessarily resolve them. It is regrettable that large financial institutions, as they have moved into owning aggregators, have not of their own volition taken steps to offer certainty that the interests of customers would always be prioritised when obtaining a home loan through lender-owned aggregators.

The Commission therefore considers that it is now necessary for a legal duty of care to act in consumers' best interests to be imposed on lender-owned aggregators and the brokers working under them. It notes that financial advisers handling similar sized sums to mortgage brokers now have a regulated obligation to act in clients' best interests, and that this obligation arises notwithstanding ownership or employment arrangements. While there is a strong in-principle case for a similar duty of care to apply to all brokers, it should in the first instance be applied to lender-owned aggregators, since this is where the potential for conflicts of interest is greatest.

DRAFT RECOMMENDATION 8.1 DUTY OF CARE OBLIGATIONS FOR LENDER-OWNED AGGREGATORS

The Australian Securities and Investments Commission should impose a clear legal duty on mortgage aggregators *owned by lenders* to act in the consumer's best interests. Such a duty should be imposed even if these aggregators operate as independent subsidiaries of their parent lender institution, and should also apply to the mortgage brokers operating under them.

INFORMATION REQUEST 8.1 HOW SHOULD NEW DUTY OF CARE OBLIGATIONS FOR LENDER-OWNED AGGREGATORS BE IMPLEMENTED?

How should obligations on lender-owned aggregators to act in clients' best interests be imposed? Can such obligations be imposed under the current regulatory and licensing regime (the National Consumer Credit Protection Act 2009 (Cth)), or is there a need for a separate regime for mortgage aggregators and brokers?

Could consumers pay for brokers directly?

To remove conflicts of interest that arise from the payment of commissions, consumers could be required to pay for brokers via fees-for-service (with commissions or other payments from lenders being banned). However, the effectiveness of price as a mechanism for achieving competitive outcomes depends on consumers' ability to judge the quality of brokers' services and exert competitive pressure. Many consumers have limited knowledge and understanding of financial products, and are poor judges of the quality of financial services (chapter 12). In addition, consumers rely heavily on mortgage brokers to provide them with what they need to know (discussed above). A requirement to pay is therefore likely to need to be supported by measures that increase consumer understanding and/or strengthen providers' obligations to prioritise consumers' interests over their own.

In addition, making consumers pay for brokers directly is likely to decrease their demand for brokers' services.

- Deloitte (2016a) found that 37% of 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 held by Deloitte revealed that most consumers would not pay, and would instead go directly to lenders for a home loan.
- Mortgage Professional Australia (2017) found that having to pay to use a broker would make 14% of consumers consider going directly to a branch.

As intermediaries, brokers have the potential to increase competition in the home loan market by reducing search costs for lenders and consumers and facilitating better matches

between them. If these benefits are not being fully realised due to conflicts of interest, measures that directly address what brokers do to manage these conflicts of interest are likely to be more effective at increasing their capacity to act as a force for competition, rather than making consumers pay.

The Commission has recommended additional obligations for lender-owned aggregators due to heightened conflicts of interest (draft recommendation 8.1), and has also recommended that brokers be required to provide consumers with better information so that they are able to evaluate the quality of the services provided by brokers (discussed below). We are also considering a recommendation to remove trail commissions, and are seeking feedback on the rationale for how mortgage broker commissions are structured (chapter 13). However, we are also interested in whether there is a case for consumers paying for brokers directly, rather than brokers receiving commissions from lenders.

INFORMATION REQUEST 8.2 SHOULD CONSUMERS PAY BROKER FEES FOR SERVICE?

Should consumers pay mortgage brokers directly through fees for service (rather than brokers receiving commissions from lenders)? What is the likely effect on consumers' use of brokers and on home loan providers' ability to source home loans through brokers? What is the likely effect on brokers' incentives to recommend loans to consumers?

Requiring brokers to provide better information

Currently, mortgage brokers have various disclosure obligations under the National Consumer Credit Protection Act (box 8.3). However, the information provided does not necessarily facilitate consumer understanding. For example, although brokers are required to disclose the commissions they would receive, ASIC found that 36% of customers with recent experience with a broker or future intention to use one thought that brokers would be paid the same amount regardless of the size of the loan. This indicates that many consumers either do not read the relevant documents containing the disclosure, or do not understand them. In general, information provided in written documents is likely be less effective than methods that require direct consumer engagement (such as verbal discussions), since consumers can easily disregard the materials provided.

Current requirements to provide information also do not ensure that consumers can evaluate the services they receive from brokers or the quality of the loans recommended. As noted above, many consumers see brokers as a source of help and advice, and rely on brokers to make them aware of what they need to know. This means that, without brokers explaining to consumers how they choose loans to recommend — including how they have matched consumers' needs with lender's offerings and how commissions or ownership structures may have influenced their recommendations — consumers are unlikely to know how to evaluate their broker's performance, and are likely instead to rely on feelings of trust (chapter 12).

Consumers should be able to rely on brokers for the credit assistance they require. However, they should also have enough information and understanding to be able to objectively evaluate brokers' advice, so that they can identify when brokers are *not* acting in their interests. The Commission recommends that disclosure requirements for mortgage brokers be broadened to include:

- the types of products offered by different lenders, to ensure a basic understanding by a client of the home loan market
- how brokers match borrowers with home loan providers, including their limitations as a result of lenders not being on an aggregator's panel or the broker not being accredited by a particular lender
- how mortgage brokers are paid, including specific information about the payment arrangements for the particular broker in question
- any ownership relationships between lenders and aggregators (the Commission notes that the industry has committed to doing this as part of pending reforms — box 8.1).

Box 8.3 **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 licensees include lenders, mortgage aggregators and brokers. Brokers may either be credit licensees or credit representatives — that is, they can operate under the credit licence of another party such as an aggregator.

The documents containing the relevant disclosures are:

- credit guides
- credit proposal documents
- pre-contractual statements.

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 (2017ac)

This information should be *discussed with consumers* rather than becoming a boilerplate document that is readily ticked off but rarely understood. Written materials should also be provided, but as a reference document so that consumers can refer to the information later if they need to. Discussions and the provision of written material should take place *before* brokers begin recommending loans.

The type of information provided and the way it is discussed and presented should be developed through consumer testing to ensure that it has its intended effect.

DRAFT RECOMMENDATION 8.2 MORTGAGE BROKER DISCLOSURE REQUIREMENTS

The Australian Securities and Investments Commission should require that before mortgage brokers recommend loans to consumers, they must have a discussion with consumers about, and provide plain-English documents to consumers on:

- the types of products offered by different lenders (including white-label loans and which lender provides the funding for them) and associated loan features
- the role of mortgage brokers in matching borrowers with home loan providers, including how brokers are limited in their ability to help consumers apply for loans from all lenders because not all lenders are on the aggregator's panel or the broker is not accredited with a particular lender
- how mortgage brokers are paid (including specific information about their payment arrangements)
- any ownership relationships between lenders and the aggregator, and the requirement for brokers to act in consumers' interest where an ownership relationship exists (draft recommendation 8.1).

Specific details regarding the information provided and the way it is presented should be developed through consumer testing to ensure that consumers understand the information, and the effect of these measures should be reviewed after they have been implemented.

The Commission notes the overlap of draft recommendation 8.2 with some reforms proposed by the Combined Industry Forum (box 8.1), and considers that the progression of the industry's reforms can contribute to the broader disclosure framework presently recommended. But in the absence of clearly enforceable obligations, ASIC must set better information provision standards.

8.2 How standard is the standard variable rate?

When pricing home loans and advertising home loan interest rates, lenders often make reference to a standard variable rate (SVR). The SVR may represent the price of a home loan, or may simply be a reference rate to which a margin is added or subtracted. Linking 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. As such, the SVR appears not to be a tool for consumers, but rather one for lenders.

Lenders set SVRs by taking into account their cost of funds, operating costs and profit margins (chapter 5). They may also have different SVRs depending on:

- the type of borrower — investor or owner–occupier, household or small business
- repayment type — principal and interest, or interest only
- loan-to-value ratios (LVRs) — different rates may apply to different LVR bands.

Some lenders use the term ‘SVR’ to describe only the indicator rate for loans to owner-occupiers with principal-and-interest repayments. However, this section uses the term to refer to indicator rates more broadly.

It is very common for home loans to be priced below the SVR (box 8.4). For example, many lenders offer discounts off this rate when home loans are taken out as part of home loan packages. Packages typically include the loan, a transaction, offset or savings account, a credit card, and some types of insurance. Lenders can also offer discounts on an individual basis, although some smaller lenders choose not to do this. Overall, it is not evident that a genuine discount is being offered when almost everyone gets it.

Consumers are generally able to obtain information about SVRs and discounts available as part of home loan packages. However, information about individually-negotiated discounts is usually not published. Such 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.

Consumers can therefore find it difficult to ascertain true prices when searching for a home loan. As the RBA explained:

transparency in ... 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)

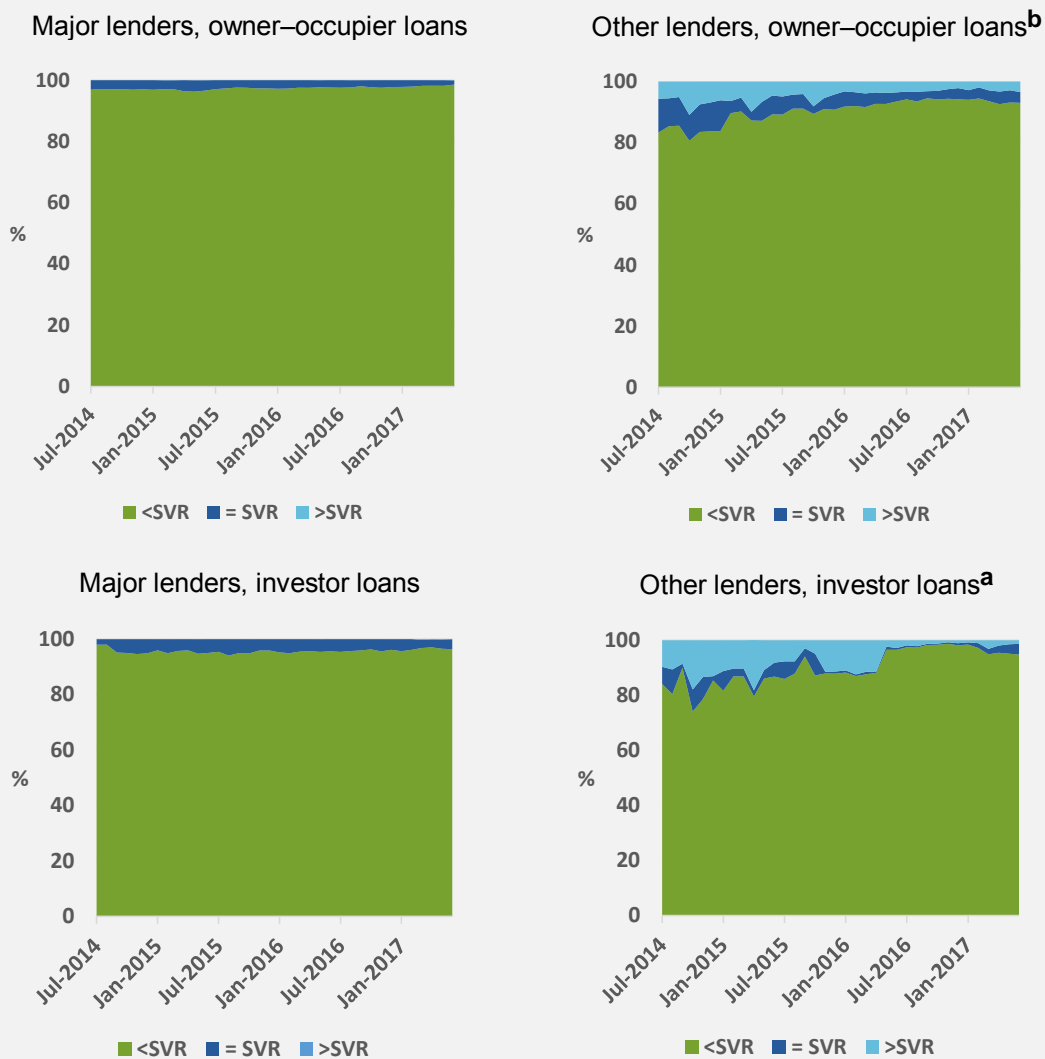
Such search costs could include the need to approach lenders individually to initiate bargaining or to make contact with a mortgage broker. This requires more time, effort and commitment than simply searching through lenders’ websites or logging onto comparison websites. The Commission therefore considers that there is a need for increased price transparency in the home loan market.

Box 8.4 Who pays the standard variable rate anyway?

Data collected by the Commission showed that the vast majority of home loan customers do not pay the relevant standard variable rate (SVR) — most loans are issued at a lower interest rate. Discounting is also more prevalent among major lenders.

When comparing loans for different types of borrowers, the data showed that discounting is slightly more prevalent for loans issued to investors compared to owner-occupiers. This is more pronounced for non-major lenders. However, recently, the shares of investor and owner-occupier loans at or below the SVR issued by non-major lenders have been similar.

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.

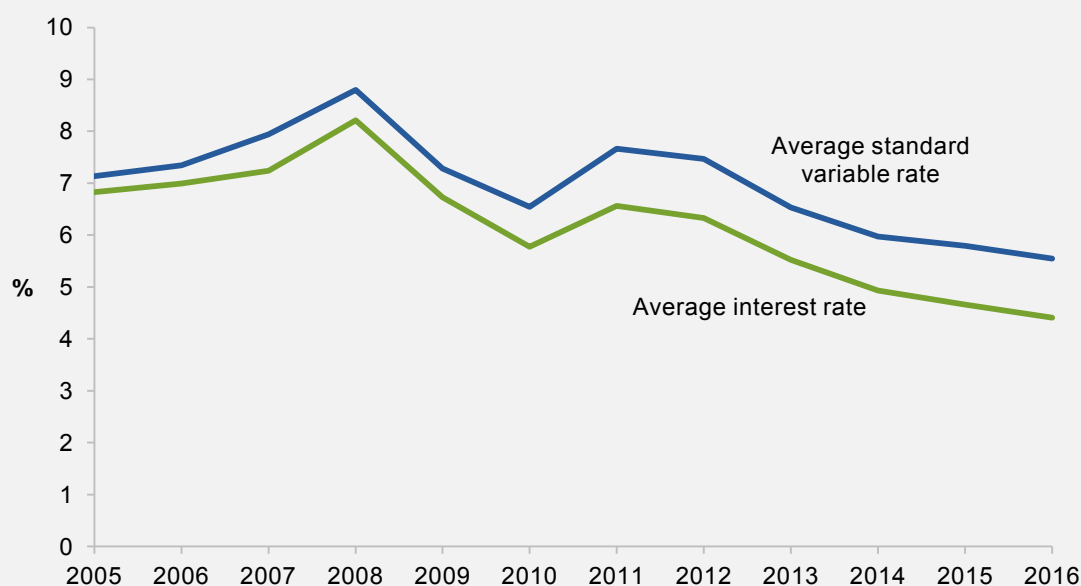
Source: Unpublished data from 14 ADIs.

(continued next page)

Box 8.4 (continued)

In terms of the level of discounts, Deloitte (2017, p. 4) noted that the long-term average discount on lenders' back books was about 70 basis points. Data from the Australian Prudential Regulation Authority and the Reserve Bank of Australia also showed that, for major banks, the gap between SVRs and actual interest rates has increased over time (figure below). This is in line with ASIC's (2017ac) finding that, for most banks, the discount margin for home loans was larger in 2015 than in 2012.

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 (2017v)

Prices vary according to many factors

The interest rates paid on home loans can be influenced by a myriad of borrower and loan characteristics. (Note: this discussion does not include the effects of regulatory settings and costs of funding on home loan prices — this is discussed in chapter 5).

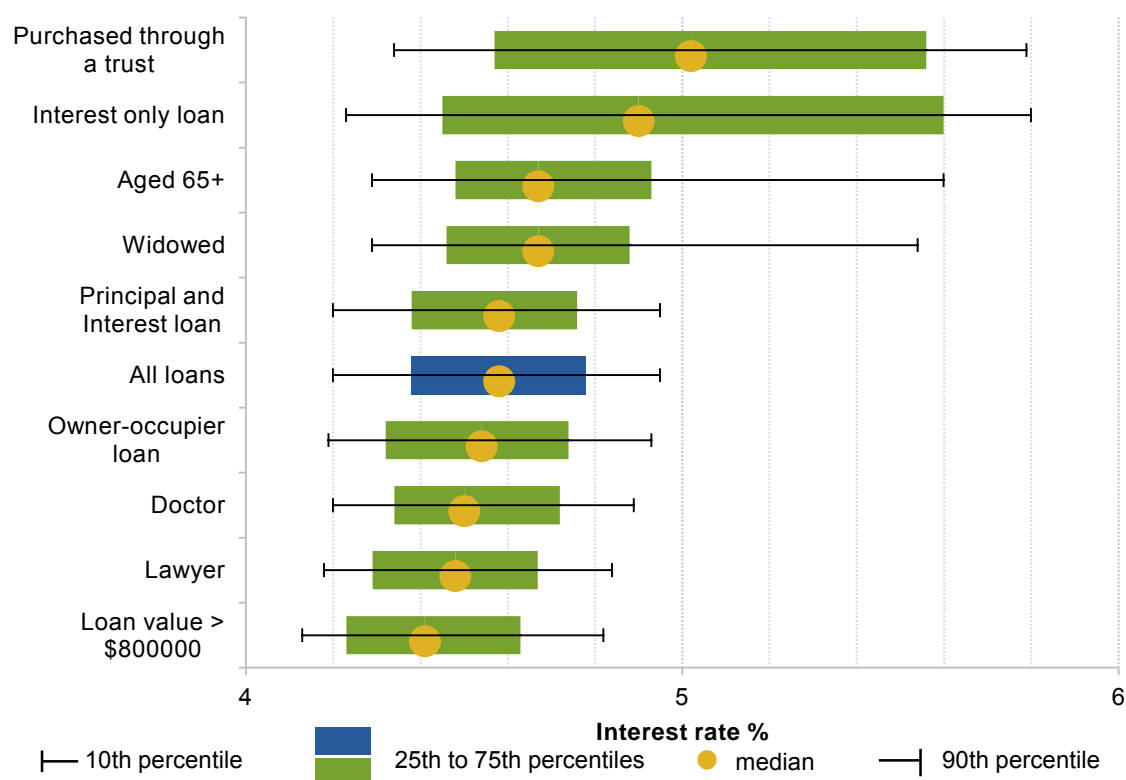
- As noted above, lenders usually take into account borrower type (owner-occupier or investor), repayment type (principal-and-interest or interest only) and LVR. Lenders may also consider more specific borrower characteristics such as income, occupation, industry of employment and credit history, although not all lenders do this. Interest rates also tend to be lower the larger the loan.
- Prices vary with types of products. For example, basic loans tend to be cheaper than standard loans, and have a narrower range of features (they may not have offset accounts and redraw facilities, for example). Lenders may also 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 certain 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.

Data obtained from ASIC showed that, in 2015, those who purchased the 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 (figure 8.8). Owner-occupiers, those with larger loans, and those of certain professions received lower interest rates.

Given the range of factors that influence interest rates, there can be wide variation in the interest rates paid for the same product within the same institution. For example, data obtained from ASIC showed that, for one ADI lender in 2015, interest rates for owner-occupier loans with principal-and-interest repayments ranged from 3.15% to 5.74%.

Figure 8.8 How interest rates vary with borrower and loan characteristics^a
2015



^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: Unpublished ASIC data

Comparison rates are meaningless if they don't incorporate discounts on standard variable rates

The National Consumer Credit Protection 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.⁴⁴ The purpose of comparison rates is to allow consumers to compare products with different fees and charges (ASIC 2016h).

However, comparison rates are calculated using SVRs as the relevant 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, SVRs do not reflect average interest rates.

Improving price transparency in the home loan market

A first step in improving price transparency would be to enable consumers to obtain interest rates on loans actually issued. Such rates would provide a more accurate and consistent benchmark than the SVR, allowing consumers to compare across different products.

However, because interest rates differ according to a range of characteristics, publishing indicator rates for broad categories of loans (for example, owner-occupier loans with principal-and-interest repayments) is likely to be less useful than tailoring interest rates to specific borrower characteristics. And, differences in indicator rates across institutions for broad categories could reflect differences in customer profiles, rather than differences in interest rates for any given type of customer.

The Commission therefore considers that consumers should be able to obtain indicator rates based on different loan and borrower characteristics. It proposes an online interest rate tool, published by ASIC, that would:

- require consumers to specify certain loan and borrower characteristics
- return median interest rates on loans by different lenders that satisfy those criteria
- detail the specific fees and charges that would affect the cost of different loans.

ASIC, rather than individual lenders, should publish this tool, so that consumers are not required to bear the cost of entering search criteria on multiple lenders' websites.

⁴⁴ Part 10 of the 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).

The specific loan and borrower characteristics that are included in the online tool should be developed through consultation and consumer testing, and should consider 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 many different variables and the cost to lenders of providing increasingly granular data. 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.

The underlying data should be collected by the Australian Prudential Regulation Authority (APRA) as part of the modernised Economic and Financial Statistics collection (if these data are not already available elsewhere), and provided to ASIC to allow it to develop the interest rate tool. APRA should also make the data publicly available in a way that is accessible to third parties such as web application developers — legislation regarding the release of data collected by APRA may need to be amended for this to occur. At a minimum, the data should be published in a machine-readable format. Making such data accessible to third parties would enable its use for the development of comparator websites, where there is a commercial benefit in doing so. 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 tool.

DRAFT RECOMMENDATION 8.3 COLLECTION OF HOME LOAN INTEREST RATE DATA

As part of the modernised Economic and Financial Statistics collection, the Australian Prudential Regulation Authority should, on behalf of the Australian Securities and Investments Commission, collect monthly data from mortgage lenders (ADIs and non-ADIs) on median interest rates for different categories of new residential home loans.

The categories of loans should be developed through consultation, but the data to be collected may include that relating to features of the loan or borrower, such as:

- the size and length of the loan
- the loan-to-value ratio
- loan fees
- the type of borrower (owner-occupier or investor)
- the type of repayments (principal-and-interest or interest-only)
- the type of interest rate (fixed or variable), and, for fixed rates, the length of the fixed period
- the credit rating(s) of the borrower(s)
- the nature of employment of the borrower(s) (for example, permanent full time, permanent part time, self-employed)
- the industry of employment of the borrower(s).

DRAFT RECOMMENDATION 8.4 INTEREST RATE TRANSPARENCY FOR HOME LOANS

The Australian Securities and Investments Commission should, using data collected on its behalf by the Australian Prudential Regulation Authority (draft recommendation 8.3), develop an online tool that:

- allows consumers to select different combinations of loan and borrower characteristics
- reports median interest rates for loans issued in the previous month with those characteristics, by lender
- details the specific fees and charges that would affect the total cost of a loan.

The Australian Prudential Regulation Authority should also publish the underlying data in a way that is accessible to third parties such as web application developers, so that these parties are able to develop comparator websites 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.

8.3 Lenders mortgage insurance (LMI)

LMI is a type of credit protection insurance that protects a lender from losses in the event of a borrower defaulting on a loan. Lenders usually purchase LMI when issuing loans with loan-to-value ratios (LVRs) greater than 80%. Premiums are paid by the lender to the insurer as a lump-sum at the start of the policy, and the cost of the premium is usually passed on to the borrower through an LMI fee. Borrowers can either choose to pay this fee upfront or capitalise it into the value of their loan — they usually choose the latter (ICA, sub. 33).

In some cases, such as for ‘low-doc’ loans, lenders may purchase LMI (but borrowers still pay for it) even if the LVR is lower than 80%. In other cases — such as for members of certain professions, employees of the lending institution or where a loan is guaranteed by another party — LMI may not be required even if the LVR exceeds 80%. There is no legal or regulatory requirement for LMI in Australia, although the prudential capital framework sometimes recognises its use (chapter 16).

LMI enables lenders to transfer the risk of borrower default to the LMI insurer, and can make lenders more willing to lend to those who are creditworthy but do not have sufficient funds for a deposit (QBE, sub. 34). LMI may be especially important in allowing smaller or regional lenders to manage their risk.

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. Therefore, where risk can be pooled market-wide, such as through the use of LMI, individual losses are absorbed within the distribution of all risk held, thereby providing added levels of stability to the Australian financial system. The use of LMI assists these lenders in diversifying

their risk, enabling them to enter and compete in the high LVR lending segment. (ICA, sub. 33, p. 4)

LMI also makes it easier for consumers without a 20% deposit (as required by most lenders) to access the housing market. QBE said that:

With the benefit of LMI, many first home buyers are more likely to be able to afford to buy, move into and accumulate equity in their home sooner. With LMI protecting the lender, home ownership is more accessible as borrowers can obtain a loan that would otherwise not be available, or obtain a loan much earlier than if they had to save for a full (20%) deposit. (sub. 34, p. 3)

LMI is therefore an important financial product, and can at the margin increase competition in the home loan market. However, some features of the market for LMI can lead to outcomes that are not supportive of competition.

- Since providers usually pass on the cost of LMI to consumers, there is no strong incentive to make sure the price is competitive. And because the LMI policy represents a relationship between a lender and an insurer, consumers who are bearing the cost of LMI cannot exert competitive pressure on providers.
- Each time a loan is refinanced, it is considered a ‘new’ loan for the purposes of LMI cover, so consumers who remain above the 80% LVR threshold can be required to pay an additional LMI fee each time they refinance their loan. This can discourage switching, if borrowers are aware of it.

The market for LMI

The market for LMI is characterised by a small number of providers — only four insurers are licensed to provide the product. These are Genworth, QBE, and two wholly-owned subsidiaries of major banks (ANZ and Westpac). These subsidiaries are only licensed to provide LMI to their parent banks.

According to the Insurance Council of Australia (sub. 33, p. 4), approximately a quarter of all residential home loans in Australia are supported by LMI, with a third of these being loans to first-home buyers. Data provided to the Commission by ADIs also show that a higher proportion of owner-occupied loans are supported by LMI, compared to investor loans (table 8.1). Thus, to the extent that LMI is being poorly priced, it is owner-occupiers rather than investors who are suffering more.

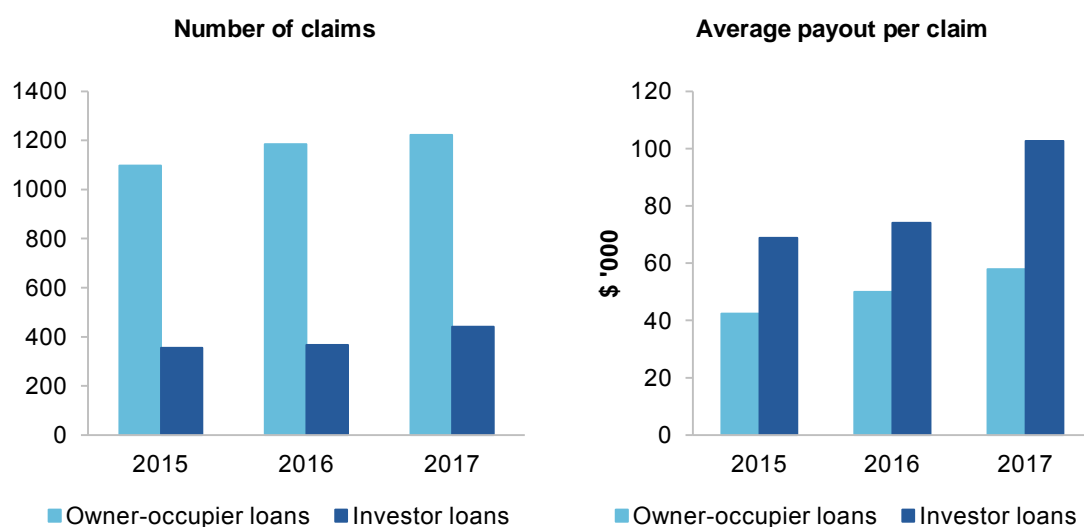
Table 8.1 Home loans supported by LMI
2017

Type of borrower	Proportion of loans with LMI (%)
Owner-occupier	23
Investor	13
All loans	19

Source: Unpublished ADI data

Both the number of claims and the average payout per claim have been increasing over the past three years (figure 8.9). The increasing number of claims is likely to reflect increased risk in the economy more generally — Moody’s Investors Service (2017b) reported that mortgage delinquencies (which raise the risk of mortgage defaults) increased in all states and territories in the year to November 2016. The increasing payout per claim is likely to reflect increasing loan sizes.

Figure 8.9 LMI claims have been rising



Source: Unpublished ADI data

How much does LMI cost?

LMI premiums are typically thousands of dollars, with the average premium about \$6500 (ICA, sub. 33, p. 2). Premiums vary according to the amount of the loan, the LVR, the location of the security property, and other factors such as whether the property will be owner-occupied or rented out.

LMI is ‘community-rated’ rather than ‘risk-rated’, meaning that premiums are calculated by determining the expected losses from the total population of borrowers and dividing this by the total number of borrowers who do not have the necessary deposit (QBE, sub. 34, p. 4). Premiums do not vary according to the individual characteristics of borrowers.

The LMI fee that a lender charges a consumer would ideally reflect the cost of the premium paid by the lender to the insurer. However, the total cost of LMI can be many thousands of dollars more for borrowers who choose to capitalise the fee into the value of the loan, since they would also pay interest on the initial fee (table 8.2).

Table 8.2 Capitalising LMI into the value of a loan — the cost adds up
Example based on a Westpac home loan for a property worth \$500 000 ^a

LVR	Loan amount	LMI fee	Estimated real LMI cost ^b (at selected interest rates ^c)		
			4%	4.5%	5%
85%	\$425 000	\$4 721	\$5 704	\$5 782	\$6 410
90%	\$450 000	\$10 717	\$12 944	\$13 738	\$14 553
95%	\$475 000	\$16 457	\$19 878	\$21 097	\$22 350

^a Example based on the cost of LMI for a first home buyer taking out a 30-year owner-occupier loan with Westpac for a newly-built property worth \$500 000 in New South Wales. ^b Reported figures are total repayments for the LMI portion of the loan, repaid over the life of the loan and discounted by consumer price index (CPI) forecasts and projections from the 2017-18 Mid-Year Economic and Fiscal Outlook. These are: 2.5% for 2017-18, 2.25% for 2018-19, 2.5% for 2019-20 and 2.5% for 2020-21. CPI is assumed to be 2.5% for every year after 2020-21 ^c Assumes the interest rate remains constant over the life of the loan (30 years).

Source: Commission estimates based on Westpac (2017b), Amortisation Schedule Calculator (2017) and Commonwealth of Australia (2017)

In addition, if a consumer refinances their loan while remaining above the 80% LVR threshold, they can be charged an additional LMI fee by their new provider. The effect of this is further compounded if they also capitalise this into the value of the refinanced loan (box 8.5).

Consumers usually have no choice but to pay LMI fees

Consumers who wish to purchase property but do not have sufficient funds for a deposit may have to pay an LMI fee to their lender. Although some lenders allow consumers to avoid an LMI fee by paying a reduced equity fee or low deposit premium, this is subject to certain criteria. For example, the security property must be located in certain areas, the borrower must have held their current full-time employment position for the preceding 24 months, and genuine savings must be able to be demonstrated (CBA 2017d; Connective Home Loans 2012; ING Direct 2011). Therefore, where consumers are asked to pay an LMI fee, they usually have no choice but to do so.

Box 8.5 Refinancing compounds the cost of LMI: an illustrative example

Assume a 90% LVR loan for a property worth \$500 000. The amount of the loan would be \$450 000, and the associated LMI fee would be \$10 717 (table 8.2). If the borrower chooses to capitalise the LMI fee into the value of the loan, the real cost of LMI would be \$13 738, assuming:

- the LMI portion of the loan is repaid over a 30-year term at an interest rate of 4.5%
- inflation is 2% in the first year, 2.25% in the second year and 2.5% every year thereafter. These inflation rates are based on forecasts and projections of the consumer price index contained within the December 2017 Mid-Year Economic and Fiscal Outlook (Commonwealth of Australia 2017).

Based on the above calculations, the borrower pays \$3021 more for LMI (in real terms) by capitalising the LMI fee into the loan rather than paying it upfront.

What happens when the borrower refinances?

Now consider that, instead of repaying the loan over 30 years, the borrower chooses to refinance after three years. Over the first three years, the borrower would already have paid \$1955 in LMI fees — or \$1873 in real terms. The amount of the loan outstanding would be \$437 380, and the LMI portion of this would be \$10 174. Assuming the value of the property remained at \$500 000, the new loan would have an LVR of 87%, which is above the 80% threshold. The borrower would therefore be likely to be required to pay an additional LMI fee upon refinancing. The second LMI fee would be \$5541, assuming that the new lender has the same LMI fees as Westpac (the previous lender in this example).

Assuming the borrower also capitalises the second LMI fee into the value of the loan, they have effectively borrowed \$15 715 as part of the second loan to cover the cost of LMI (\$10 174 from the remainder of previous loan's LMI fee, plus the new fee of \$5541). Assuming for simplicity's sake that the new loan had the same interest rate as the initial loan and that it is repaid over 27 years (the time remaining on the term of the initial loan), the real cost of LMI on the second loan would be \$18 328. (That said, the new loan is likely to have a lower interest rate than the initial loan, since this might be the reason the consumer switched in the first place).

Subtracting \$15 715 from \$18 328 gives \$2614, which is the extra amount the borrower pays by capitalising the cost of LMI into the second loan, rather than paying it upfront (although in reality the bulk of this is the unpaid portion of the LMI fee on the previous loan, which would have needed to be paid upfront at the start of the first loan). Adding this to \$1873 (the cost of capitalising LMI into the first loan), the total cost of *both* capitalising the LMI fees into the loans and refinancing would be \$4487. This is in contrast to the \$3021 the borrower would have paid if they had not refinanced.

Increasing property values may allow borrowers to avoid a second LMI fee

If, instead of remaining at \$500 000 over the three years, the value of the property had risen to \$550 000, the refinanced loan would have had an LVR of 80%. The borrower may have therefore avoided the need to pay an additional LMI fee when refinancing the loan.

Source: Commission estimates based on Westpac (2017b) and Amortisation Schedule Calculator (2017)

Further, consumers have no influence over how much they pay in LMI fees — lenders choose the LMI provider (since the policy is an agreement between them and LMI provider) and pass on the cost to consumers. Thus, consumers cannot influence prices by exerting competitive pressure on LMI providers, except indirectly through their choice of home loan provider. It is unlikely that borrowers would select their home loan provider based on the cost of LMI — other factors such as interest rates or loan features (for example, access to a redraw facility or the ability to make repayments ahead of time) are likely to be more important to a borrower.

Capital requirements and the risk of default

The cost of LMI is heavily influenced by capital requirements for LMI providers, which reflects the risk presented by a borrower over time. Although LMI policies provide cover for the term of the loan (which could be up to 30 years), the greatest risk usually occurs in the early years, when there is a large proportion of the property’s value outstanding. However, risks can also increase in the later part of the loan term if property prices fall, since the LMI provider would recover a smaller sum through the sale of the security property.

APRA sets capital requirements for LMI providers, and these requirements are adjusted depending on the age of the underlying loan (adjustments are known as ‘seasoning factors’). The older the loan, the less capital LMI providers have to hold, reflecting the decreased risk of default over time. The greatest risk occurs in the first five years, and therefore the cost of an LMI policy is heavily ‘front-loaded’(table 8.3).

Table 8.3 Capital requirements on LMI providers
Adjustments for age of loan

<i>Age of Loan</i>	<i>Seasoning factor</i>
Less than 3 years	100%
3 to less than 5 years	75%
5 to less than 10 years	25%
10 years or more	5%

Source: APRA (2013e)

Importantly, capital requirements ‘reset’ each time a lender issues a loan that requires LMI, regardless of whether it is a new or refinanced loan. Therefore, each time a borrower refinances a loan while remaining above the 80% LVR threshold, they are likely to be charged an additional LMI fee that is equivalent to what a borrower taking out a loan for the first time would be charged.

This is a serious pricing inefficiency, as well as raising the more subjective issue of fairness. Potentially a quarter of owner–occupiers (table 8.1) are exposed to being overcharged for LMI upon making the effort to refinance. In some cases, additional LMI may be justified — industry figures suggest that in many cases (up to 90%) borrowers who are asked to pay

additional LMI upon refinancing have increased their total exposure, for example through the inclusion of credit card or personal debt in the refinanced loan (The Treasury 2011, p. 3). However, the number of consumers affected is immaterial to the principle of the matter. Currently, borrowers can be charged additional LMI even if they do not substantially change their risk of default when refinancing — for example, they are refinancing simply to get a lower interest rate and have not changed their loan amount or the security property. This issue has been unaddressed for too long.

Making LMI pricing more efficient

Ideally, LMI cover would be portable. However, if this cannot be done, then the ‘unused’ portion of the policy must be refunded to consumers when they refinance.

In 2011, the Government considered LMI portability as part of a broader package of banking system reforms (the *Competitive and Sustainable Banking System* package). However, it decided not to pursue this on the basis 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). Refundability of LMI was not considered at that time.

Refunds of LMI already occur in some instances — for example, Genworth offers LMI refunds if a loan is repaid within the first two years, subject to additional conditions (table 8.4). Given the ‘front-loaded’ nature of the insured risk (discussed above), refunds are **not** given on a *pro-rata* basis.

QBE confirmed that partial refunds are offered in some cases where the loan is terminated early, although this depends on arrangements between the lender and the LMI provider (QBE LMI 2017).

Given that consumers bear the cost of LMI premiums, refunds offered by LMI providers to lenders should be passed back to consumers. However, this does not always occur. For example, CBA (2017d) stated that it does not offer refunds of LMI premiums to consumers.

Table 8.4 Genworth LMI refund rates^a

<i>Period from date of premium payment to date when loan has been repaid in full</i>	<i>Refund payable^b</i>
1 year or less	40%
Over 1 year to 2 years	20%

^a Refunds are not available under some circumstances, such as where there is already an arrangement for a reduced premium rate in lieu of taking refunds, where the loan is repaid close to the maturity date of the mortgage, where the refund amount would be small, and where a loan is already in arrears or a loss has already eventuated. ^b Based on the total LMI premium less any rebate paid to the lender.

Source: Genworth (2017a)

Even where refunds are offered, many consumers are unaware of this option. Mortgage Providers said that:

A little-known aspect of LMI is the possibility of seeking a refund farther down the road with your property investment. When you close or reduce your exposure on a high-LVR loan within two years, you may be eligible for an *LMI refund*. High growth in the value of your property may also reduce your loan's LVR to a level that eliminates the need for LMI, paving the way for a refund.

At **Mortgage Providers**, we find that many borrowers have no knowledge of LMI refunds, but the amount of this often forgotten provision can be significant; generally, these refunds range from 10% to 50% of the LMI premium amount. (2017)

The National President of the Finance Brokers Association of Australia estimated that 90% to 95% of people were unaware that they could be eligible for a rebate on an LMI premium if they repaid their loan within 12 to 24 months (SERC 2011).

The Commission considers that consumers should be entitled to receive refunds on LMI fees from lenders when they refinance or pay out their loan. And the limitation of refunds being given only when loans are repaid within 12 to 24 months does not seem to be a legitimate one at face value, given the paucity of analysis available to support it.

The Australian Government should, rather, require lenders to:

- offer consumers refunds when they refinance with another lender or pay out their loan
- facilitate the refund process by providing consumers with the refund schedule for the life of the loan at the time the policy is started.

In consultation with regulators, lenders, LMI providers and consumer groups, the Australian Government would also need to develop the specific requirements regarding:

- how refunds would be calculated
- the circumstances under which consumers would (or would not) be eligible for refunds
- the information that lenders would need to provide to consumers regarding how to receive a refund, and when this information would be provided
- the extent to which these requirements could be applied to existing LMI policies, recognising that they would have been priced on a different basis
- whether borrowers should be offered the option of a non-refundable policy (at a lower cost) when they take out a loan.

DRAFT RECOMMENDATION 8.5 LENDERS MORTGAGE INSURANCE REFUND

The Australian Government should require all lenders to offer home loan customers refunds for the cost of lenders mortgage insurance when customers choose to refinance or pay out their loan. The refund schedule for the remaining life of the loan should be set and made available to the borrower at the time the policy is started.

Higher-risk consumers pay twice for the risk they present

The purpose of LMI is to compensate lenders for losses resulting from a borrower defaulting on their loan. As noted above, consumers who are perceived to be at a higher risk of default are often required to pay an LMI fee to cover the cost of the policy taken out by the lender.

However, these consumers can also pay a higher interest rate on their home loan. As Ms Rigoni said:

In the circumstance of high loan to value ratio or low deposit loans, we see a premium interest rate for risk being applied. Yet these borrowers pay many thousands of dollars for the lenders mortgage insurance premium, which protects the lender against loss due to borrower repayment default. (sub. 46, p. 5)

Both Genworth and QBE said that the use of LMI meant that a lender did not charge a higher interest rate to cover the increased risk that a low-deposit borrower presents (QBE, sub. 34; Genworth, sub. 44). However, based on data obtained from ASIC, the Commission estimated that a borrower who is charged for LMI is, on average, also charged a slightly higher interest rate, after taking into account other factors such as the borrower's age and the loan amount. The difference is small, at 0.00066% of the average interest rate for all borrowers (the difference in basis points therefore depends on the average interest rate). 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%. This difference is statistically significant, and, although it is small, the Commission questions why it exists at all when lenders are already protected from losses arising from borrower default by the LMI policy.

DRAFT FINDING 8.3 IF YOU HAVE A HIGH LOAN-TO-VALUE RATIO, YOU ARE PROBABLY PAYING FOR IT TWICE OVER

Home loan consumers with a loan-to-value ratio in excess of 80% are often required to compensate lenders twice for this risk: by bearing the cost of lenders mortgage insurance, and also by paying a higher interest rate on their home loan, even after other loan and borrower characteristics have been accounted for.

INFORMATION REQUEST 8.3 ARE CHANGES NEEDED TO LENDERS MORTGAGE INSURANCE?

Are there any circumstances in which it is reasonable for a home loan consumer to be paying both lenders mortgage insurance and a higher interest rate? If not, what changes could feasibly be implemented?

LMI factsheets would help consumers

In August 2011, the then Treasurer announced that the Australian Government would require lenders to produce one-page factsheets to help consumers 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. (Treasurer 2011)

This proposal was not implemented. However, some firms — including lenders and the two independent LMI providers — have voluntarily prepared such factsheets (Genworth 2017b; ING 2017). Some mortgage brokers' websites also include the cost of LMI in comparisons between products offered by different lenders (Home Loan Experts 2017).

The Commission recognises and commends these efforts, and encourages all lenders to produce similar factsheets to increase consumers' understanding of LMI and make it easier for consumers to compare different products.

9 Provision of finance to small and medium businesses

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 who applied for debt finance were successful.
- Home ownership in the key entrepreneurial period of life (ages 25-34) is down by a third over the past 25 years; yet Australia's risk weighting system for SME loans continues to emphasise home ownership.
- 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 local banks. Foreign banks branches operating in Australia have access to their home country risk weights — a factor that should provide them with a regulatory advantage in SME lending.
- New business, 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.
- But since 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.
- Credit availability could be improved by moving to a more finely tuned approach to risk weightings for SME lending that better reflects the different types of lending products provided and risk profiles of different SMEs.
- The current single risk rating provided by APRA for unsecured SME lending under the standardised approach (which affects all but the very largest banks) is in need of review against international better practice and data improvements.
- New entrants and innovative lenders are also entering SME credit markets using online platforms to connect with customers, improving competition at the margin.
 - With improved access to data under Open Banking and the Comprehensive Consumer Right proposed by the Productivity Commission in 2017 (*Data Availability and Use*), as the new entrants develop their systems and expertise to assess the risks involved in SME lending, the advantages of the large banks may be eroded.
 - Regulators should recognise this as a significant improvement to the finance market.
 - However, where SMEs require the physical presence of a branch or rely on their lender for products such as point of sale terminals, the large banks will retain much of their advantage.
- Another key to improving the functioning of credit markets for SMEs is to improve the information available to lenders via Comprehensive Credit Reporting, a process now moving into mandatory provision of information. This and the use of electronic platforms to enable consumers to share their financial information with prospective lenders will allow lenders to more accurately assess risk and price credit accordingly.

9.1 Finance provided to SMEs

The ability of small and medium enterprises (SMEs) (see box 9.1) 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 SMEs are able to access the finance they require at prices that reflect the risk to the investors.

Much of this focus has been on debt finance as there is relatively limited use of equity finance by SMEs. 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 2015a). 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 9.1 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 Bankers' 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.

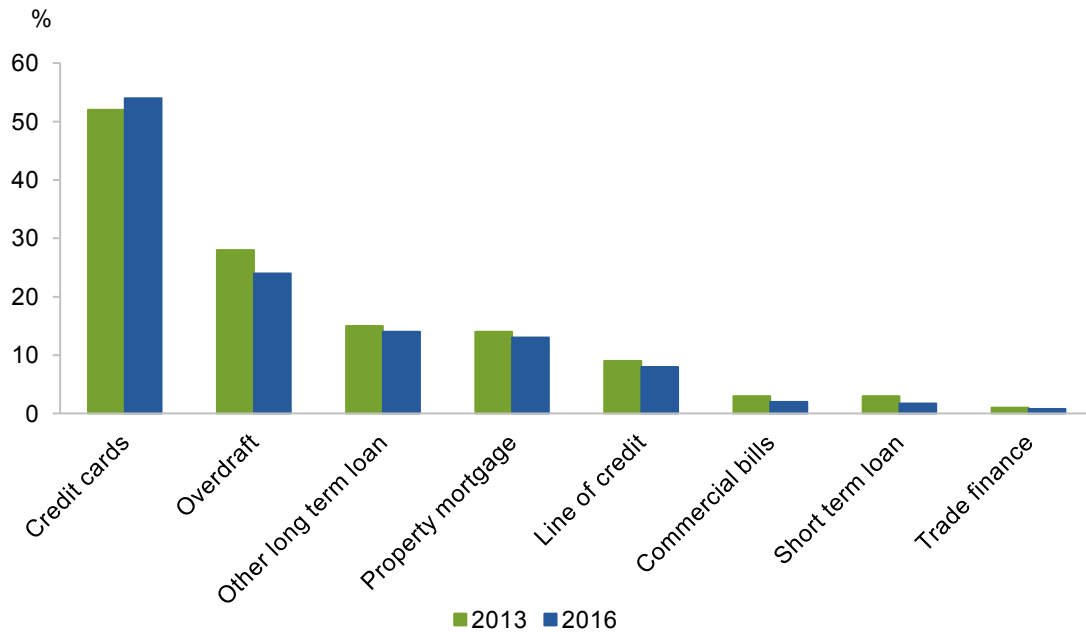
Source: RBA (sub. 29), ABA (2017a)

The most commonly used form of debt finance by small business are credit cards, followed by overdrafts, long term loans and property mortgages (figure 9.1).

By value, small business lending is dominated by term loans. These loans account for over 80% of the lending (consisting of credit cards, term loans and overdrafts/lines of credits) by ADIs (figure 9.2).

Further information on the different lending products provided to SMEs is contained in appendix C.

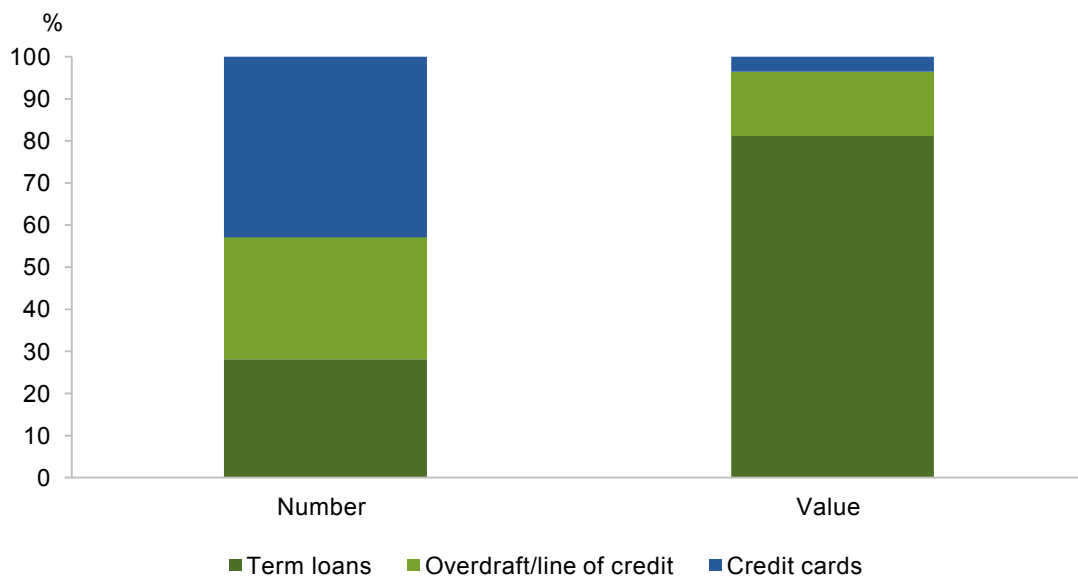
Figure 9.1 Small businesses with lending products



Source: ABA (2016)

Figure 9.2 Small business lending by selected debt finance products provided by ADIs

Share by number and value, June 2017^b



^a One ADI's data is based on June 2016.

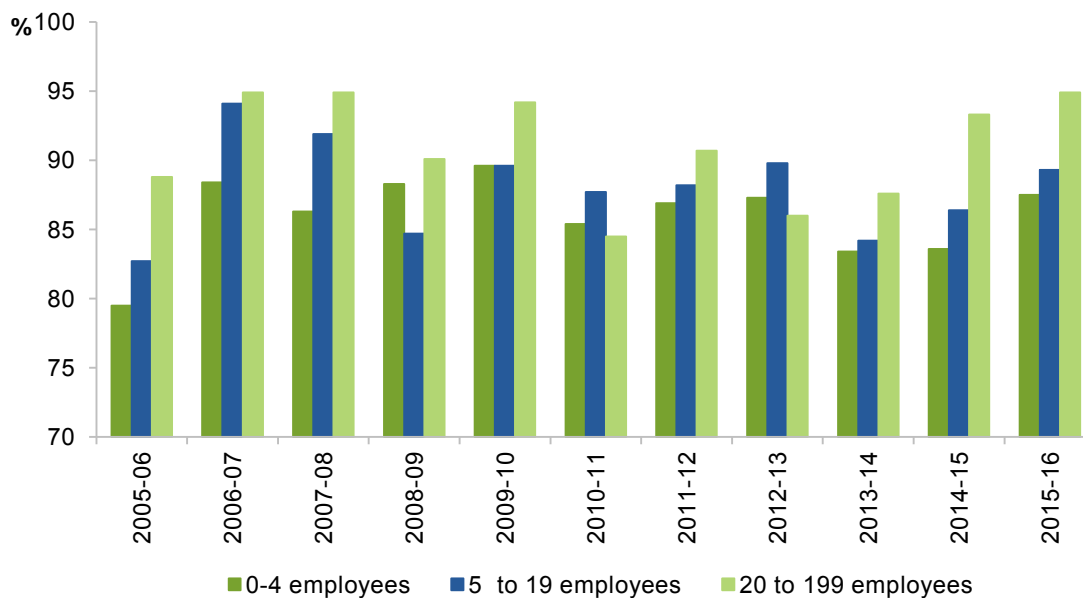
Source: Unpublished ADI data, representing 84% of the market for SME lending

9.2 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 are confident to apply. Nearly 90% of SMEs who applied for debt finance in 2015-16 were successful (figure 9.3). Since 2006-07 approval rates have been well over 80% (Murray et al. 2014a). A survey of small business for the ABA and 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 9.3 **Share of business that successfully obtained debt finance, by employee numbers**
2005-06 to 2015-16



Source: ABS (*Selected characteristics of Australian business* Cat. no. 6167.0, 2017)

That not every SME applicant is successful in accessing debt finance does not necessarily indicate that there are fundamental problems with the financial system. 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 would indicate that financial institutions and their investors were not taking account the risks and uncertainties of financing SMEs. Westpac 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. (sub. 28, p. 48)

New businesses find it more difficult

New businesses do find it more difficult than established businesses to access debt finance. Almost invariably new businesses are 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 a lack of information on these 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 2015a) (box 9.2)

Box 9.2 **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 business 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 Reid 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)

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 2015a). At June 2017, the interest rate gap between residentially secured small business term loans and low rate credit cards was over 6% and over 13% for standard rate credit cards (figure 9.5).

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 and that 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 2015a).

The GFC had an impact on provision of finance to SMEs

During the GFC, obtaining finance was more difficult for SMEs as lenders became more risk averse, the price of credit increased due to defaults and business failures, while 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 2017j). The share of SMEs who were able to obtain debt finance declined in 2008-09 and has taken some time to return to pre-GFC levels (figure 9.3).

This is reflected in business surveys that indicate that access to finance between 2009 and 2011 was considered to be the most significant barrier to business competitiveness whereas by 2016-17 it was considered the least significant barrier to business competitiveness (WEF 2017b).

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 timeframe. In response to these concerns, the banking Code of Practice was implemented at the end of 2017 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 2017c).

Good practice in this area would strongly suggest compliance with the new Code should be reviewed by the ABA after 12 months of operation.

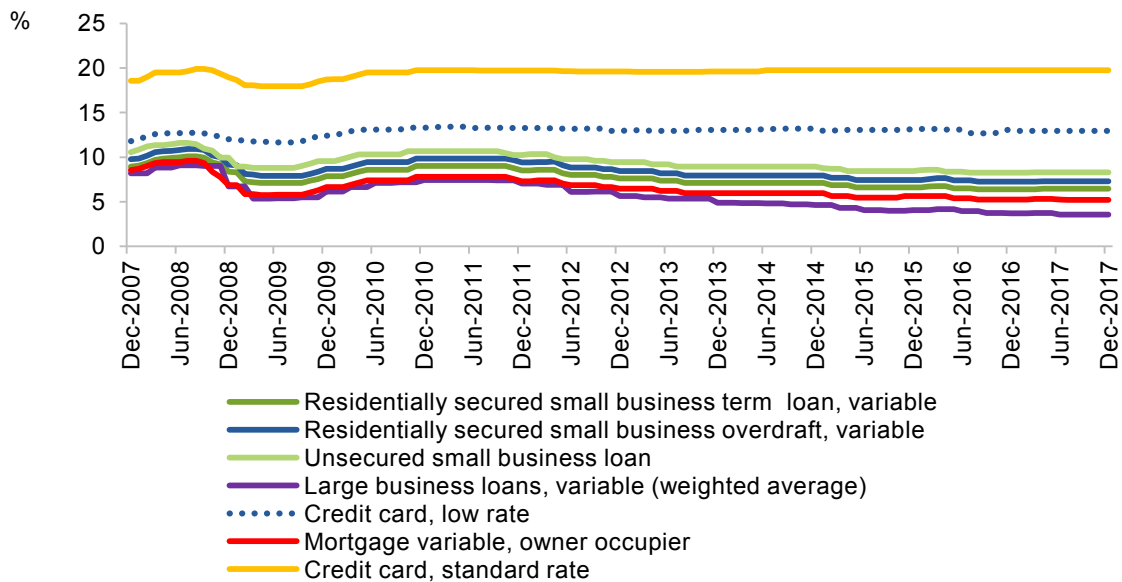
But there are some issues concerning the financing of SMEs

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 slightly higher interest rates for small business loans secured by residential property than for residential housing 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 9.4). The higher price of unsecured SME finance is due to the higher risk lenders place on lending to small business and the higher capital provisions required of lenders by 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 (figure 9.5). 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 finance⁴⁵. 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.
- *The large banks dominate SME lending.* Most business finance, particularly for small business, is obtained through the four major banks. They 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 9.6). 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 (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).

⁴⁵ In some cases, this will require a second mortgage or a mortgage with a higher LVR.

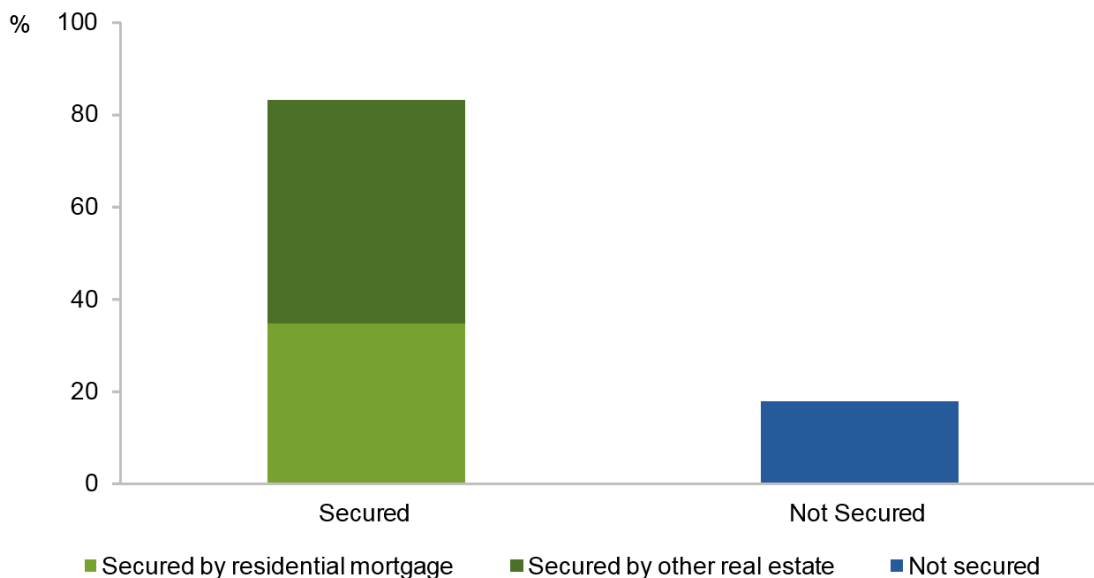
Figure 9.4 Selected lending rates
December 2007 to December 2017



Source: RBA (2017v)

Figure 9.5 Small business lending by the major banks on term loans secured by real estate^a

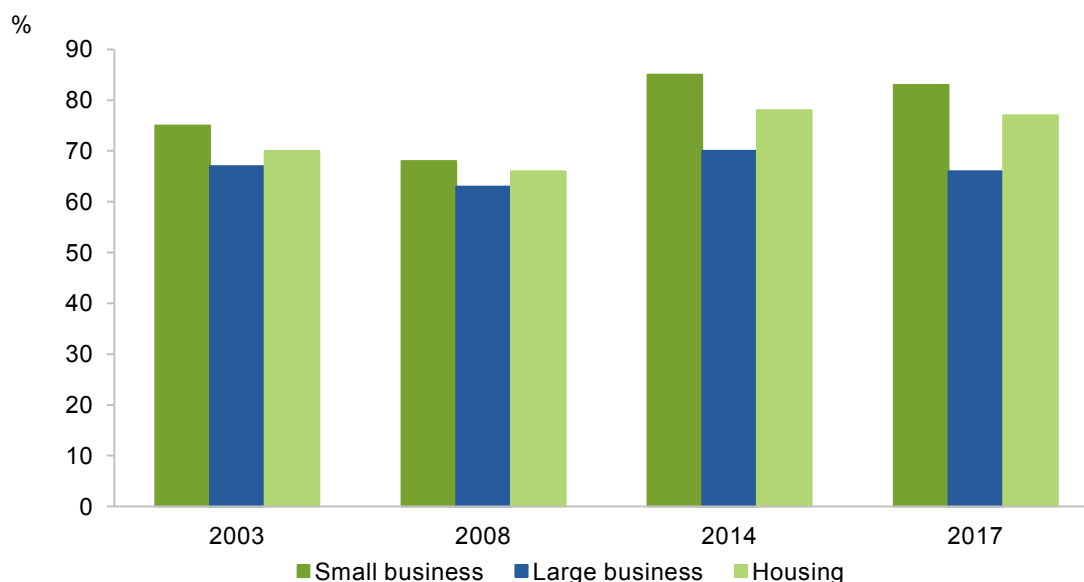
(Share of all small business lending on term loans by value, June 2017)



^a Major banks are the CBA, Wespac, NAB and ANZ. The data from the ANZ bank is at 30 September 2016. The classification of a small business loan is determined by each bank.

Source: Unpublished ADI data

Figure 9.6 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 loans less than \$2 million.
Source: RBA (sub. 29)

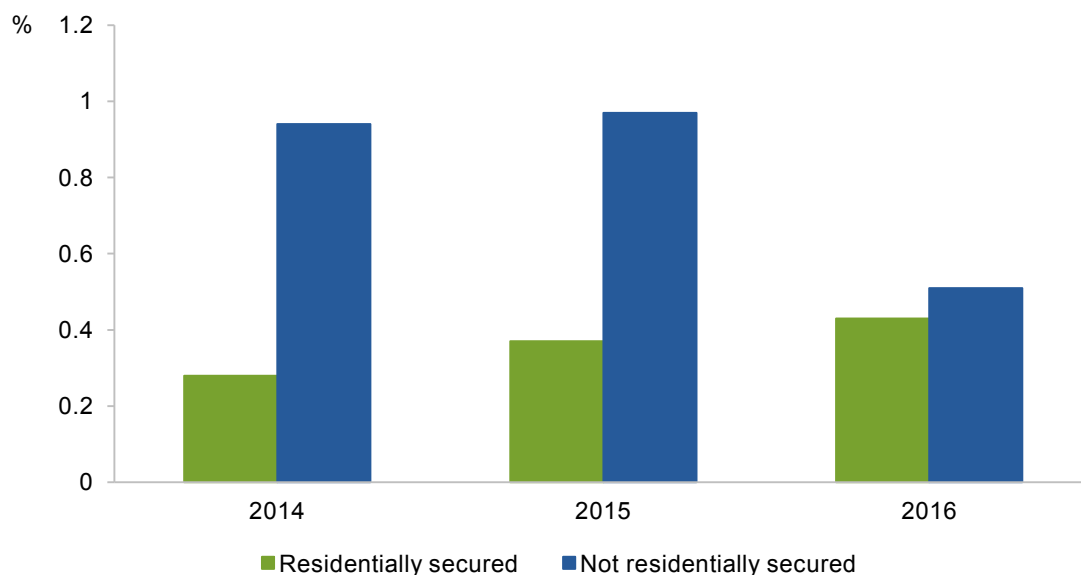
9.3 Can the provision of finance to SMEs be improved?

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 mortgage. 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. There is also an increasing number of service based small businesses, with few ‘hard assets’.

There is also a lower risk profile for SME lending that is secured by residential property. This is highlighted by the relative difference in default rates between SME loans secured by residential property and those not residentially secured (figure 9.7).

Figure 9.7 Proportion of the Commonwealth Bank's small business lending by value in default^a
2014 to 2016



^a The proportion of the Commonwealth Bank's (CBA) small business lending by value at June in each year. The CBA classifies small business lending as businesses with exposures up to \$1 million.

Source: Senate Standing Committee on Economics (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 people — who are also more likely to engage in entrepreneurial activity than those of other ages — 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) and impacts on the efficient flow of credit for SMEs.

The risk weighting attached to SME lending

Overseas, there have been concerns that the new Basel III arrangements to improve overall financial stability may generate some costs on SMEs by requiring banks to hold higher minimum levels of risk weighted capital that in turn could reduce their lending capacity.

In Europe, small businesses and individuals (as under the existing Basel II standardised approach to credit risk) will be ascribed the retail risk rating of 75% provided the bank's retail portfolio is diverse and no loan exceeds € 1 million. However, if the loan does not meet the conditions to be ascribed a retail risk rating, a SME loan will be assigned a risk weight of 100% compared to 20% for a large AA or AAA rated company. This means for a \$100 000 loan made to a large AA or AAA rated company, the bank would only be required to offset the loan with \$1400 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).

Similar risk weightings for SME lending apply in other jurisdictions. For example, SME lending is assigned the retail risk weighting of 75% — provided, in Canada, that the lender's portfolio is diverse and no loan exceeds CAD \$1.25 million, or that in the United Kingdom, the loan does not exceed € 1 million (FCA 2017b; OSFI 2017).

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. The standardised risk weights used in Australia reflect APRA's implementation of Basel II, but are not identical to Basel II in all areas. The Basel III arrangements for standardised risk weighting have not yet been implemented (table 9.1).

In Australia, the standardised approach as applied by APRA, provides for a single risk weighting of 100% for any SME lending that is not secured by a residential mortgage. There is no delineation 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. This differs to the Basel II standardised risk weightings where SME lending below €1 million is covered as retail lending and a risk weighting of 75% applies (table 9.1).

APRA's standardised approach applies 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). For example, 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 LVR and whether the loan is standard or non-standard and/or is covered by mortgage insurance) (table 9.1).

Table 9.1 Standardised credit risk weightings, Basel II, APRA Prudential Standard APS 112 and Basel III

<i>Type of lending</i>	<i>Basel II Standard risk weightings</i>	<i>APRA Prudential standard APS 112</i>	<i>Basel III Standard risk weightings</i>
	%	%	%
SME lending covered under retail lending	75 ^a	100 ^b	75 ^a
SME corporate lending (lending not covered under retail)	100	100	85 ^c
Lending for/secured by commercial real estate	100 ^d	**	80 (LTV < 60 %) 100 (LTV is 60 to 80 %) 130 (LTV > 80 %) ^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 LVR)

** Under Prudential Standard APS 112 risk weights are derived from the counter-party and not the collateral, except for business loans secured by residential mortgages. ^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. ^d Lending on office or multi-purpose/ multi-tenanted commercial premises can receive a risk rating of 50% where the market value of the loan does not exceed 60% of the mortgage value of the property ^e 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 LVT of 40% or less. ⁱ LVT between 90 % and 100%.

Source: APRA Prudential Standard APS 112; Bank for International Settlements (2015)

This means that for a \$100 000 loan made to an SME, an ADI using the standardised approach to regulatory capital holdings would currently 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)⁴⁶ or with \$2450 to \$5250 in capital (if secured by a residence).

In contrast, the IRB approach to regulatory capital holdings (used by only the very largest banks in Australia) 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

⁴⁶ 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). Most ADIs under the standardised approach have capital ratios well in excess of the current minimum capital ratio (common equity tier 1) of 7% (APRA 2017z).

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).⁴⁷ 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.

Currently, the use of a single flat risk weighting for all SME lending not secured by a residential mortgage provides simplicity at the expense of reduced lending. It impacts on the efficient provision of lending to SMEs given that a single flat weighting cannot differentiate between the different risk profiles of each borrower and the type of lending. This is not say that risk weightings should be refined to such an extent to attempt to emulate the granularity applied to risk through an IRB approach.

However, adding further broad categories to the standard applied by APRA to reflect the different types of lending to SMEs and some of the broad risk characteristics of SMEs themselves would improve credit flows and be beneficial to both SMEs and those lending to SMEs. For example, the Basel Accord's standardised approach provides for differentiated risk weighting for SME lending based on the type of security held and the size of the borrowing — including lending secured by commercial property (below a specified loan to valuation ratio) and where lending to the one party is below a certain threshold.

Further refinement to the risk weights used is becoming increasingly desirable as the rapid escalation 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 Comprehensive Consumer Data Right are two such developments. 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 to enable APRA to consider proposals to vary 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 some refinement of a single based risk weighting for SME lending.

⁴⁷ 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).

DRAFT RECOMMENDATION 9.1 STANDARDISED RISK WEIGHTINGS FOR SME LENDING

Instead of applying a single risk weight to all small and medium business lending not secured by a residence, the Australian Prudential Regulation Authority (APRA) should provide a broader schedule of risk weights in its 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. International best practice should be closely considered.

In light of apparent major improvements in the use of Artificial Intelligence algorithms and data collection via the new payments platform, APRA should consider proposals by ADIs for variations to the standardised risk assessment for business lending, based on their data and risk management systems.

SME lending is relatively less profitable to ADIs than other lending

That 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, has resulted in more capital being allocated to lending in those areas with higher returns.

For example, of the two major banks who provided data, 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). The other major banks did not provide ROE by product line.

This may have been a contributing factor to the long-term decline in business lending relative to lending for residential property. In 1990-91, all business lending accounted nearly two-thirds of total lending, but declined to a third by 2016-17. In contrast, lending for owner occupied residential property increased from 20% to 40% and investor housing from 4% to over 20% in the same period (figure 9.8).

Judo Capital (sub. 12) commented that 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 to maximise ROE.

Figure 9.8 Type of lending, as a share of total lending



Source: RBA (2017b)

This shift in lending focus to housing has seen some particular groups of ADIs with relatively less exposure to SMEs than to residential mortgages. However, the foreign banks operating in Australia are the only group of ADIs that have relatively larger exposure to SMEs than to residential mortgages (figure 9.9). This is because the branches of foreign banks operating in Australia are unable to take retail deposits and are not involved in retail mortgage lending. 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.

Increased competition from non-ADIs in all business lending, and SME lending in particular, has not shifted the lending focus of ADIs into housing. 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 2017u) (figure C.6, appendix C).

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 appears instead to be in better risk assessment — making a higher margin loan less risky than its cohort — 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.

Figure 9.9 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)

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) 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), a number of the potential applicants have a strong SME focus (APRA, pers. comm., 12 December 2017). There are also the registered financial corporations, that are outside the prudential regulations applying to ADIs, that engage in lending 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 around 6% of financial systems assets in 2016 compared to 10% in 2007 (RBA 2017u).

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 the 5 years to 2017 with turnover that year of around \$39 billion (Information provided by the Australian Finance Industry Association).

The use of new technology to increase competition

New lending models are emerging

The use of technology to establish new lending models for SMEs and the operation of fintechs is also 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. 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; PC 2015b).

Other new lending platforms, such as 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: over \$86 billion of new loans under \$2 million were provided in 2016 (RBA 2017j).

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.

Some of the major banks have 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). If this proves to be successful, data flows via payments systems at point of sale and accounting systems will strengthen opportunities for this type of lending.

APRA (sub. 22) considered that the provision of finance to SMEs would benefit from the increase in innovative financiers and additional new entrants were beginning to appear utilising online platforms to connect with customers.

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 will not face these difficulties). The advantages of the large banks in Australian SME lending is discussed below.

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 timeframes 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 FSI (Murray et al. 2014a) recommended that the unfair contract provisions under the *Australian Securities and Investments Commission Act 2001*, that 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 coming into effect in November 2016. Finally, following further work and consultations by ASIC and the ASBFEO throughout 2017, the four major banks agreed to specific changes with ASIC 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 2017k).

Will the large banks continue to dominate SME lending?

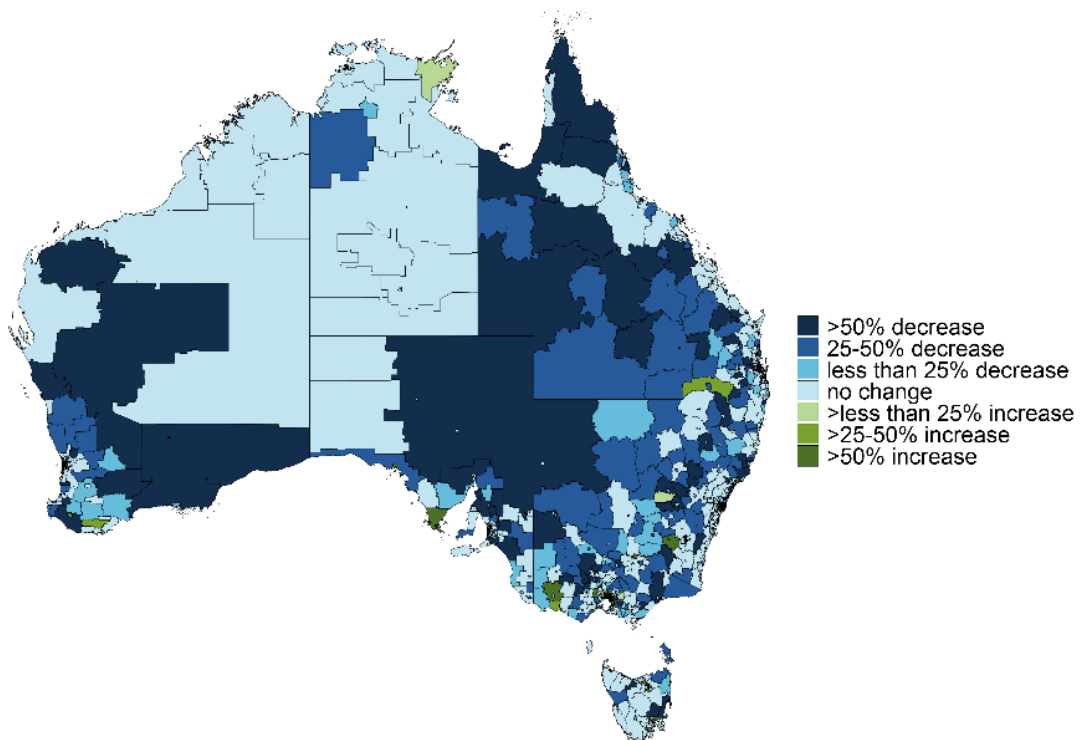
In Australia, the dominance of the large banks has resulted from their large branch network which has been used to maintain relationships with their customers, including SMEs, for a range of banking products and through their systems and expertise in assessing business risk.

As the 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 even 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 10), the large banks may retain their advantage.

Not all small businesses need ready access to a bank branch and as the number of bank branches decline due to declining overall demand for physical banking services this advantage will be eroded. The decline in bank branches is highlighted in figure 9.10.

Figure 9.10 Changes in bank branches
% change between 2008 and 2016

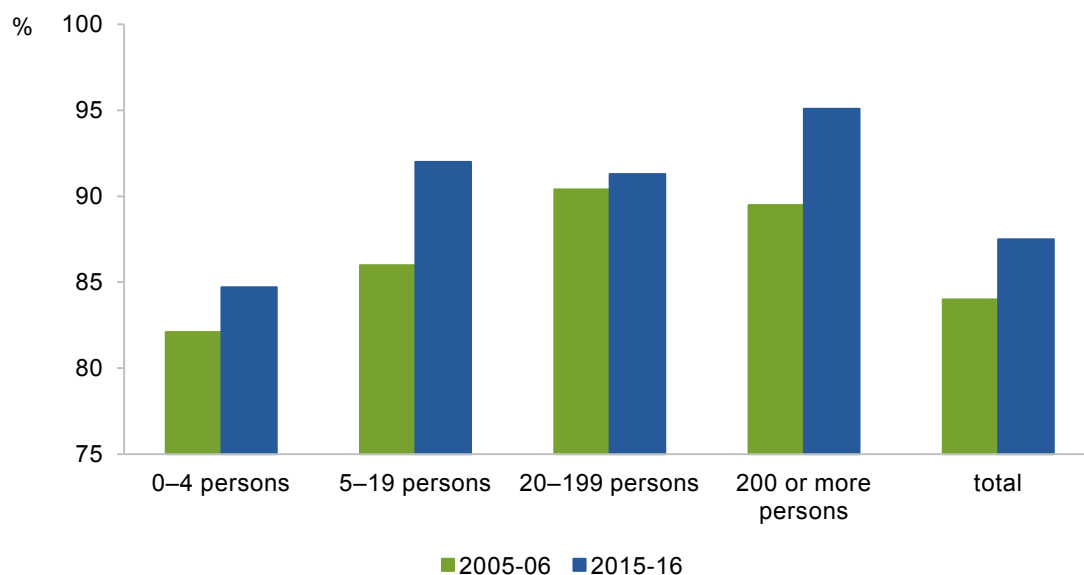


Source: Unpublished APRA points of presence data

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 9.11). 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.

Figure 9.11 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*, Cat. no. 8129.0)

Based on the RBA's liaison with business and banks, the expansion in activity by foreign banks in Australia has mainly focused on lending to large highly rated Australian companies whereas competition has been less vigorous for small business lending, which remains dominated by the major Australian banks (Connolly and Jackman 2017).

As to competition between the major banks, the level of competition in SME lending is not as strong as in the more profitable home loan market. However, there appears to be greater competition in regard to lending products, in part driven by smaller innovative lenders operating off new platforms, then on the price of the loan which is strongly linked to the security offered against the loan.

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 would be more likely to be able to set terms for the finance that accommodates the business, instead of turning them away as an unknown

risk. It also assists lenders as additional information better enables them to identify high risk borrowers.

These information asymmetries were highlighted by the Murray Financial System Inquiry (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).

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 9.3).

Box 9.3 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)

Equifax (sub. 38) reported that voluntary participation by credit providers in the comprehensive credit reporting (CCR) 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.

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 — legislation

will come into effect by July 2018 to impose mandatory participation in comprehensive credit reporting (including the reporting of repayment history) by ASIC-licensed credit providers (Morrison 2017d).

The proposed mandatory arrangements for CCR do not extend to SMEs, only 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 business owner/s as an individual remained the primary information source for credit decisions rather than information about the SME itself.

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 9.4).

Box 9.4 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. This is not unsurprising, as 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 data-bases 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 located a significant number of individuals as a high-credit risk that were previously invisible to lenders under the previous 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, provides 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.

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).

Similarly, Open Banking systems, where properly designed, can improve information flows. The Australian Government has set up an independent review to establish an Open Banking regime to enable banking customers, including SMEs, 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 offer them new or better services. The review reported to Government at the end of 2017 (The Treasury 2017c).

For an SME, this will enable them to provide financial data to lenders (who then have access to more detailed information) when seeking finance. This reflects previous reviews and inquiries that have recommended expanding consumer's access to their own data, such as the Commission's inquiry, *Data Availability and Use* (PC 2017c) that recommended consumers 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.

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 draft recommendation 13.1).

10 The payments system

Key points

- The use of cash and cheques is in decline in Australia, but card transactions and bank transfers have grown. Innovations, such as digital wallets, are changing the way people interact with their money and may be a strong factor in shaping future trends.
- The market for debit and credit cards and bank transfers is dominated by the major banks and two card schemes, Visa and MasterCard. eftpos is often the most price-competitive debit card scheme, but is nevertheless rapidly losing market share. But smaller players and entrants are helping some parts of the payments system to become more competitive.
- Payment methods that use stored value, such as PayPal, have the potential to be a significant source of competition to traditional payment methods, but face a complex set of regulations that may limit their incentive to grow. APRA should review these regulations (itself or outsourced elsewhere) so that they do not unduly constrain growth.
- The ePayments Code is a voluntary set of basic rules for making electronic payments. ASIC should mandate the code for all organisations that send or receive electronic payments. The code should be amended to clearly allocate liability for unauthorised transactions when a customer has shared their pass code with a third-party provider.
- Consumers don't always face the direct cost of 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 consumers' payment choices. Most merchants do not directly impose customer surcharges on particular transactions for fear of losing business to competitors. Further, smaller merchants find it hard to negotiate lower costs of accepting payments and can struggle to search for, and switch to, a lower-cost provider. These factors create significant scope for price exploitation by parties with market power.
- The Payments System Board (PSB) currently regulates the price of 'interchange fees' paid on card transactions by a merchant's financial institution to the customer's institution. Instead, the Board should ban all card interchange fees as a way to lower overall costs to users.
- Merchants should be given the ability to choose their default network to route transactions for dual-network cards. This would allow merchants to route these transactions through less expensive networks and thus reduce their fees.
- The New Payments Platform (NPP) offers instant payments, 24–7, using simple bank aliases.
 - The NPP is a nationally significant piece of infrastructure and should be subject to an access regime imposed by the PSB. This should also require that certain entities that use an overlay service must share transaction-level data with the overlay service provider.
 - The NPP's transaction fees should be reviewed to make sure they are competitive.
 - The capability of banking aliases is presently limited to single transactions, one way. This can be improved to lower barriers to customer switching.

Australians make millions of payments worth billions of dollars every day. Thus, the payments system is an essential part of the financial system. 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 touches the lives of all Australians. It involves low-value payments between people, businesses and governments to make purchases or transfer funds.

The Commission has focused its 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 outcomes for consumers. Second, the system involves many complex relationships between parties in the supply chain and prices that are not always transparent.

10.1 Competition in the retail payments system

There are many ways that people and businesses can pay each other (figure 10.1). These ‘payment methods’ include cash, cheque, card, direct entry (bank transfers) and purchased payment facilities (such as PayPal).⁴⁸ There is scope for providers to compete *within* and *between* these payment methods. For example, card schemes compete amongst 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.

In Australia, banks and other authorised deposit-taking institutions (ADIs) are the main institutions involved in the payment systems underlying each payment method. They disburse cash throughout 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 also have important roles in payment systems, such as card schemes and platform providers.

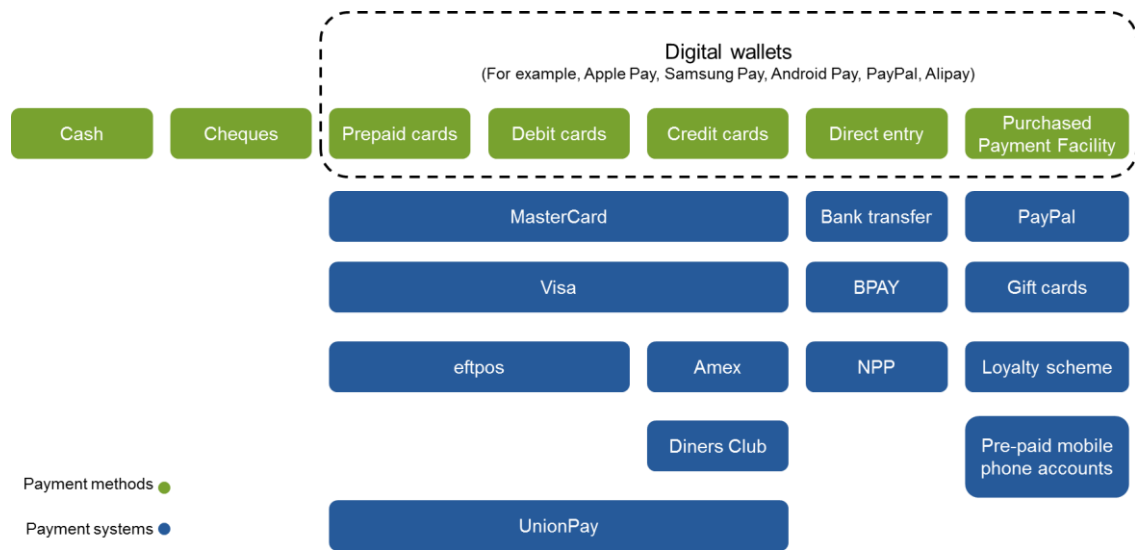
It is ultimately up to people and businesses to decide how to make and accept payments, based on the methods available to them. But to do so at least cost and greatest efficiency, they must be able to recognise when a cost is being imposed and have both a choice of alternative payment instruments and the incentive to use the best value payment method.

Australians are strongly embracing electronic payments. The majority of retail payments in Australia are now made through non-cash methods (Doyle et al. 2017). Australia has the

⁴⁸ Purchased payment facilities provide a store of value for deposits, but can generally only be used to make payments to other users of the facility. Examples include gift cards and pre-paid mobile phone accounts.

fourth highest number of non-cash payments per person and the highest level of contactless card use in the world (ASIC 2016f). Most of the growth in the *number* of non-cash payments came from cards and growth in the *value* came from bank transfers (figure 10.2). 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 begun to decline from its peak in 2009 (RBA 2017h), and the use of cheques has declined.

Figure 10.1 Overview of payment methods and systems in Australia



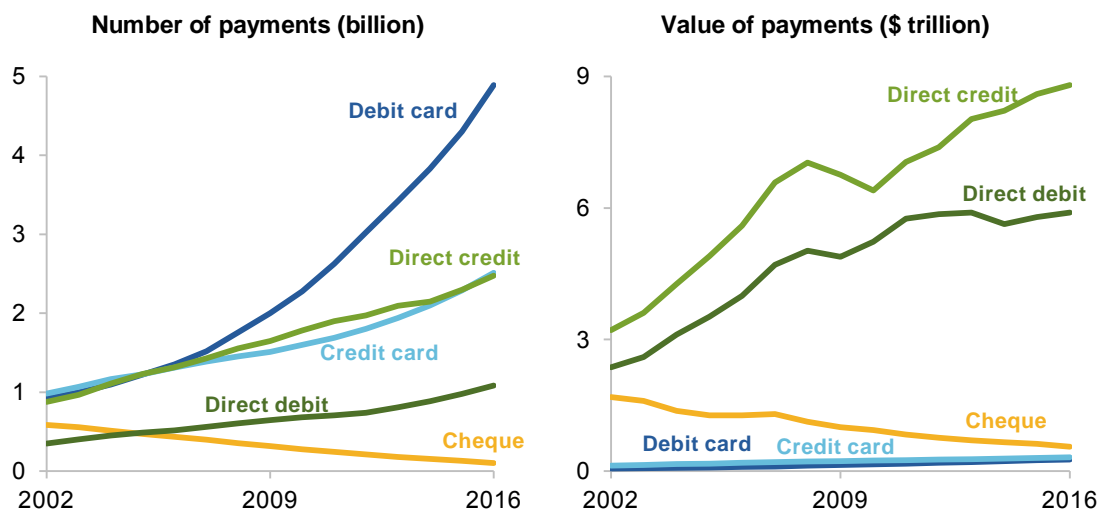
As consumer preferences change, providers of payment systems are also adapting. Payment systems are undergoing a wave of innovation driven by digital technology and the growing use of data. Incumbent providers are investing in innovation and the ‘fintech’ sector is also capitalising on these developments (chapter 4). Many fintechs are providing complementary services to existing systems. Others are focusing on ways that technology and access to data can disrupt the way people make payments. There are growing opportunities for fintechs to work with or compete against incumbent payment system providers. For example, purchased payment facilities, such as PayPal, are alternative payment methods that provide a growing source of competition to incumbent payment systems.

New ways of authorising payments, such as blockchain, are in their infancy, but show promise to reduce costs and improve efficiency of payment systems (Hanson, Reeson and Staples 2017). And new platforms for accessing payments, 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 efficiency and competition of the payments system. These joint objectives led the PSB to distinguish between payments

systems where stability is very important (high-value payments) and those where competition and efficiency are very important due to the large number of transactions (retail payments). Accordingly, the RBA owns and operates Australia’s only high-value settlement system, but takes a relatively hands-off approach in the retail payments system.

Figure 10.2 Number and value of non-cash transactions^a
Calendar year 2002–2016



^a Direct credit and direct debit are both types of bank transfers.

Source: RBA (2017m, 2017o, 2017p).

Debit and credit card providers have substantial market power

Apart from the cardholder and merchant, there are generally three different parties involved in processing a card payment (figure 10.3):

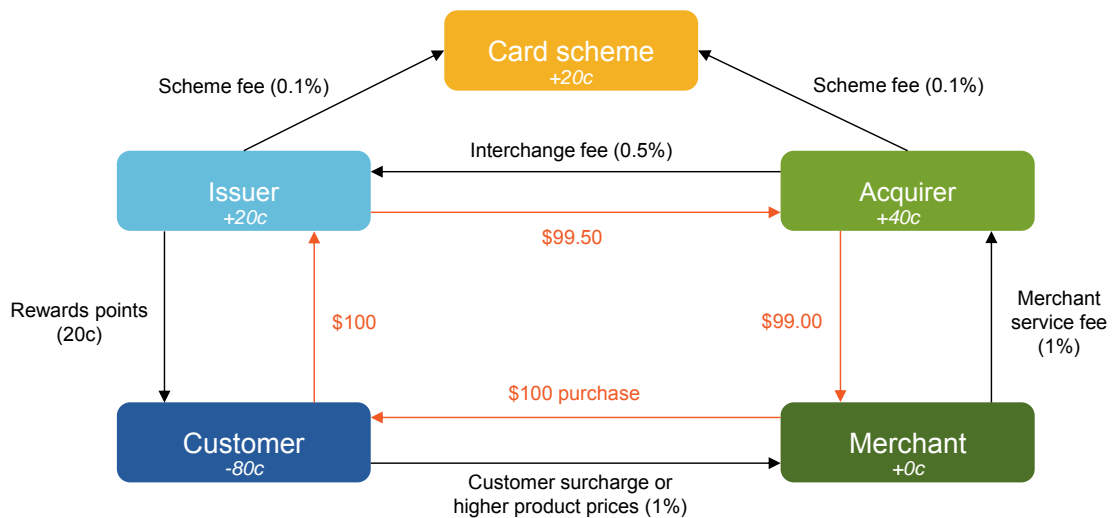
- issuer — the customer’s financial institution that issues the card
- acquirer — the merchant’s financial institution that accepts the payment
- card scheme — the network that routes payment messages between issuer and acquirer.

Each card transaction triggers a flow of payment and fees between these participants (figure 10.3). When a customer makes a purchase, their card issuer (often a bank) pays the acquirer (again, often a 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 acquirer is charged an ‘interchange fee’ by the issuer. These fees are set by the card scheme. Interchange fees can be used to fund benefits offered to the customers, such as rewards points. Rewards programs can make up to a quarter of the overall costs of issuing credit cards (ABA 2015).

The acquirer generally recoups the costs of this interchange fee by charging a merchant service fee to the merchant. Interchange fees, and thus merchant service fees, are typically charged as a percentage of the transaction value or a flat rate per transaction. The merchant can then choose to absorb the cost, or recoup it by imposing a direct surcharge on the customer or charging higher prices for its products or services.

Figure 10.3 An illustrative example of a card system^a



^a The numbers in this example are for illustrative purposes only.

There are three distinct arrangements for card-based payments.

- Four-party system: the merchant, cardholder, issuer and acquirer. This arrangement includes the eftpos, MasterCard and Visa schemes. The four-party system is open for other institutions (such as banks) to enter and compete in issuing their own cards.
- 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). This arrangement includes American Express-issued cards and Diners Club. The three-party system has no competition within the brand, only competition with other brands. In the illustration below, the issuer, acquirer and card scheme are one and the same (RBA 2015g).

Debit and credit cards are bank-dominated and heavily concentrated

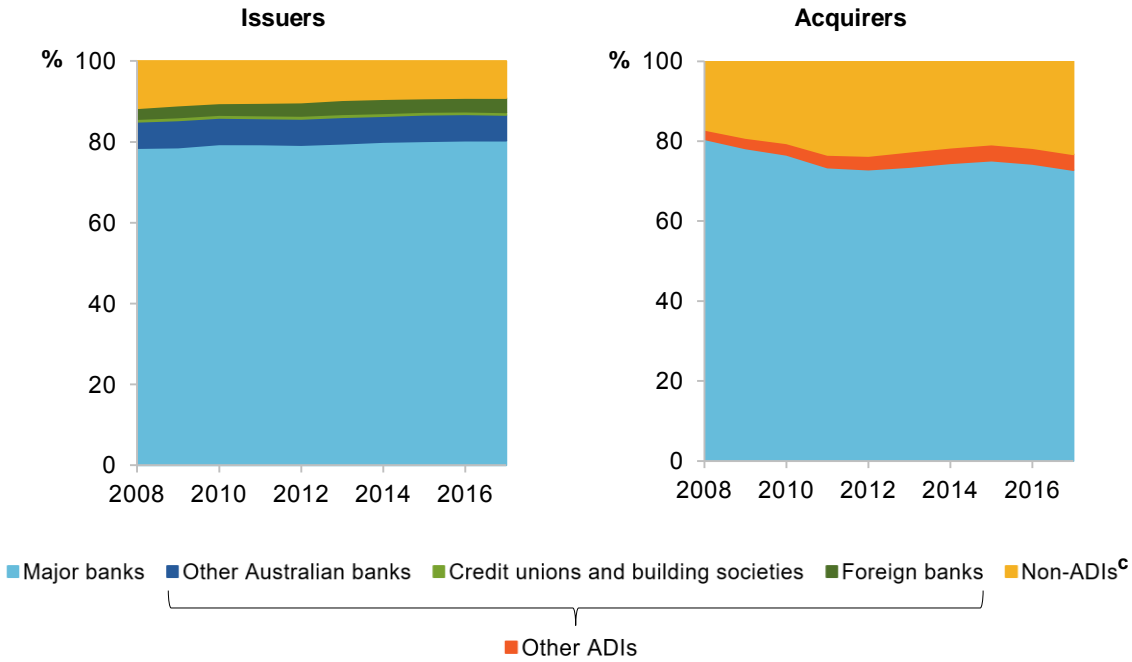
In Australia, the major banks are the main card issuers. In 2017, they provided over 70% of all debit and credit cards on issue in Australia and made up about 80% of the value of

payments (RBA, pers. comm., 3 October 2017; figure 10.4). The rest are provided by other ADIs and non-ADIs. Market shares have remained relatively static over the past decade.

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 10.4).

There has been strong growth in acquiring services provided by organisations that are not traditional ADIs, such as Cuscal, Tyro and Indue, as well as new acquirers to the Australian market, such as Adyen, First Data and Pin Payments.⁴⁹ For example, since entering the Australian card acquiring market in 2016, Square has signed up more than 60 000 SMEs to its merchant services (Redrup 2017). Some of the decline in market concentration is also partly attributed to growth in the market share of American Express (Amex) cards — which are directly acquired by Amex (RBA, sub. 29).

Figure 10.4 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 ended June 2008–2017. ^c Includes some ADIs whose primary business is payments.

Source: RBA (pers. comm., 3 October 2017).

⁴⁹ Cuscal, Tryo and Indue are all ADIs regulated by APRA, but their primary business is payments.

Australia’s 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 has risen to more than half of the debit card market (figure 10.5). This is largely a result of the strong uptake in contactless and online payments originally introduced by MasterCard and Visa (RBA, sub. 29).

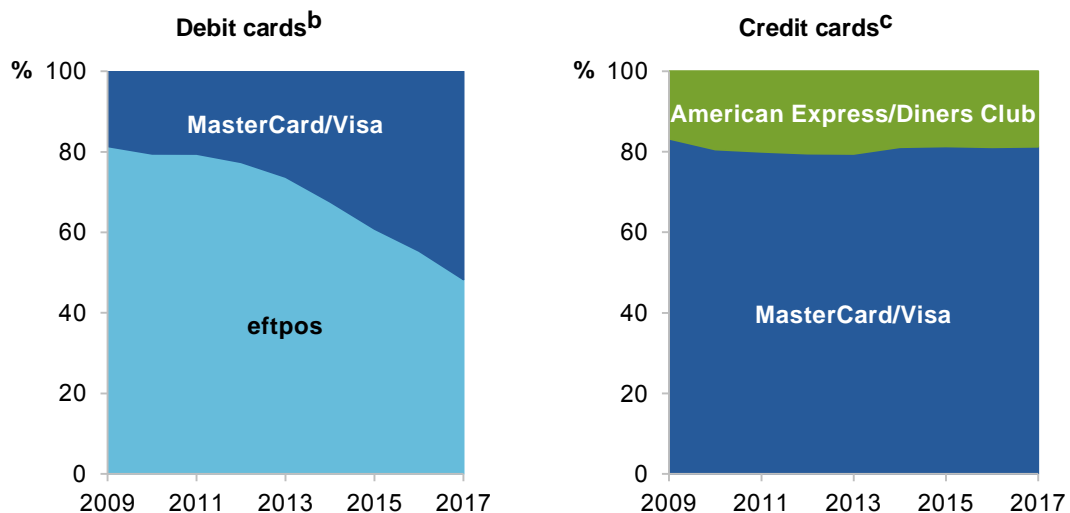
The market for credit card schemes is also dominated by MasterCard and Visa, which make up over 80% of credit card payments (figure 10.5). Amex and Diners Club make up most of the balance. These market shares have remained relatively static over the past decade.

Card schemes have invested heavily in growing their networks and are widely accepted by businesses throughout the country. This ubiquity is convenient for customers and merchants. Concentration in a few card schemes is characteristic of many payments markets because they have strong network effects. This gives established card schemes strong market power.

Consumers tend to only want to hold a card if there are many merchants that accept it, while merchants tend to only accept a brand of card as a means of payment if many potential customers hold it. (RBA, sub. 29, p. 33)

A high degree of concentration does not necessarily mean a lack of competition in payments (chapter 2). It is also necessary to assess the barriers to entry of new suppliers, as well as the incentives driving participants to compete.

Figure 10.5 Market shares of card schemes
By value of payments^a



^a Year end June (debit) and month end June (credit). ^b Debit card schemes uses publicly available market share data for 2013 and 2017 and links the two data points. ^c Credit card schemes include general purpose credit cards and charge cards, including personal and commercial cards.

Source: RBA (2017y, pers. comm., 23 January 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 new card network. This makes it difficult for a new card network to achieve the critical mass necessary for merchants to actively adopt their systems. Further, there are inherent advantages to incumbency. Merchants have little incentive to switch to, or adopt additional, card networks with relatively less customer reach. That said, entry of new card system providers is happening. Chinese credit and debit card system provider, UnionPay, is one of the largest card schemes worldwide and is gradually building merchant acceptance in Australia (RBA, sub. 29).

New entrants also face other barriers. Financial institutions often bundle cards with other products, such as debit cards bundled with transaction accounts or credit cards bundled with home loans. Product bundling makes it more difficult for a customer to assess the value of a single product in the bundle, and compare it to another provider (chapter 13). This can make it difficult for a customer to decide whether to switch to another provider or new entrant. Therefore, innovations which focus on helping users switch cards or unbundling cards from products might drive competition among card issuing institutions if they are designed to overcome the lack of transparency. In addition, many of these institutions have exclusivity arrangements with either Visa or MasterCard, making it difficult for new card schemes to grow their network.

New entrants face regulatory barriers to entry. Issuers of debit cards face the strictest barriers because they are linked to a customer's transaction account and must therefore be an ADI. On the other hand, issuing credit cards is relatively easy. In 2014, the Australian Government introduced reforms to reduce regulatory barriers to entry for institutions providing credit cards (ABA 2015). Institutions that issue credit cards are not required to be ADIs, but are subject to the responsible lending obligations under the *National Consumer Credit Protection Act 2009* (Cth). If a potential new card scheme becomes large enough, it can expect to face regulation by the PSB, such as interchange fee caps and access regimes. However, there is no set trigger point at which the PSB automatically regulates a new card scheme.

All new issuing and acquiring institutions must also comply with the particular card scheme's rules and standards for participation (APCA 2015a). These establish rules for operating, such as security and transaction standards. Visa, MasterCard, Amex and Diners Club administer their own rules and standards for participation. The PSB (2017ac) imposed an access regime on Visa and MasterCard to prevent these schemes from unduly restricting participation. However, three-party card schemes, such as Amex and Diners Club are not regulated in the same way because they act as both the customer and merchant's financial institution.

The rules and standards (such as the security of PIN handling) for Australia's domestic debit card scheme, eftpos, are developed by the industry body, Australian Payments Network (AusPayNet). That AusPayNet, made up of industry participants, is responsible for

determining the eligibility of new financial institutions to join the eftpos scheme, inevitably raises the potential for incumbents to block or create barriers to new competitors.

Two possibly linked observations suggest possible competition issues in payments.

First, relatively new acquirer Square has not been approved by AusPayNet to accept eftpos transactions because of stated security concerns, since Square captures PINs through smartphones rather than a physical keypad (Eyers 2017; Gluyas 2016; Gray 2017). To date, Square is capable of accepting cards from Visa, MasterCard and American Express, but remains unable to accept eftpos transactions (Square 2018). More generally, incumbents including the major banks and the Visa and MasterCard networks can act as gatekeepers for cards-based innovations.

Second, despite being highly price-competitive (Stewart et al. 2014; section 10.2), eftpos is losing market share (figure 10.5). This suggests that competition between providers is stymied by other forces. To the extent that price matters (and it normally does), consumers are likely to be worse off under the current market trend but have no easy way of being aware of this or of acting to promote lower-cost payments.

The major banks dominate bank transfers

The market for bank transfers — the transfer of funds between deposit accounts — 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 10.6). 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 also regulatory barriers to entry for bank transfers. In order to make bank transfers, a provider generally must be an ADI and settle payments using their own Exchange Settlement Account held with the RBA, or through an agent, such as Cuscal (RBA 2012a, 2014b).

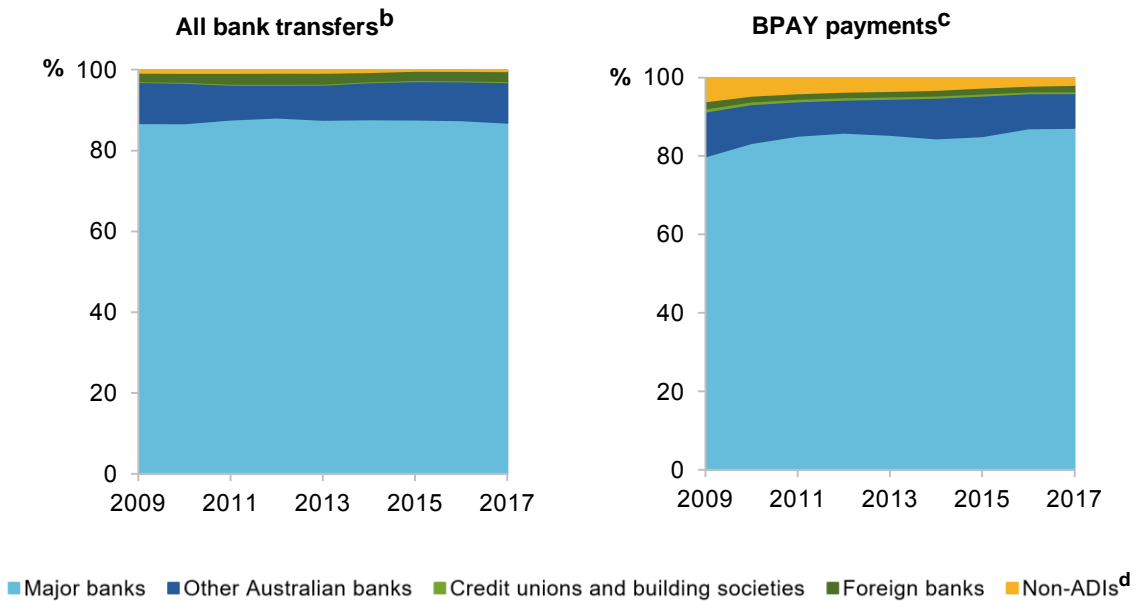
A small proportion of bank transfers are bill payments made through the BPAY system. Over the past decade, just over 10% of the number and about 3% of the value of bank transfers were made through BPAY (RBA pers. comm., 3 October 2017). Over 150 financial institutions are members of BPAY, covering 95% 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 10.6).

If new members want to join the BPAY scheme, they are required to comply with BPAY scheme rules and operating procedures, as determined by BPAY Pty Ltd (2017b). There is no access regime imposed on BPAY to prevent the scheme from unduly restricting new

members. However, the Commission is not aware of any banks that have been refused membership.

Figure 10.6 Market shares of bank transfers and BPAY payments

By value of payments^a



^a Year ended June. ^b Made up of total debit and credit transfers, including BPAY transactions. ^c Includes internet and telephone initiated BPAY payments. ^d Includes some ADIs whose primary business is payments.

Source: RBA (pers. comm., 3 October 2017).

Further, BPAY (2017b) members are required to pay fees, including processing costs, membership fees and a wholesale fee called the ‘Capture Reimbursement Fee’ (CRF). The CRF is equivalent to an interchange fee to be paid by the biller’s financial institution to the sender’s institution. These fees are generally recouped through merchant service fees.

In 2005, and again in 2007, the PSB examined the case for regulating BPAY’s CRF (RBA 2005, 2007). The PSB expected that regulating the CRF would reduce the merchant service fees associated with BPAY, but lead to an increase in the price charged to consumers. Therefore, no regulation was ultimately imposed.

Innovations are changing the way people interact with their money

Consumers are embracing payments innovation around the world (box 10.1). Innovation is a major driver of the migration towards electronic payments (WEF 2017a).

Digital wallets

Australians are rapidly adopting online payments — the value of online payments rose from 13% of all retail payments in 2007 to 39% in 2016 (Doyle et al. 2017).

In recent years, digital wallets have burst onto the payments landscape. These wallets are digital platforms (such as apps) on a mobile phone that can provide some of the same functions as a physical wallet. This includes storing details of people’s various payment methods so that they can readily access them to make payments, typically debit cards, credit cards and bank transfer details. In 2016, about 20% of online payments were made using a mobile phone, up from 6% in 2013 (Doyle et al. 2017). Digital wallets complement existing payment methods, such as card schemes or bank transfers, by providing another way to access them. Digital wallets have been a major driver of online and mobile payments globally (box 10.1).

Box 10.1 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 first launched in 2004 as an internet-based payment system for the Chinese e-commerce platform, Alibaba. Its primary product, Alipay Wallet, is a digital wallet, like PayPal, that can either make payments using credit cards, bank accounts or store value in the same way as a purchased payment facility. In 2009, Alipay developed a mobile app so its service could be used on smart phones. People can make payments using Alipay Wallet 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).

Kenya

In 2007, Kenya’s largest telco operator 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).

(continued next page)

Box 10.1 (continued)**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 (Ahlfors 2015; Brunet 2017).

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 and has about 10 million users.

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. However, these aren't all available in Australia. These organisations use their established networks of users to compete in the payments system. For example, Facebook introduced the ability for its users in the US, Britain and France to make free payments between each other, using a linked Visa or MasterCard debit card (Mason 2017). There are plans for Facebook to launch this service in Australia in 2018. In 2017, Apple made Apple Pay Cash available in the US, giving its users the ability to make payments using stored value (Cipriani 2017).

Incumbent financial institutions are becoming more innovative in the payments system. For example, the New Payments Platform gives incumbent financial institutions the ability to offer instant bank transfers (section 10.3). Further, in 2017, CBA, NAB and Westpac announced that they would soon launch a new smartphone application, 'beem', that lets anyone with a scheme debit card make payments to other beem users (CBA 2017c).

Many innovations have also focused on integrating payments into products or services.

- Many e-commerce platforms partner with payment service providers to offer integrated payments. For example, in 2017, Gumtree partnered with fintech Assembly Payments, which holds payments in suspension and releases them once the service is satisfactorily completed (Smith 2017).

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- Some 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 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 using an existing payment method.
 - Social media platforms, such as Facebook and WeChat, are also integrating payments into their services.
 - Innovations are also improving the business experience with payments. For example, Tyro (2017a) offers innovative merchant acquiring services, such as the ability for a business to use Tyro's payment acceptance facilities, while banking with a separate financial institution.

Many innovations have focused on improving 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 2013c, 2016d). 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 a high rate of smartphone penetration in Australia — over 80% of Australians own 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 (Deloitte 2016b). That said, the number of mobile phone payments is expected to rise in the coming years as people grow more comfortable with the technology.

Further, many people don't 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 hardware on Apple devices to make mobile payments, primarily from credit or debit cards. However, not all Apple users can take advantage of its digital wallet, Apple Pay. 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 Near-Field Communication controller in Apple iPhone devices in order to provide their own digital wallets. The ACCC ultimately 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. Several financial institutions, such as ANZ, Macquarie and American Express, have negotiated deals with Apple and now offer customers the ability to use Apple Pay (Gizmodo 2017).

The rise of purchased payment facilities can threaten incumbents ...

Some digital wallets, such as PayPal, have also developed their own purchased payment facilities (PPF) which act as a competitor to traditional payment methods. PPFs compete directly with debit cards, credit cards and traditional bank transfers.

A PPF is similar to a deposit at a bank, with some minor differences. The PPF can be loaded up with funds from an existing bank account or received from other users of the PPF. The funds are then stored in the PPF, like deposits, and can be used to make payments to other users (in some cases for free) or withdrawn from the system. 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). Therefore, PPFs do not require an Exchange Settlement Account held with the RBA.

In contrast, most other payment methods in Australia (such as cards, bank transfers and cheques) operate an open-loop system which can exchange value between different financial institutions. While the closed-loop nature of the system can limit its growth — users must be willing to join the system — it does make it easier to innovate.

This type of system is much simpler to operate and adapt because there is no need for cooperation across different entities. Of course, unless the system is very widely used and users are prepared to hold their savings in the system (equivalent to all Australians banking with one financial institution), funds need to be transferred in and out of the system to be readily usable. (RBA 2014a, p. 217)

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 or Apple Pay Cash as an alternative to using a linked credit card or bank account. Further, with the introduction of near real-time payments under the New Payments Platform, it will be faster and more seamless for people to reload their PPF from a bank account.

... but more flexible regulations could encourage new entrants

PPFs face some complex and potentially stunting regulation which can act as a barrier to 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*). Given their deposit-like nature, APRA regulates these PPFs as limited ADIs. This means they are able to take deposits, but not permitted to pay interest on customers' stored balances. APRA requires that PPFs meet prudential standards in order to strengthen financial

stability. PPFs have simpler capital requirements than traditional ADIs, but stricter liquidity requirements.

PPFs must hold high-quality liquid assets that are of equal value to their stored-value liabilities, while standard ADIs have lower liquidity requirements. (Murray et al. 2014a, p. 165)

And at the same time, these PPFs must meet many of the same prudential standards as traditional ADIs, such as outsourcing and governance standards, despite having a 100% liquidity requirement. These standards impose a significant compliance cost on PPFs.

If PPFs are not widely available or not redeemable for Australian currency, they fall under the jurisdiction of the PSB. However, 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 does not exceed \$10 million, 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, are redeemable on demand. However, because they are not redeemable for *Australian* currency, — they require a Chinese bank account to redeem stored value (box 10.1) — they do not fall under APRA’s prudential regulation. These PPFs would fall under PSB regulation. However, the PSB has not regulated them, likely because they do not make up a sizeable portion of payments in Australia.

The Murray Financial System Inquiry (Murray FSI) suggested that APRA’s regulatory regime for PPFs 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 traditional ADIs, providing an incentive to limit their growth to avoid entering APRA’s PPF regime. The Murray FSI proposed that APRA develop a two-tier prudential payments regime for PPFs, to replace the current single-tier regime.

- 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 manage their compliance costs and prudential requirements better. 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 customers hold more than \$1000.

In its response, the Australian Government (2015) agreed with a clearer graduated regulatory regime in principle and stated that APRA, ASIC and the RBA will review the framework for payments system regulation and develop clear guidance. In 2015, the Commission also

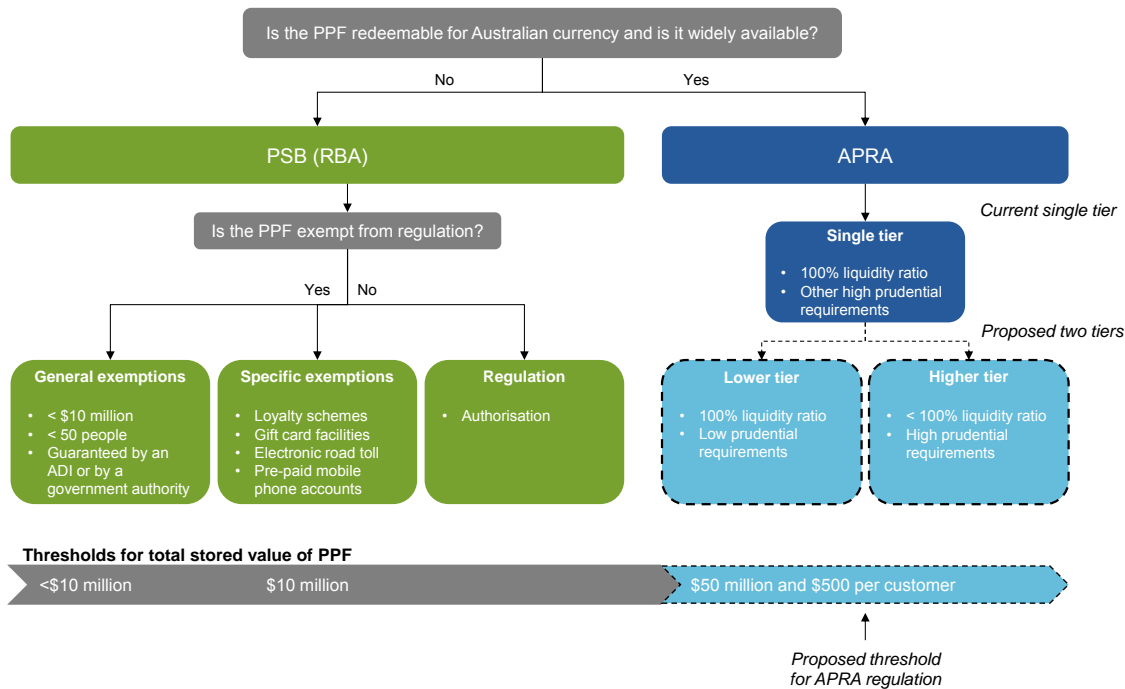
broadly supported changes to prudential regulation along the lines recommended by the Murray FSI (PC 2015a). In its response, the Australian Government again committed to a review of the framework for payments system regulation (The Treasury 2017a).

However, there has been no progress on these reforms to date. While APRA (2017j) began consultations on a new phased approach to licensing ADIs, this does not involve changing the prudential regime for PPFs.

The Commission considers that a tiered regime for APRA regulation of PPFs is more likely to encourage potential new entrants and reduce barriers for small PPFs to grow. But the most important reform may be to give PPFs the chance to prove themselves while keeping at-risk funds relatively low. While the Murray FSI recommended freeing-up entities that stored value greater than \$50 million and individual customer deposits up to a maximum of \$1000, a simpler way to at least see deregulation started may be to reduce the individual customer threshold — for example to \$500 per customer — just to get a start on innovative options, while reducing the risk.

Therefore, under this revised approach, PPFs with stored value below \$10 million remain exempt from both PSB and APRA regulation (figure 10.7). PPFs with stored value between \$10 million to \$50 million must be regulated by the PSB or otherwise specifically 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 10.7 **Reduced regulatory barriers for purchased payment facilities**



APRA has many other tasks on its plate aimed at improving regulation (and will have more if this inquiry is successful). Therefore, a team similar to that which was recently tasked to design policy in Open Banking could take on the task of designing, for APRA’s approval, the creation of a tiered structure for PPFs, including one tier that does not attract prudential regulation.

DRAFT RECOMMENDATION 10.1 REVIEW REGULATION OF PURCHASED PAYMENT FACILITIES

The Australian Prudential Regulation Authority should, either itself or outsourced elsewhere, design a tiered prudential regime for Purchased Payment Facilities to reduce barriers to growth.

- Purchased Payment Facilities with total stored value below \$50 million and individual holdings of no more than \$500 would not face prudential regulation.
- The lower prudential tier would maintain the current 100% liquidity ratio requirement but reduce other prudential requirements to lower compliance costs.
- The higher prudential tier would reduce liquidity requirements but strengthen other prudential requirements.

These reforms should be implemented no later than mid-2019.

Amending the ePayments Code could promote healthy competition

Innovative products and services can encourage competition in the payments system. Regulators have set up consumer protections so that competition does not harm consumers.

In particular, ASIC (2017n) administers the ePayments Code — a set of requirements for payment providers to follow when making electronic payments. 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 licensed subscribers to have internal and external dispute resolution in place.

The code is currently voluntary, though most financial institutions that make electronic payments have subscribed (ASIC 2017n). The Australian Government has committed to making it mandatory, to act as minimum standards for consumer protection (Australian Government 2015). However, there has been no progress to date.

The Commission considers that making the code mandatory for all entities involved in electronic payments may create an unnecessary barrier to entry for new entities. A less restrictive method may be to make the code mandatory for any organisation that *sends or receives* electronic payments. Therefore, entities that simply 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 only rely on read-only access to bank account information.

DRAFT RECOMMENDATION 10.2 MAKING THE EPAYMENTS CODE MANDATORY

The Australian Securities and Investments Commission should amend the ePayments Code to make subscription to the code mandatory for any entity that intends to send or receive electronic payments.

Typically, if a consumer wants to allow a third-party service, such as an account aggregator, to access their financial data, they presently need to give the third party their passcode. However, unless the consumer's financial institution expressly or implicitly endorses the third party, the consumer is liable for any losses from unauthorised transactions. This has led to uncertainty among consumers about whether they are protected. ASIC is aware of this issue, but it has not yet made any changes to 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 2016m, p. 3)

In its submission, CHOICE suggested that this liability rule creates a barrier for new third-party service 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 incumbent 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 using the passcode is at risk of a data breach. The security of the passcode is only as strong as its weakest link. 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 Code institution) has refused to endorse a third party for security or competition reasons. In some cases it may be both. However, the Commission considers that incumbents should not be in a position to create barriers for new competitors. There may be several ways to achieve a more competitive outcome.

First, Open Banking reforms now under active consideration by the Treasurer could make the need for such activity redundant. Much will depend on the timing for the introduction of these reforms, which the Commission understands may address the security needs of data transfer between institutions at a consumer's direction and without the need for a consumer to give out their passcode.

If Open Banking is seriously delayed, this problem will need a stronger solution than at present. One option is that liability could remain with the subscriber, as long as third parties meet minimum security standards. For example, CHOICE (sub. 42) proposed a new form of accreditation for third parties that meet adequate security standards. The ePayments Code would then be amended to allow accredited third parties access to a consumer's pass code, without the consumer being liable for losses from unauthorised transactions. FinTech Australia (2017) suggested that the change to the code would need to see it made mandatory, otherwise institutions may opt out.

Another option would balance the liability between the subscriber and the third party under specific circumstances. For example, if a customer gives a third party access to their finances, the code institution would be obliged to give the third party a new 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 is attributable to the customer or the third party.

Thus, the code would be amended such that the third party would take on the liability of unauthorised transactions that use their unique access details. In this case, it would be necessary for the third party to be subject to a dispute resolution scheme, such as the Australian Financial Complaints Authority currently under consideration in parliament, if they are not a code institution. Shared liability for unauthorised transactions is similar to new payment regulations — the Payment Service Directive 2 (PSD2) — that are being implemented in Europe (Payments UK 2016).

The Commission considers there is merit in ASIC more clearly defining the liability provisions of the ePayments Code for unauthorised transactions, including participation in financial dispute resolution schemes, and is interested in stakeholder views on different approaches available. The Commission is also seeking views on whether Open Banking policy could be relied upon as a better alternative.

INFORMATION REQUEST 10.1 HOW SHOULD LIABILITY FOR UNAUTHORISED TRANSACTIONS BE SHARED?

What would be the costs and benefits of different ways that liability for unauthorised transactions under the ePayments Code may be shared between financial institutions and third parties, including participation in financial dispute resolution schemes? This includes the feasibility of having Code subscribers provide unique access details to third parties approved by customers.

We are also interested in stakeholder views about whether the new Open Banking policy (once implemented) could be relied upon as a better alternative for secure, shared access.

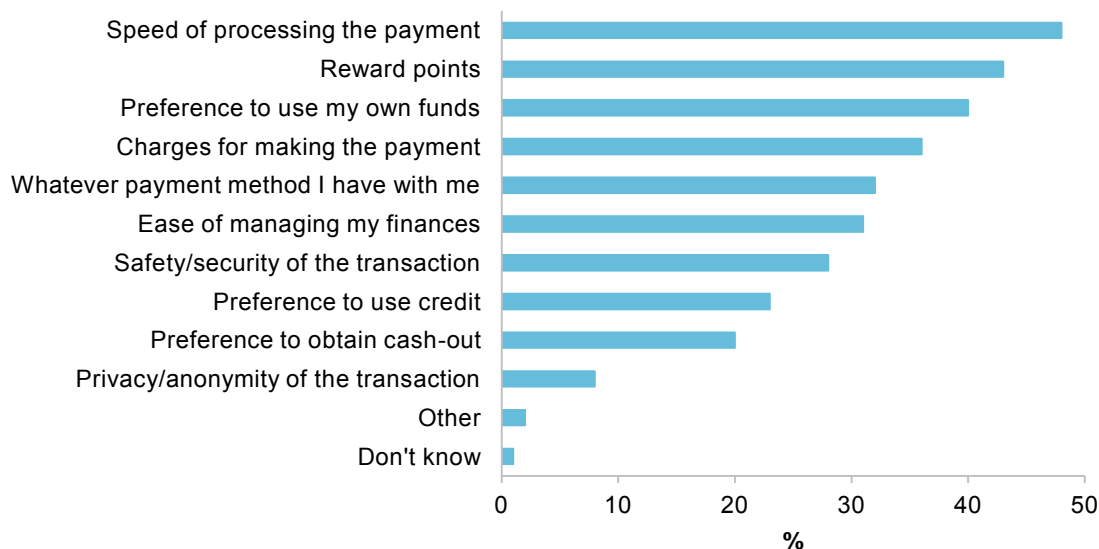
10.2 Empowering users can promote competition

Consumers choose how to pay given the costs and benefits they face

Consumers' and businesses' use of different payment methods have evolved over time as their preferences change and technology has developed. Each payment method offers different costs and benefits to consumers and merchants, including availability, convenience, security, cost and rewards. For example, credit cards give people the opportunity to buy now and pay later as well as providing security benefits relative to cash, but this facility 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 10.8). These factors are likely to differ somewhat if a consumer instead makes a payment online or over the phone. Similarly for businesses, there are a variety of factors influencing their choice of financial institution, such as dependability, speed of settlement, pricing and customer service (McKinsey 2013).

Figure 10.8 Factors influencing consumers' choice of payment method^a



^a Payment at the point of sale, in person. Excludes payments over \$9999, transfers to family and friends and automatic payments. Respondents could choose more than one factor.

Source: RBA (2016d).

One of the most important factors driving consumers' choice of payment method is cost. In principle, if people face the full cost of payment, this provides 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 10.2). If enough consumers were similarly motivated to switch, this would put pressure on payment system providers to compete by lowering the cost of processing payments. The RBA (2016c, 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. The outcome is that merchants are able to set prices for goods and services lower than would be the case if surcharging was prohibited, and the extent to which users of lower-cost payment methods subsidise users of higher-cost methods is reduced.

Box 10.2 The impact of cost on people's payment choices

If they are confronted with the cost of their chosen payment method, customers are more likely to choose lower-cost payment methods.

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)

In 2009, the Reserve Bank of Australia (RBA) reformed ATM fees to make them more transparent to customers. Prior to the reforms, customers who withdrew cash from a 'foreign' ATM only saw the fee on their subsequent monthly statement. The new reforms require ATM owners who wish to charge customers for withdrawals do so directly, with the 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 increased 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 2013, a survey found that when respondents were asked to pay a credit card surcharge or transaction fee, about half of respondents chose to use an alternative fee-free payment method (Commonwealth Consumer Affairs Advisory Council 2013). Further, if there were no fee-free alternatives, about one quarter of respondents chose to cancel the purchase or find another supplier.

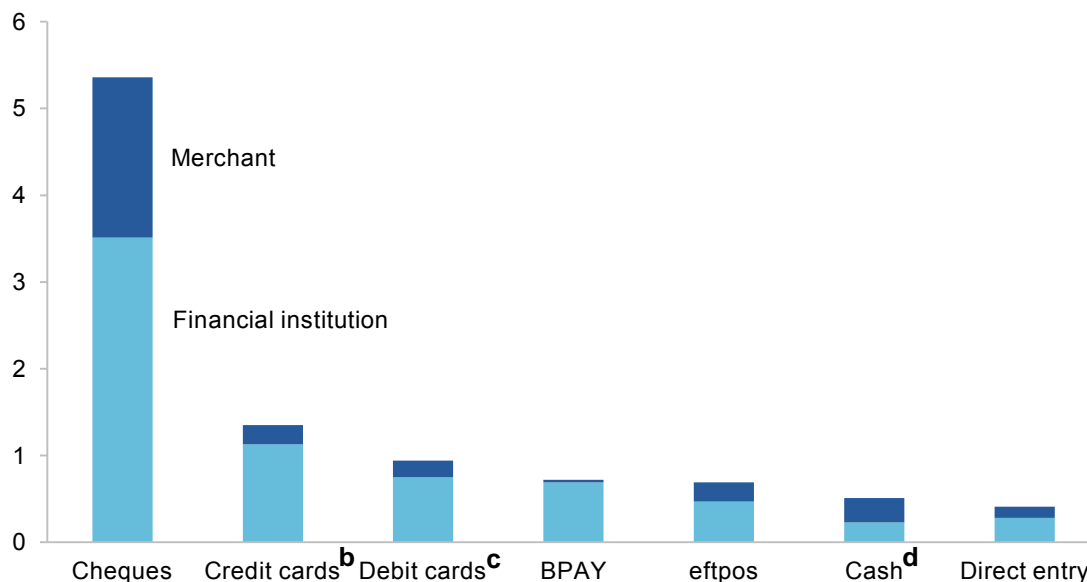
In 2015, the RBA estimated the willingness to pay surcharges to use debit and credit cards, rather than cash. Using data from its 2013 consumer payments survey, the study estimated that about 60% of consumers are unwilling to pay a 0.1% surcharge. Further, the study found that on average, consumers have a higher willingness to pay for the use of credit cards than debit cards, likely because there is additional value placed on rewards and interest-free periods associated with credit cards.

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 2014, the RBA estimated the 'underlying resource cost' for each payment method (figure 10.9). This includes overheads, such as the cost of infrastructure supporting payment methods, and direct costs. There is a vast difference in the costs of each payment method.

The RBA (2014) also estimated that the *per transaction* cost of each payment method fell between 2006 and 2013. However, the overall reduction in costs across the system was limited because of a change in the mix of payments, from cash (less expensive) to cards (relatively more expensive).

Figure 10.9 Underlying resource cost for each payment method^a
 \$ per average-sized transaction, 2013



^a The underlying resource cost is made up of the direct costs to merchants and both direct and overhead costs to financial institutions (issuers and acquirers) for processing an average-sized transaction. ^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 for cash transactions include costs incurred by the public sector.

Source: Stewart et al (2014).

But people rarely directly face the costs of their card payments ...

While cost can 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.

Today, people do not always face the cost of their chosen payment method. This distorts the customer's choice when deciding which payment method to use. For example, many merchants and financial institutions do not charge customers for making bank transfers. These payments tend to have the lowest resource costs, making the distortion relatively small. On the other hand, the number of transactions and cost per transaction is greater in the card system, making the distortion significantly larger.

Cards, particularly credit cards, have a relatively high cost per transaction. Yet, consumers choose to use this payment method more often than any other method and their use continues to grow (figure 10.2). Some of this growth is likely attributable to the benefits provided by reward schemes, interest free periods, security and a preference to use credit. For example, participation in a reward scheme and access to an interest-free period both tend to increase credit card use (Simon, Smith and West 2010). Therefore, in the absence of any direct costs, people are more likely to opt for this payment method.

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)

Customers may face the costs of processing card payments directly or indirectly. Surcharging is a direct way of passing the cost onto the customer. However, the RBA estimated that just 3% of all card payments attracted a surcharge in 2016 (Doyle et al. 2017).

In most cases, customers pay the cost indirectly — either through charges from the issuing institution, such as annual fees or interest charges, or higher overall product prices charged by the merchant. But these costs are generally paid in a lump sum, away from the point of sale (such as foreign currency conversion fees on overseas purchases⁵⁰), or are otherwise hidden from view. This dilutes consumers' incentives to choose the lowest-cost payment method for each transaction.

Further, if a merchant passes on the costs of payment through higher product prices, there is an inherent cross-subsidisation from customers who use low-cost payment methods, such as debit cards, to those who use relatively higher cost methods, such as credit cards.

... leaving businesses to pick up the tab

Most merchants are compelled to accept the widely used card schemes (MasterCard and Visa) because if they don't, they fear losing business to competitors who do (RBA 2016c). Further, many merchants consider they are unable to surcharge customers due to the risk of losing customers to competitors who do not surcharge (Murray et al. 2014a).

The other option for merchants is to negotiate lower merchant service fees or switch to a lower cost financial institution. Merchants that are small or subject to 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. That said, the introduction of new competing institutions such as Tyro can strengthen these merchants' negotiating power.

If merchants lack market power, the cost of processing transactions and benefits to cardholders can be more readily passed on to them. Indeed, 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). However, it is the consumer who chooses the actual payment method to use at the time a transaction takes place.

⁵⁰ Many cards offered by financial institutions charge foreign currency conversion fees as a percentage of each overseas purchase. Consumers generally don't see these fees until after they make the purchase and check their card statement. However, some institutions offer specialised prepaid, debit or credit cards that do not charge a foreign currency conversion fee per transaction (Cabral 2018; Liu 2018).

This creates an incentive for the customer’s financial institution and card schemes to compete on the value to customers — such as rewards and other benefits — rather than the cost to merchants. For example, interchange (and therefore merchant) fees vary depending on the benefits associated with credit cards — a customer who pays with a premium credit card may cost the merchant a higher fee than a customer who pays with a basic card. However, by using the premium card, the customer receives more ‘loyalty points’ or other rewards compared to using the basic card.

On the other hand, large (and some mid-sized) merchants, that make many transactions, 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 level of transaction volumes processed, with large supermarket chains receiving lower ‘strategic merchant fees’. Further, merchants that face limited competition, 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 2015g).

Options to promote healthy competition that reduces payment costs

Healthier competition can come from regulation to improve market incentives and outcomes or empowering merchants and customers to apply pressure on financial institutions to compete on costs.

The regulatory approach acts to limit costs and align incentives

The PSB introduced regulations to limit costs and better align incentives in the card system. This includes requiring card schemes to allow customer surcharging and imposing interchange fee caps.

From 2003, the RBA (2016c) required card schemes to remove restrictions on merchants that prevented surcharges on credit card payments. Following the Murray FSI, the PSB developed a new standard to limit excessive surcharges on customers using lower-cost payment methods, with the ACCC responsible for enforcing the standard (appendix B).

Interchange fees typically make up the majority of merchant service fees. For example, 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.

Since 2003, the PSB (2015g) has limited interchange fees using a weighted-average benchmark. From 2016, the PSB (2016c) set a ceiling on individual interchange rates at 0.80% of the transaction value for credit cards and 15 cents (or 0.20%) for debit cards. The weighted-average benchmark for interchange fees is currently maintained at 0.50% for credit

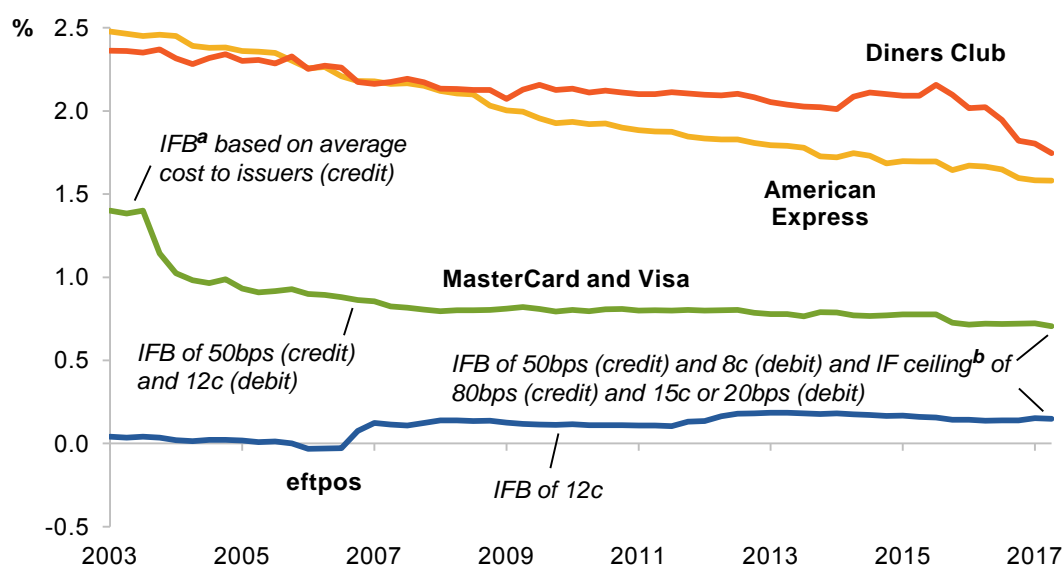
cards, but was reduced for debit cards in 2016 from 12 to 8 cents per transaction. This provides flexibility for card schemes, without being overly restrictive.

The PSB caps on interchange fees have coincided with (and possibly contributed to) a reduction in merchant service fees over time (figure 10.10).

Since the Bank started regulating MasterCard and Visa interchange fees in the early 2000s, average (credit and debit) merchant service fees for these networks have roughly halved, to around 70 basis points. (RBA, sub. 29, p. 35)

Figure 10.10 **Average merchant service fees**

% of transaction values acquired



^a IFB is interchange fee benchmark (generally a weighted average). ^b IF ceiling is a cap on the individual interchange rates.

Source: RBA (2006, 2015g, 2016c, pers. comm., 3 October 2017).

The extent to which fees in another part of the system have increased to compensate is not known. But it is apparent that the recent changes and limits to interchange fee regulation have likely reduced the value of credit card rewards programs (Emmerton 2017; RBA 2017a). This is mainly because rewards programs can make up to a quarter of the overall costs of issuing credit cards (ABA 2015), which are in turn funded from interchange fees.

One aspect of the PSB's interchange fee regulation involved capturing the companion-card system, which previously circumvented interchange fee regulation. From 2016, the PSB has regulated issuer fees on companion cards in the same way as four-party credit card systems (MasterCard and Visa). Consequently, some banks such as ANZ, NAB and Westpac, scrapped their Amex companion cards in 2017 (McMullen 2017). 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). Further, Westpac has formed a new partnership with Amex for them to issue two new high reward cards to Westpac customers and thus bypass the new PSB interchange fee regulation (McLachlan 2017).

The PSB's interchange fee caps appear to have improved competitive outcomes in card payments. First, they have contributed to the reduction in merchant service fees over time. Second, they have reduced the incentive for people to use credit cards for their rewards programs, thus making them more substitutable with lower-cost payment options, such as debit cards.

The case for interchange fees is not strong. The actual cost of an additional transaction on a card network is negligible. Indeed, interchange fees for eftpos transactions were close to zero or even negative in the 2000s (figure 10.10). 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). Domestic debit card schemes in other countries, such as Canada and New Zealand have set interchange fees to zero (FRB of Kansas City 2017).

Card systems have a range of fixed costs but these can be recovered through both fixed customer and merchant fees rather than a transaction-based charge. Continued regulation of the level and range of the interchange fee is likely to lead to further regulatory gaming, as was observed with the companion card schemes.

The PSB should ban card payment interchange fees altogether. Any remaining fees on card payments should be directly related to the costs incurred in operating the card payment system and be justified to the PSB. All fees should be published and made explicit to consumers and merchants.

DRAFT RECOMMENDATION 10.3 BAN CARD INTERCHANGE FEES

The Payments System Board should introduce a ban on card payment interchange fees by mid-2019.

Any remaining fees should be directly related to the costs of operating the system. Such fees should be made transparent and published.

How to improve access to lower-cost payment methods

Innovations can encourage consumers to use lower-cost payment methods if they are more easily substitutable for higher-cost methods. For example, in 2017, ANZ began offering eftpos (2017a, 2017b) debit cards that can be linked to Apple Pay and Android Pay. This allows customers to make contactless mobile payments using the lower-cost eftpos system, rather than the relatively higher-cost international card schemes. Further, new features made available by the New Payments Platform may readily enable consumers to switch some payments from their credit or debit cards to lower-cost bank transfers (section 10.3).

Alternatively, if consumers are directly confronted with the cost of making payments, there would be an incentive for them to switch to lower-cost payment methods. For example, the Australian Centre for Financial Studies proposed an alternative approach to regulation whereby card transaction fees are directly charged to consumers (King and Maddock 2017). In a practical sense, when a customer initiates a payment, they would be charged a fee directly by their financial institution. The customer could then choose to accept or decline the payment method and move to an alternative. This approach mirrors the way in which, prior to 2017, customers withdrawing cash at ‘foreign’ ATMs were generally charged a fee directly and given the option to continue or abort the transaction.

This proposal is likely to be unpopular among consumers who would be slowed in performing their transactions and would now see a cost that was previously hidden. Further, there is scope for consumers to end up disregarding these upfront charges at the time and make complaints or disputes after the fact — similar to the way in which consumers may disregard a product’s lengthy terms and conditions in order to use it straight away (chapter 12).

However, this solution would remove the cross-subsidisation from consumers who use low-cost payment methods to those who earn rewards for using relatively high-cost credit cards. It would also create strong incentives for financial institutions to compete to reduce the fees faced by customers.

This may lead to financial institutions abandoning transaction fees altogether, just as they removed foreign ATM fees in 2017 (Mather 2017). Financial institutions might choose instead to recoup the costs of these payment systems through fixed charges, such as annual card fees. Finally, this proposal could simplify card payments regulation, by removing the need for customer surcharging and interchange fee regulations.

Least-cost transaction routing can lower merchant costs

Regulations could be aimed at supporting merchants to negotiate better deals or switch to lower-cost financial institutions. This could be done by lowering barriers to merchant switching, encouraging customer surcharging and putting pressure on financial institutions to default to lower-cost payment methods.

The introduction of a Comprehensive Consumer Right, as recommended in the Commission’s Data Availability and Use report (PC 2017c), would give merchants greater market power in the payments system. These reforms would allow small merchants (and consumers more broadly) to access data that financial institutions hold about their transactions, and direct the institutions to send it to others (chapter 13). For example, merchants could give third parties access to their business transactions to help them find a better deal on merchant services. This would put more pressure on financial institutions to compete for merchants, by lowering merchant service fees or increasing the value of merchants services.

Merchants may also prefer that their financial institution route dual-network debit card payments to the lowest-cost option by default. This is commonly available overseas (box 10.3) and it is perhaps a reflection of poor competitive conditions in the Australian financial system that Australian providers have been lax in not pursuing this option.

Many financial institutions issue dual-network debit cards, which provide point-of-sale functionality from two card schemes — eftpos and one of either MasterCard or Visa. In 2015, about two thirds of the 32 million debit-only cards on issue were dual-network cards (RBA 2016a).

If a customer makes a ‘contact’ transaction (by inserting the card and inputting a PIN) using a dual-network debit card, it is up to the customer to choose whether the transaction is routed through eftpos (if they select CHQ or SAV) or one of either Visa or MasterCard (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 from the past situation in which international card schemes were the only networks that offered contactless transactions, so all contactless debit transactions were automatically routed through their networks.

With contactless transactions, the debit card issuer determines the default route (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 (2017b) claimed that the Visa and MasterCard schemes instead mandated that issuers (as noted earlier, mostly banks) use their network by default.

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 (figure 10.10). 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 Australian Retailers Association (2017) estimated that this can increase overall costs by \$290 million per year.

In 2015, eftpos (2016) introduced contactless functionality on most debit cards and terminals. Sending contactless debit card transactions through the eftpos system can be achieved by switching off the credit button on the payment terminal when a debit card is presented. But the Australian Retailers Association indicate that acquirers (again, mostly banks) appear unable or unwilling to make such 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 [Australian Retailers Association] 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)

Such decisions appear to demonstrate substantial market power on the part of the institution. This behaviour could be expected if acquiring institutions receive higher revenue per debit card transaction if they are processed through Visa or MasterCard, rather than eftpos. Or if the issuing arm of the same institution prevents least-cost routing for the same reason.

That said, routing all transactions through the eftpos network may not be a merchant's only option. Where the merchant service fee paid on eftpos (fixed fee) is not lower than Visa or MasterCard (variable fee) — for very small transactions (Richards 2017) — merchants could still minimise the total cost of service fees, as is possible in some other countries (box 10.3). All this would require is readily available technology offered without restriction in Australia to dynamically route each transaction through the lowest cost network *by default*.

Box 10.3 **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. Customers 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.

China — Dual network cards to be banned (announced November 2016).

Malaysia — Merchants have first priority in deciding which payment card network a transaction is to be processed by. Cardholders have second priority.

Source: APCA (2017); Bank Negara Malaysia (2014); First Data (2011); Groenfeldt (2017).

The RBA (sub. 29) stated that some acquirers are considering providing least-cost routing to merchants. In October 2017, ANZ stated that it would allow any merchant of its acquiring business to change the default route for its transactions (HoRSCE 2017a).

This simple adjustment could lead to a significant reduction in merchant service fees. The RBA (2017aa) has strongly supported calls for acquirers to provide merchants with least-cost routing. It has indicated that it is likely to impose regulation to require this, if (as recommended by the parliamentary inquiry (HoRSCE 2017c)) banks do not voluntarily give merchants this ability by April 2018.

... the Bank expects that by early in 2018 there will be concrete indications that a critical mass of acquirers are moving to provide least-cost routing and that the international schemes are not attempting to prevent this. However, if this expectation is not met, I expect that the Payments System Board will consider consulting on a regulatory solution that deals with all the relevant considerations. (Richards 2017, p. 9)

We consider that ultimately whichever party faces the cost of making the payment — the consumer or the merchant — should be given the ability to determine 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 payment, and therefore should be able to set their preferred default route. Dual-network card issuers, acquirers or schemes should not be able to prevent merchants (or their acquirers) from setting the default route. This system has similarities to that currently in place in Europe, the US and Malaysia (box 10.3). This could potentially be implemented by the PSB setting a standard that a scheme, nor any of its participants, can prohibit or deter a merchant from setting the default route. It is important to note that the *default* route does not restrict consumers from actively selecting an alternative network at the point of sale.

DRAFT RECOMMENDATION 10.4 MERCHANT CHOICE OF DEFAULT NETWORK ROUTING

Merchants should be given the ability to choose the default network to route contactless transactions for dual-network cards. As the technology is readily available, this option should be offered from 1 January 2019 at the latest.

The Payments System Board should require that neither a scheme, nor any of its participants (including issuers and/or acquirers), can prevent merchants from setting (or asking their acquirers to set) the default route.

10.3 The New Payments Platform

In 2012, the PSB completed a strategic review of innovation in the payments system which identified a set of features that would be desirable for the payments system, such as real-time settlement of bank transfers (RBA 2012d). In response to this review, the payments industry developed the New Payments Platform (NPP) to deliver some of these features, including:

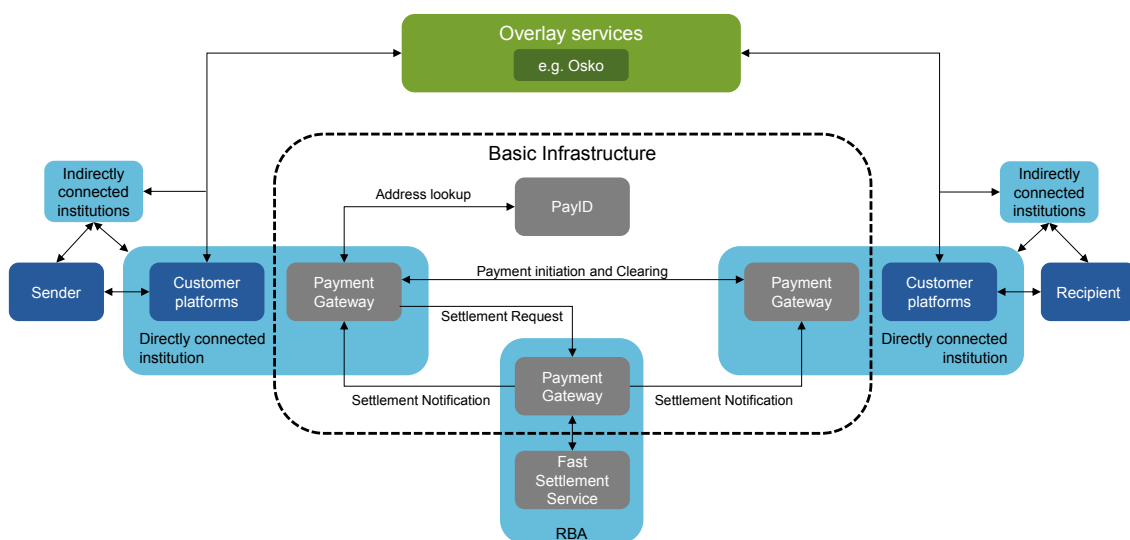
- near real-time settlement, available 24/7

- 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 is made up of two components: the ‘basic infrastructure’ made up of hardware and software protocols; and ‘overlay services’ that provide the portals and applications which make up the user experience (figure 10.11).

Making bank transfers using the NPP involves sending payment messages between 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 10.1).

Figure 10.11 A schema of the New Payments Platform



Source: Adapted from NPPA (2017c).

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. In essence, overlay services are a set of rules for subscribing financial institutions to follow when making payments through the basic infrastructure.

For example, 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 — utilising the functionality of the NPP’s basic infrastructure, such as near real-time payments using PayID.

Overlay services 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. Overlay services can be simple or complex, depending on whether they require changes to the basic infrastructure in order to work. Overlay service providers do not have to connect to the basic infrastructure in order to operate, but may choose to, if for example, it optimises delivery of the service.

The NPP was set up, and is mutually owned, by 13 initial shareholder participants (including the RBA), many of which are Australia’s largest banks. The major banks are all common shareholders of the NPP, BPAY and eftpos. New Payments Platform Australia Limited (NPPA) is the governing body that operates the NPP. The NPP became operational in early 2018 and is initially available to customers of the major banks and many smaller institutions (Yeates 2017d).

Table 10.1 Levels of participation in the NPP

<i>Parties</i>	<i>Clearing and settlement</i>	<i>NPP payment gateway</i>	<i>NPPA shareholder</i>
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).

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 unique benefits. Therefore, the major banks can be expected to retain their dominance in the market for bank transfers. 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.

The ability to make near real-time settlement is likely to directly benefit customers. The current batch settlement system can result in significant delays between the day when the payment is initiated by the sender and settlement actually occurs, such as over the weekend (RBA 2017b). This might result in significant costs to consumers in interest forgone (box 10.4), but even in a low interest environment, it is likely to provide a ‘windfall’ return to financial institutions whilst funds are ‘in transit’. It reduces liquidity and the

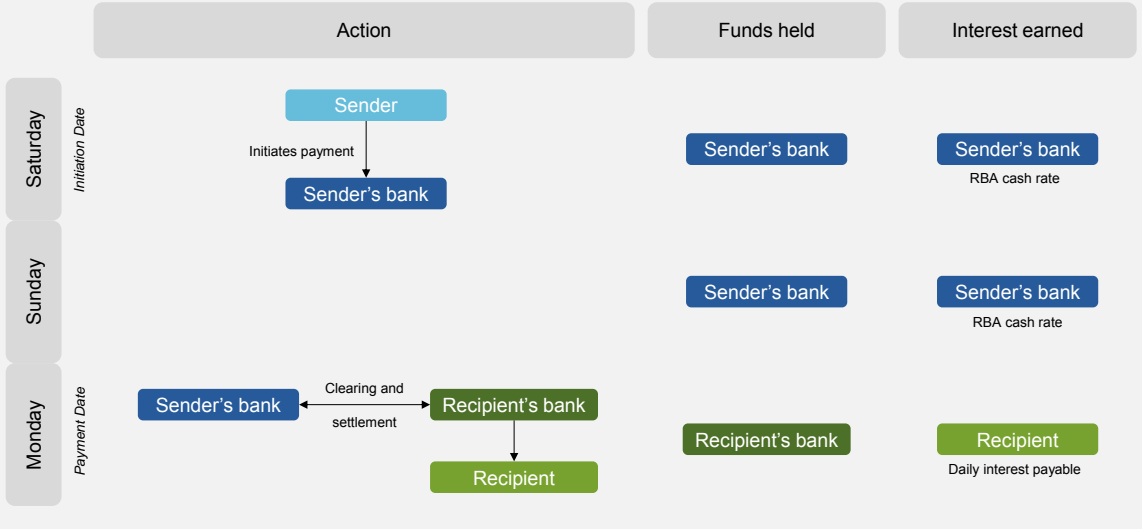
efficiency of the economy as funds in transit are not available to either the payer or the recipient for other uses. It also limits the types of transactions that can be carried out using bank transfers, leading customers to choose more costly alternatives, creating a further loss for the entire economy.

Box 10.4 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 in the account, and daily interest is payable on the transferred amount.

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 Reserve Bank of Australia cash rate. The Commission estimates that this gain to financial institutions is likely to be small.

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 this 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 financial institutions to enter the payments system. The basic infrastructure of the NPP gives new entrants the ability to 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 by using an outsourcing arrangement to a shareholder 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.

It is up to the Board of the NPPA to determine whether or not to accept the applicant (NPPA 2017e). At launch, the NPPA Board is made up of 11 members, the majority of which are incumbent banks.⁵¹

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. 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. Concerns about the potential for conflicts of interest were raised during the ACCC’s consultation processes.

The confidential submissions submit that the NPPA Board comprises primarily of incumbent market participants who may have a conflict of interest between the goals of the NPP (increasing adoption for the benefit of consumers), which would include allowing new entrants to participate in the NPP, and benefiting their own organisations by restricting access by new entrants to the NPP. (ACCC 2017b, p. 7)

Indeed, in a sample of Australian fintechs, 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 (EY 2017).

In response, NPPA submitted that it structured its governance arrangements to avoid and manage potential conflicts of interest. NPPA suggests that the composition of the Board, including a representative Board member from the RBA, acts as a safeguard that stops the eligibility criteria disadvantaging prospective entrants (ACCC 2017b).

Despite the presence of an RBA representative on the Board, the Commission considers that conflicts of interest may still lead the Board to unduly restrict access to new competitors. If the Board rejects an applicant, it is required to give the applicant its reason for rejection. The unsuccessful applicant can appeal the Board’s decision, but the review is undertaken by a sub-committee of the Board, not an independent reviewer.

⁵¹ At launch, Board members include a chairman, CEO, and representatives of the RBA, major banks, Bendigo and Adelaide bank, CitiBank, Cuscal and ING Direct (NPPA 2017d).

At launch, the NPP is not subject to an 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 payment system (appendix B).

However, the PSB has taken a wait-and-see approach to access regulation for the NPP. In its submission, the RBA (sub. 29, p. 39) stated that it is not planning to regulate access to the NPP prior to its launch, but will monitor whether access regulation is needed in the future.

The [RBA], which is also represented on the Board of the NPP, will continue to monitor the progress of the platform, including its arrangements around access and support for competition. At some point after the NPP is operational, it will be appropriate for the [RBA] to assess how well the NPP has met the initial set of strategic objectives and whether there are other areas where cooperative industry approaches to innovation in the payments system are needed.

The Commission agrees that active monitoring will be essential. However, the Commission also considers that there is a strong case for pro-active intervention to avoid both uncertainty and potential anticompetitive behaviour. 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.

NPP transaction fees should be closely monitored by the RBA

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, but will not be set until 1 July 2018 once transaction volumes are determined (NPPA, pers. comm., 7 November 2017).
- The RBA will charge a per transaction fee capped at 1c, split between the sender and recipient's financial institution (RBA, pers. comm., 3 October 2017). This fee will be set to recoup the cost of settling each transaction.
- There may also be a fee for using the PayID addressing service.

Given advice from the RBA and NPPA, the Commission expects 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 over time, the transaction 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 the price of transaction fees as part of its access regime.

If the cost to merchants in processing NPP payments is competitive with card schemes, this may put downward pressure on card interchange fees. However, not all institutions are directly connected to the NPP. Many, even some shareholder participants, rely on a directly connected shareholder participant 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.

The Commission considers that the PSB should monitor and review the fees set by participants of the NPP as part of its access regime.

Access to NPP data can provide a competitive advantage

One of the NPP's benefits is the ability to send richer payment information with payments. For example, payment messages sent through the current bank transfer system can only carry 18 characters, whereas the NPP is capable of sending messages with up to 280 characters and can provide links to externally hosted documents (NPPA 2017b; RBA 2015a).

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 and data generated by overlay services. Data generated by the NPP can be valuable to gain insights into customer behaviour and spending patterns.

The RBA runs the Fast Settlement Service used to settle all individual payments made through the NPP (figure 10.11). Therefore, the RBA is the only participant in the system that can record the number and value of every transaction settled across the system.

NPPA can generate de-identified aggregate reports, such as traffic reports of the total number of payments sent and received through the NPP. This can track use of the NPP over time and the market shares of participants (table 10.2). NPPA does not have access to individual PayID data, but can access aggregated reports on PayID registrations.

There is no central store of customer transaction data. Participant entities that are actually involved in processing transactions (transacting participant entities, such as direct and indirect participants (table 10.1)) are responsible for recording these data, such as the value of individual transactions. They also have access to aggregated reports of payments sent through *their* connection.

Table 10.2 Data access under the New Payments Platform

	<i>Participant^a</i>	<i>Overlay service provider</i>	<i>NPPA RBA</i>	
Aggregated data ^b	✓	✗	✓	✓
Aggregated data specific to participant entity	✓	✗	✓	✓
Aggregated data specific to overlay service	✗	✓	✓	✓
Individual transaction data ^c	✓	✗	✗	✓
Individual transaction data using overlay service ^c	✓	✗	✗	✓

^a Any transacting participant entity that is a subscriber (not provider) of an overlay service. ^b Refers to the aggregated de-identified traffic reports. ^c Sent through the participant entity.

Source: NPPA (pers. comm., 14 August 2017).

Competition in payments is most likely to be encouraged through the use of overlay services which will use the NPP. For example, while Osko is the first overlay, others might include the ability for businesses to request and follow up late payments or allow consumers to purchase a car with an all-in-one registration transfer and finance check (NPPA 2017c).

Providers of overlay services have access to aggregated traffic reports of the payments made using their service. If a foundation NPP participant entity is also a *provider* of a competing overlay service, they too have access to these reports. Participant entities that are not overlay service providers (that is they merely *subscribe* to an overlay service) do not.

Moreover, all overlay service providers will not be treated equally. Only those which are also transacting participant entities will have access to de-identified individual transaction-level data of the payments made using their service (table 10.2). Entities that only provide overlay services do not have access to these data. This is problematic because transacting participant entities can capture data for all transactions they are involved in, including data of payments made through overlay services.

Of course, overlay service providers can require these entities to share these data as part of the terms and conditions of subscribing to the service. However, these entities may prefer to subscribe to overlay services that do not require access to these data instead.

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 the full 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 competitive advantage over new overlay service providers, the Commission considers 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.

DRAFT RECOMMENDATION 10.5 ACCESS REGIME FOR THE NEW PAYMENTS PLATFORM

The New Payments Platform (NPP) is a significant piece of national infrastructure that can benefit competition in retail banking and payments. But more transparency is needed to facilitate third-party access. The NPP should be subject to an access regime imposed by the Payments System Board.

As part of an access regime, the Payments System Board should:

- review the fees set by participant entities of the NPP and transaction fees set by New Payments Platform Australia
- require all transacting participant entities that use an overlay service to share de-identified transaction-level data with the overlay service provider
- consult the Australian Competition and Consumer Commission on the final design of the data sharing obligations.

The NPP could do more to improve customer switching

Under the current bank transfer system, switching financial institutions can be difficult for customers, thus inhibiting competition (chapter 13).

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. At NPP launch, customers can use a phone number, email address or organisation identifier (such as an ABN) as their PayID alias. However, there is potential for PayID to offer additional identifiers in the future.

At launch, 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. Figure 10.12 shows three ways that PayID under the NPP can be improved to ease customer switching and convenience.

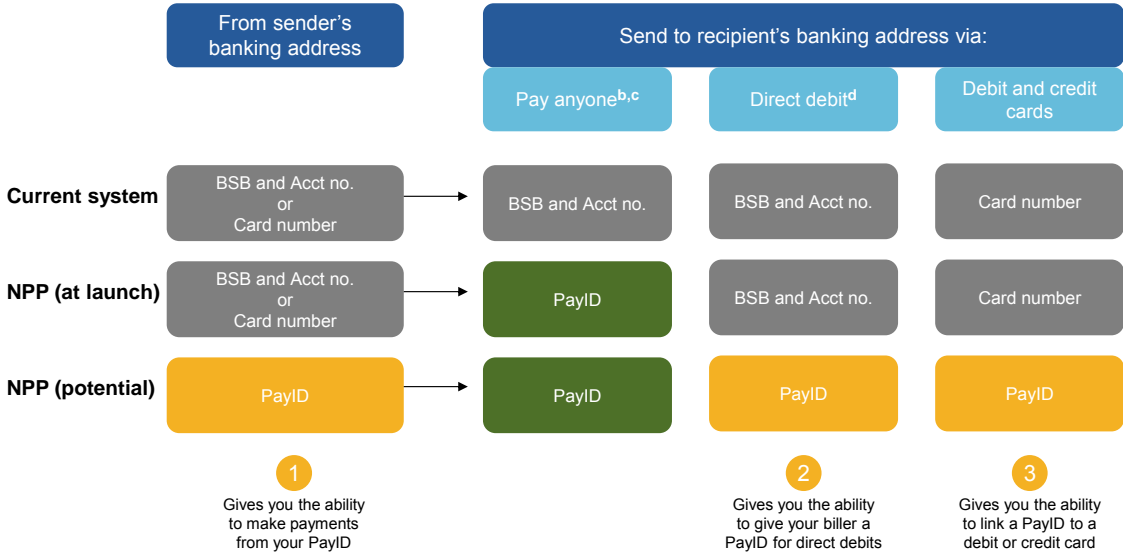
First, a payment can only use the recipient’s PayID, not the sender’s. If instead you could set up recurring payments, such as a gym membership, from your PayID, then you would only need to change the account linked to your PayID once, rather than cancelling and re-establishing each recurring payment.

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, 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 card-related PayID once.

Figure 10.12 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).

DRAFT FINDING 10.1 THE NEW PAYMENTS PLATFORM COULD DO MORE TO EASE CUSTOMER SWITCHING

The New Payments Platform's addressing service, PayID, has the potential to improve competition by making it easier for customers to switch financial institutions or products. However, at launch, PayID will have very limited functionality.

New Payments Platform Australia Limited and its participating financial institutions have the capacity to improve the capability of PayID to give customers the ability to both send and receive *recurring* bank transfers, direct debits and card payments.

Changing bank accounts with many direct debits, or credit cards with recurring charges, would then require only a single update, removing one of the apparent reasons why there is limited switching of accounts.

11 General insurance providers and products

Key points

- As with banking, the general insurance market is dominated by a ‘big four’ followed by a long tail of much smaller providers. 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 companies hold in excess of 70% of market share.
- However the big four are not always the same companies in each market.
- Some of the entry and exit in general insurance markets over the past 10 years can be attributed to mergers and acquisitions, restructures and name changes.
 - New entrants have included foreign entrants, insurers with links to banks and other large retailers, and niche providers that specialise in particular insurance lines.
 - Some of the new entrants over the past 10 years have since been acquired by existing insurers pursuing a strategy of growth through creeping acquisition.
 - Overall, most classes of insurance in Australia are heavily concentrated across a handful (or fewer) of firms.
- Insurers underwrite general insurance through a variety of different brands, which creates the illusion of more competition than actually exists.
 - The two largest insurers underwrite more than 25 different brands between them, and two relatively recent entrants underwrite 50 brands.
- Individual insurance products are highly differentiated. While distinguishing between different risks is an essential element of insurance, excessive product differentiation can hinder competition as consumers struggle to compare products that are not like-for-like.
- While the prices of retail general insurance products (such as home and contents insurance) have been rising over the past decade, the profitability of the industry has fallen in recent years. This may indicate that a degree of competition is present.
- Australia appears to be lagging 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.
- To improve competition:
 - providers should be required to include more comparative information, including the previous year’s premium, on insurance renewal notices.
 - Consumers should also know who it is that is underwriting the brand they are considering and any other brands underwritten by the same insurer.
- State and territory stamp duties on general insurance are a poor quality tax causing significant deterrent to use of a key product and should be phased out.

Insurance is a risk management tool designed to protect policy holders from financial loss when things go wrong (box 11.1). Policy holders transfer their risk to an insurer, under the terms and conditions agreed in the insurance policy, and pay insurance premiums for the service. If an insured event occurs, the policy holder receives a compensation payment from the insurer in accordance with the terms of the policy. In some instances, businesses and consumers are required by law to take out insurance.⁵²

There are three broad types of insurance in Australia: general insurance, life insurance and health insurance. This inquiry focusses solely on general insurance, as:

- more than 70% of life insurance policies are provided through superannuation, 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.

11.1 The general insurance market

General insurance provides cover for events that cause financial loss, property damage or personal injury. It is a significant sector of the Australian economy, with gross written premiums in the order of \$45 billion in the year ending September 2017 (APRA 2017v), and the industry employing around 60 000 people (ICA, sub. 32).

The markets within general insurance

The private consumer market is the largest part of the general insurance market and it is increasingly being written directly through insurers via online channels. Home insurance, domestic motor vehicle insurance and travel insurance are three of most widely purchased personal products. On the commercial side, products include fire and industrial special risk, public and product liability, commercial motor vehicle, professional indemnity and employer's liability (Wu 2017a, 2017b).

⁵² Compulsory third party insurance is an example of an insurance policy that state and territory governments requires owners of motor vehicles to take out when they register their vehicles. Workers Compensation is another form of compulsory insurance for employers.

Box 11.1 Insurance, reinsurance and retrocession are tools used to pool and spread risk

Insurance operates on the basis of pooling and spreading risk. A relatively large number of consumers pay relatively small premiums into a pool to cover a particular risk, for example to cover damage to their house in the event of fire. Insurers spread the risk across policyholders that have different risk profiles, including spreading the risk geographically. Thus if the risk eventuates, it tends to apply to a relatively small number of policy holders within the pool who receive relatively large sums of money in relation to their policy.

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 [there are 12 exemptions including life and health insurance business]

With some types of insurance, claims will usually be known and settled within a twelve month period (for example motor vehicle insurance) for others, it could be many years before a claim is made (for example workers' compensation).

- **Short-tail** — where claims are usually known and settled within 12 months.
- **Long-tail** — where notice of a claim may not be received for many years and claims may be outstanding for more than one year before they are finally quantifiable and settled by the insurer (QBE 2016).

The Insurance Council of Australia notes:

The central role of insurance in an economy is the mitigation of insurable risk. Through the acceptance and pooling of such risks, general insurance improves economic welfare in Australia by reducing the cost of self-insurance and freeing resources for more productive uses. Insurance helps ensure that risks are more efficiently allocated and, at a practical level, that individuals and businesses in Australia can pursue economic activities secure in the knowledge that risk has been transferred to their insurer. (ICA, sub. 32, p. 3)

Policy holders can make choices about how much risk they take on by adjusting the terms and conditions of their policy. By agreeing to pay an excess out of their own pocket in the event of any claim or by excluding certain things 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.

Reinsurance is effectively 'insurance for insurers'. In return for a premium, insurers can purchase insurance on the policies they sell and thus transfer part of their risk to reinsurers. Access to reinsurance can enable insurers to set a cap on their maximum possible loss. For example, a general insurer that provides household insurance in a particular geographic region may want to diversify their risk in the case of a localised event, such as a natural disaster, and can use reinsurance to do that.

Reinsurance can enable small niche insurers, which by definition operate only in particular parts of the market, to diversify their risk. Reinsurance for general insurance risks can be provided by any reinsurer, whereas reinsurance for life insurance can only be provided by Australian reinsurers.

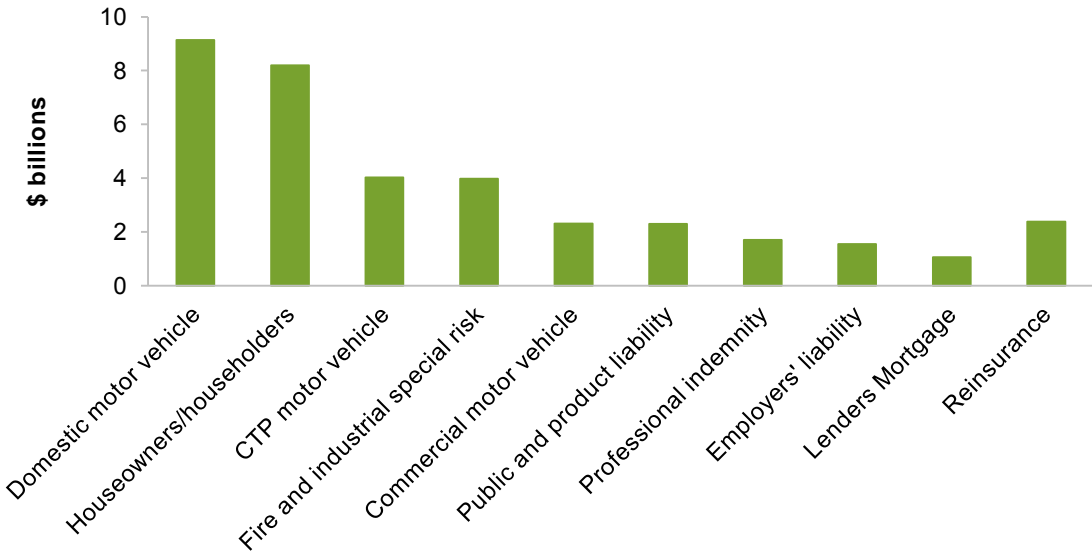
Retrocession is 'reinsurance for reinsurers', where a reinsurance company insures another reinsurance company by accepting risk the other company has underwritten.

We are considering nine general insurance markets in this inquiry. Each has been selected because of its size, unique characteristics, or because particular issues have been raised in relation to it throughout the course of this inquiry. They are:

- home insurance
- domestic motor vehicle insurance
- travel insurance
- commercial insurance
- lenders mortgage insurance (LMI) (chapter 8)
- pet insurance (see section on branding)
- consumer credit insurance (chapter 14)
- compulsory third party insurance (see section on government)
- reinsurance (box 11.1).

In the year ending 30 June 2017, the highest annual spend was on domestic motor vehicle insurance with over \$9 billion, followed by householders’ insurance, with over \$8 billion. Figure 11.1 shows the annual premium spend for some of the key general insurance markets.

Figure 11.1 Gross written premium by various types of general insurance
Year ending September 2017



Source: APRA (*Quarterly General Insurance Performance Statistics*, September 2017).

11.2 General insurance providers

General insurance has its own ‘big four’

Australia’s general insurance industry is a mature market and, as with banking, it is dominated by four large players. All major players are upwards of 100 years old. As with banking, the ‘big four’ general insurers account for a large proportion of the total market and are followed by a long tail of much smaller providers. Table 11.1 provides further information on each of the big four general insurers.

Table 11.1 The ‘big four’ general insurers

A different four from banking, but still accounting for a large proportion of the relevant market and followed by a long tail.

	<i>IAG</i>	<i>AAI Limited</i>	<i>QBE Insurance</i>	<i>Allianz Australia Insurance Limited</i>
Overview	Formerly known as NRMA Insurance Group, IAG is a multinational insurance company providing insurance through Insurance Australia Limited and Insurance Manufacturers of Australia Pty Limited.	A private company which is wholly owned by the top 20 ASX-listed Suncorp Group which also provides banking, wealth and life insurance products	Australia’s largest global insurer	An unlisted foreign-owned public company. Local subsidiary of Allianz SE
Annual gross written premium (general insurance)	\$10.6b	\$7.7b	\$5.0b	\$4.5b
Origins	1925 – provided insurance to NRMA members through CGU 2000 – NRMA demutualised	1916 – commenced business as the State Accident Insurance Office	1886 – commenced as the North Queensland Insurance Company	1914 – commenced as Manufacturers’ Mutual Insurance Association 2000 - renamed Allianz Australia

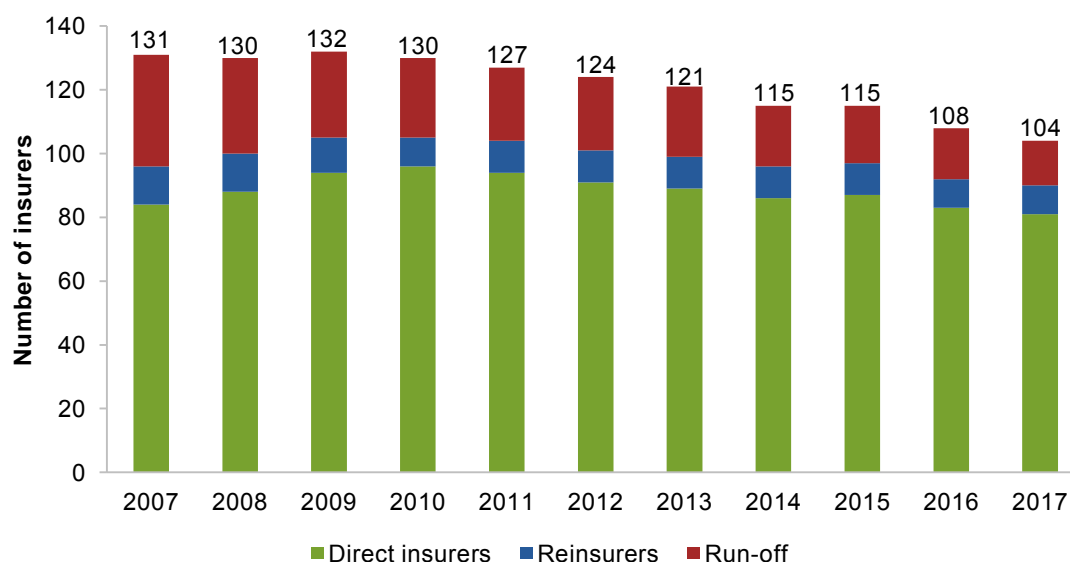
Source: APRA (*General Insurance Institution Level Statistics*, December 2016); IAG (2014, 2017a); Suncorp Group Limited (2017); QBE (2017); Wu (2017b).

In the case of general insurance, the long tail of providers is shrinking. There has been a steady decline in the number of APRA-authorized general insurers⁵³ over recent years, falling from 171 in 1999 to 104 in 2017 (figure 11.2). APRA notes this decline is ‘partly attributed to a rationalisation of insurance licenses resulting from past acquisitions, in addition to a fall in the number of run-off insurers and limited new entrants’ (APRA 1999, p. 19, 2017a, p. 28, sub. 22, p. 14).

⁵³ In addition to APRA-authorized insurers, Lloyds operates in Australia, along with a number of Unauthorised Foreign Insurers (see section on Other players).

Figure 11.2 The number of APRA-regulated general insurers is falling

Australia had 81 direct insurers authorised by APRA to write new and renewal policies at 30 June 2017



Source: APRA (pers. comm., 5 December 2017; various Annual Reports).

As at 30 June 2017, there were 104 APRA-authorised general insurers.

- 81 of them are direct insurers. While this number is now at its lowest over the past 10 years, the number of direct insurers has fluctuated over the period, peaking at 96 in 2010.
- 14 were in run-off. These are insurers who are closed to new business, so they are not licensed to write new or renewal insurance policies, but they still need to meet claims. Of the 14, most have been in run-off for a number of years, including one since 1985. The number of insurers in run-off has fallen from 35 in 2007 (APRA 2017h).
- 9 are reinsurers. They provide insurance for insurers — in return for a fee, direct insurers can pass certain risks on to a reinsurer. This helps insurers diversify their risk, for example geographical risk in the event of a natural disaster. The number of reinsurers has fluctuated between 12 and 9 over the last 10 years.

Of the 81 direct insurers as at 30 June 2017, some, including the largest, provide a wide range of insurance products to business and individuals covering a variety of home and business risks. Others are niche providers, who choose to operate only in particular parts of the general insurance markets. There are some that have licences issued by APRA restricted through a condition on the type of insurance they can provide. For example, to ensure systemic risks in lenders mortgage insurance are not cross-linked to other types of insurance, lenders mortgage insurers are required to be ‘monoline’ insurers and as such are only authorised to provide the one type of insurance (APRA 2017a). Lenders mortgage insurance is considered in further detail in chapter 8.

The illusion of having many competitors exists through the proliferation of products (some of which are undoubtedly differentiated, others not so much). Consumers certainly see many more brands in the insurance market than there are competitors. The big four general insurers provide more than 30 brands in total between them (figure 11.3).

Other players

In addition to the APRA-regulated insurers identified above, there are a number of other players in general insurance markets in Australia, including Lloyds, unauthorised foreign insurers (a regulatory term — see below) and government. In addition, there are no apparent regulatory barriers that would stop consumers from placing business with overseas insurers, however in doing so they would not be covered by Australian prudential or other regulation.

Lloyds

Lloyd's of London, known as Lloyds, underwrites general insurance and reinsurance. It is not an insurance company, rather it is a corporate body, governed by United Kingdom legislation, that operates a market place where its underwriting members, known as syndicates, come together to pool and spread risk (Lloyd's 2017).

Lloyds underwriters are authorised to write Australian insurance business under the *Insurance Act 1973* which is administered by APRA. The Act provides for special Australian policyholder protection provisions associated with Lloyd's (APRA 2017).

Business placed with Lloyds in the first 6 months of 2017 equated to less than 5% of total business written by APRA-authorised general insurers (table 11.2).

Unauthorised foreign insurers

Unauthorised foreign insurers (UFIs) are foreign domiciled insurers that are permitted to carry on insurance business in Australia under limited exemption arrangements contained in the Insurance Act. This enables insurance business, for example atypical risks, high-value insureds and other risks that cannot reasonably be placed in Australia, to be provided by a UFI.

Unlike Lloyd's, UFI's are not regulated by APRA, so UFIs are not required to comply with APRA's general insurance prudential requirements and consumers who purchase insurance from UFIs do not have access to the protection provided by the Australian regulatory system. However intermediaries that place business with UFIs are required to provide data to APRA (see table 11.2).

Table 11.2 Business placed with Lloyds and UFI is only a small proportion of overall general insurance

	<i>Lloyds</i>	<i>UFIs</i>	<i>Total business (excluding Lloyds)</i>
Insurance placed over the first 6 months of 2017	\$0.9b	\$0.5b ^{a,b}	\$19.7b
Number of intermediaries placing business	253	74	751

^a More than half of the business placed with UFIs related to fire and industrial special risk. ^b 59% of premium placed with UFIs in the period was concentrated in Singapore and the United Kingdom

Source: APRA (2017i)

Government

Governments are participants in the general insurance market in Australia. For example, the Australian Government owns the Australian Reinsurance Pool Corporation, which is a reinsurance agency established under the *Terrorism Insurance Act 2003* (Cth).

Governments have made some types of insurance compulsory, including workers compensation and compulsory third party insurance for personal injury. In Victoria, Tasmania, the Northern Territory and Western Australia, insurance is underwritten by the state/territory government, whereas in NSW, Queensland, the ACT and South Australia it is offered privately (Thompson 2017).

Governments also provide comparator websites (such as that for North Queensland home insurance (ASIC 2016i)).

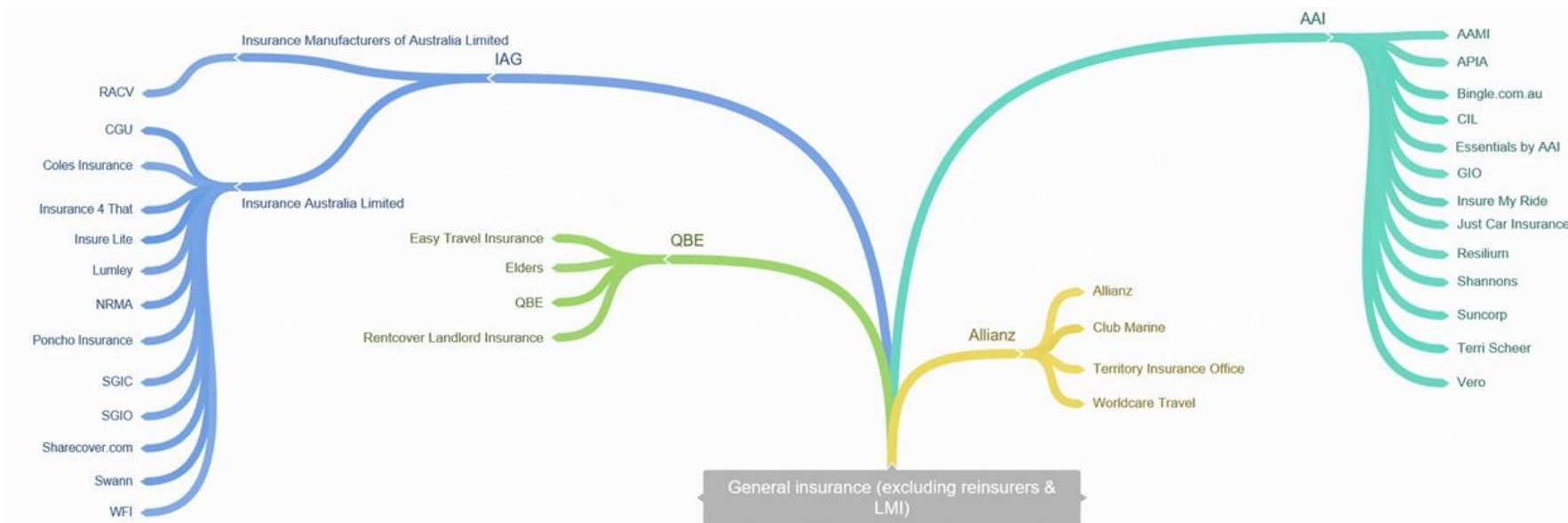
Branding creates the illusion of more competition than actually exists

While there are around 80 direct insurers registered by APRA to conduct new or renewal insurance business in Australia (APRA 2017g), consumers see many more brands in the insurance market. The brands offer insurance that is underwritten by an APRA registered insurer, with some of these wholly owned by the insurer and others operating in partnership arrangements. While this is clarified in the ‘small print’ on the relevant brand company’s website and in Product Disclosure Statements, the use of branding does create the illusion of more competitors than there actually are.

The big four general insurers provide more than 30 brands in total between them (figure 11.3).

This phenomenon is particularly pronounced in the pet insurance market. Of the 22 brands that we identified offering pet insurance, 20 of them were underwritten by the same APRA-regulated insurer (The Hollard Insurance Company Pty Ltd — see table 11.3).

Figure 11.3 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)

Table 11.3 Pet insurance branding

<i>Insurer</i>	<i>Number of brands</i>
The Hollard Insurance Company	20 ^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, Guardian Insurance, HCF Pet Insurance, Insurance Line, 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 ^b Brand is Pet Plan. ^c Brand is RACQ.

Source: Hollard Insurance (2018); Petplan (2018); RACQ (2018); and brands' product disclosure statements and websites as at 18 January 2018

Distribution channels

General insurance is typically sold either through intermediaries or direct to the consumer. Of the nearly \$20 billion gross written premium that was placed with APRA-authorised general insurers (excluding Lloyds) in the six months to December 2016, 42% was placed by intermediaries, brokers and agents (APRA 2017i; Wu 2017b). The remainder is placed directly with the insurer, and this can be done face-to-face, by phone or online.

While private insurance is increasingly being written directly, the use of intermediaries is more common for commercial insurance where policies are likely to be more complex (Wu 2017b).

In order to conduct general insurance business, intermediaries must hold Australia Financial Services Licences and be authorised to deal in general interest products (appendix B). At the end of June 2017, there were 1645 intermediaries licensed to conduct general insurance business (APRA 2017i).

'Bancassurance', whereby insurance providers sell their product through partnerships with retail banks, has been another distribution channel.

Bancassurance allows major banks to use their existing customer relationships as a new source of revenue by selling other financial products, like life and general insurance. And it comes free of the cost of intermediaries because the bank already owns the customers. (Insurance News 2010, p. 1)

Bancassurance saw Australia's major banks build significant insurance and funds management arms of their own in the late 1990s and early 2000s. However, the trend has recently been reversing with a spate of major banks divesting their wealth management businesses and reducing their exposure to underwriting life insurance risk (although they remain distributors of life insurance products).

Back when the bancassurance model was emerging, product was king. If banks were going to offer insurance and wealth management to their clients, then why not control both the manufacture and distribution of those products?

However, this model of bancassurance didn't live up to expectations. The cost/benefit ratio in favour of owning wealth and insurance product manufacturers shifted negatively in the years since the GFC. Poor conduct, often related to warped incentive structures, led to increased regulatory scrutiny and oversight, as well as reputational damage. (IOOF nd, p. 1)

We believe that the term 'bancassurance' ... is outdated, but the notion of providing customers with easily accessible solutions that combine wealth management, banking and insurance is not. In today's open markets, customers expect to be able to readily access products that meet their needs. Increasingly this doesn't involve face-to-face transactions (as the traditional bancassurance models would suggest), but is more digitally enabled and omnichannel in design. (PwC 2016b, p. 2)

See also the section on integration below and chapter 7 for consideration of integration in the financial system more broadly.

Comparison web sites also influence distribution (see box 11.2). ASIC has identified the following criteria for an effective comparison service:

- (a) comparison website should cover all, or at least a substantial portion, of the relevant market;
- (b) It should avoid, or at least manage any conflicts of interest, such as clearly disclosing sponsored or promoted links, the basis for any awards or ratings, and any relationship between the website and the product provider(s);
- (c) It should provide clear, accurate and up-to-date information;
- (d) It should explain how the ratings work; and
- (e) It should provide information about relevant product features other than price, and be easy to use and widely promoted. (ASIC 2017ae)

11.3 The current state of competition in general insurance

As outlined in chapter 2, the key question to address when considering the provider perspective of competition in the Australian financial system, is whether the extent of rivalry and capacity for entry by new firms is such that innovation and efficiencies that improve community (consumers, employees and shareholder) outcomes are possible. We consider this in the context of a range of indicators of concentration and contestability.

Box 11.2 Comparison websites — consumers beware

The benefits of comparison websites are generally thought to be lower prices through fierce online competition, better transparency and more streamlined searching for consumers (Financial Rights Legal Centre 2016).

However, they do have a number of limitations.

Existing private sector [price comparison websites] in Australia suffer from a range of deficiencies – most importantly, their lack of independence and coverage. (Fels and Cousins 2017, p. 4)

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. The scope of cover, product options and claims experience vary greatly across the industry and using a comparison website can fail to take these factors into account and carry some hidden catches ... We do not believe that comparison websites increase transparency in insurance markets. 'Free' comparison sites can earn commissions from insurers. These commissions can make up a big portion of a consumer's total insurance premium. Additionally, some comparison sites are misleading about how much of the market they compare and some sites are actually owned by the insurance companies they're supposedly comparing. (CALC, FCA and Financial Rights Legal Centre, sub. 23, p. 21)

[P]rice comparison tools (e.g. websites) ... are often owned by insurers and do not always show the full market of products ... (ASIC, sub. 40, p. 52)

The Insurance Council and Financial Rights Legal Centre (2016) have similar concerns about comparing on price alone. The Insurance Council suggests 'Better assisting consumers to assess and compare policies on their coverage will stimulate deeper competition based on product features and not just price.' (sub. 32, p. 14)

Choice has found that 'free' comparison sites can earn substantial fees per sale from the insurers, and that these fees can make up a sizeable chunk of the total insurance premium. In addition, Choice also notes that some sites compare only a fraction of the market, the large insurers are reluctant to participate in online comparisons, and it is not unusual for the comparison sites to be owned or affiliated with the insurance companies listed on the site.

When you buy insurance through websites such as iSelect and Compare the Market, online or over the phone, the insurance company pays an upfront commission to the site — usually a percentage of the premium. The comparison site may also receive trailing commissions from the insurer — an additional kickback for anything from 12 months to the whole time you maintain that policy with the provider.

Other sites such as Canstar and Finder work on a "cost per click" model. When you click through to the product website, the provider pays the comparison site a referral fee, or an acquisition fee if they subsequently sign you up.

... Canstar is privately owned by shareholders with no links to insurers

... Finder is privately owned by two shareholders and doesn't have any equity links to the providers on its site. (Bird 2017, p. 1)

Concentration

Market share and concentration ratios

The Insurance Council submits that the Australian general insurance industry is highly competitive (sub. 23, p. 4). However, we have found that with a relatively small number of

providers underlying the proliferation of insurance brands, the markets for many of Australia's general insurance products are concentrated (figure 11.4 and table 11.4).

Table 11.4 Concentration ratios for five general insurance markets indicate they are all concentrated^a

Based on gross written premiums unless otherwise indicated, 2016

	<i>4-firm ratio</i>	<i>Herfindahl-Hirschman Index^b</i>	<i>Notes</i>
General insurance	0.73	1 948	Concentrated, with the top two players, IAG and AAI holding almost 50% of the market in 2016.
Domestic home insurance	0.73	1 794	Concentrated. While this market had the lowest levels of concentration amongst the markets considered, and the most brand diversity, the largest two players hold over 53% of the market. ^c
Domestic motor insurance	0.78	2 194	Highly concentrated. ^c
Travel insurance	0.83	2 333	Highly concentrated. ^c
Lenders mortgage insurance	1.00	3 120	With only four providers of LMI, the market is naturally concentrated.
Reinsurance	0.90	4 215	The highest concentration of all markets considered, providing evidence of a highly integrated market and indicating that market share is particularly concentrated among the largest players, as shown by the 4-firm ratio.

^a Calculated at the level 1 insurer level, with level 1 insurers within the IAG insurance group aggregated, and IAG Re has been excluded from all measures. General insurance includes direct general insurance only (excludes reinsurance and lenders mortgage insurance). ^b As noted in chapter 2, HHI of 1500 is commonly viewed as indicative of an acceptably concentrated market, but HHI of 2000 or more is generally viewed as problematic. ^c Based on 2016 estimates of gross earned premium.

Source: Productivity Commission estimates based on APRA (*General Insurance Institutional Level Statistics database*; unpublished data for home, domestic motor and travel insurance).

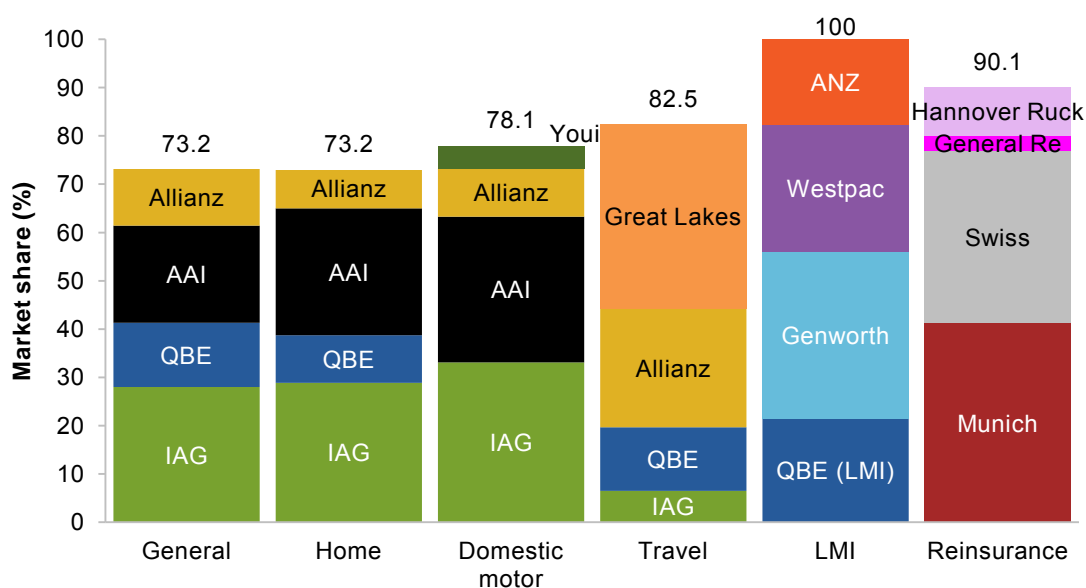
Moreover, as the RBA (sub. 29) points out, concentration is a common starting point for considering competition within a market.

- In the overall general insurance market, each of the four largest general insurers had market share by gross written premium ranging from 28% to 12% in 2016. In total, the top four (IAG, AAI, QBE and Allianz) accounted for 73.2% of the market. The next largest insurers, including Zurich, RACQ, CommInsure and Youi each accounted for between 1.7% and 2.2% (APRA 2017f).
- The largest market players in the overall general insurance market have in some cases strengthened their dominance, with the general insurance market becoming more concentrated over time in part due to industry-wide consolidation. In 2012, the top four (IAG, Suncorp, QBE and Allianz) accounted for 69.5% of the market (APRA 2017f).

- In the markets for home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance, market share calculations reveal similar trends — each market has a ‘big four’ followed by a tail (with the exception of LMI, which has no tail as there are only four reinsurers). While the largest four insurers were not always the same companies (although they were the same in general insurance and home insurance and three of them were the same in the domestic motor insurance market) in all markets they accounted for more than 70% of that market.
- Concentration in the home, travel and reinsurance insurance markets has also increased since 2012, at which point the top four insurers held 73%, 75% and 87.5 of their respective markets. The lenders mortgage insurance was similarly composed of only four providers in 2012, while the share of the domestic motor insurance market held by the top four providers has declined slightly from 81%.⁵⁴

The Grattan Institute has recently conducted a similar analysis of general insurance, finding the top five firms hold almost 90% of market share 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).

Figure 11.4 There are ‘big fours’ in many general insurance markets^a
But they are not always the same insurers



^a All calculations based on gross written premium, except home insurance and domestic motor insurance, which are based on gross earned premium. Calculations also based on level APRA 1 insurers, with level 1 IAG insurers aggregated. ‘General’ includes direct general insurance only, and excludes reinsurance and lenders mortgage insurance. Based on 2016 data.

Source: Productivity Commission estimates based on APRA (*General Insurance Institutional Level Statistics database*; unpublished data for home, domestic motor and travel insurance).

⁵⁴ Productivity Commission estimates based on APRA (*General Insurance Institutional Level Statistics database*; unpublished data for home, domestic motor and travel insurance).

This is consistent with information provided by both APRA and ASIC.

Most industry sectors regulated by APRA display relatively high levels of concentration, with a small number of large entities holding a significant combined share of the market ... Concentration within the General Insurance (GI) industry has steadily increased by a number of measures over the past 10 years, predominantly due to acquisitions ... Retail product markets are highly concentrated with the five largest providers representing a combined market share of approximately 80 per cent or greater in each of the householders, domestic motor and travel insurance markets ... at June 2017. (APRA, sub. 22, pp. 4, 14-15)

The Australian banking, insurance and financial services industries have become increasingly concentrated over the past two decades ... The general insurance market is also concentrated. The four largest firms accounted for approximately 77% of the market by gross earned premiums for the calendar year 2016 ... We have observed the use of white labelling in the general insurance market. These white label products may appear to consumers as alternate offerings with different providers. However, these products have the same underwriter as other offerings in the market. For example, in some product sectors of general insurance, we have observed a very small number of product issuers, when there are many distributor brands offering the issuers white label product, which creates the illusion that the market is more competitive than it actually is. (ASIC, sub. 40, pp. 37-38)

Some participants (APRA, sub. 22; ICA, sub. 32) and the ACCC (2008a) in its merger guidelines note that industry concentration may not of itself be determinative of the level of competition. In undertaking our overall analysis of competition in insurance provision, in addition to considering market share and concentration ratios, we have examined a number of other variables (box 11.6).

DRAFT FINDING 11.1 MARKET POWER IN GENERAL INSURANCE PROVISION

Because many general insurers provide insurance under multiple brands, this creates the illusion of more competition than actually exists in the general insurance market.

In every general insurance market considered — home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance — the largest four firms (which are not always the same four) account for more than 70% of the relevant market.

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

Performance

Prices of retail general insurance products, such as home and contents insurance, have been increasing over the last 10 years, with some consumers now paying significantly higher premiums than they were previously. The Insurance Council suggests the main drivers behind these increases have been:

- increased claims costs following series of disasters including Queensland floods, cyclone Yasi etc;
- the increasing cost of reinsurance also linked to recent disasters; and
- better use of technology and data (granular pricing) leading to more accurate pricing of individual insurance risk. This means those customers with high risk are likely to be paying more for their insurance. Equally, many consumers with a lower individual risk will see lower prices, and in the case of IAG, the inclusion of flood cover in home and contents policies. Consumers in flood prone areas have generally seen significant increase in their premiums depending on the risk to their property. (ICA, sub. 32, p. 7)

Price increases have been of particular concern to residents of Northern Australia, and were considered as part of the Northern Australia Insurance Premiums Taskforce.

In two reports conducted in 2014, the [Australian Government Actuary] found that the higher premiums in northern Queensland compared to east coast cities largely reflected higher losses in the region and did not represent excessive profits to insurers. The modelling commissioned by the Taskforce also suggests that current premium rates are not out of step with estimates of the magnitude of the risk.

If the level of insurance premiums now better reflects the higher insurance risks in northern Australia because of cyclones, the question that has been posed by the insurance companies, in submissions and consultations with the Taskforce, is ‘what is the problem?’ The industry has stressed that there is no market failure in the insurance industry in northern Australia. Moreover industry representatives, along with other stakeholders, have stressed that any intervention that lowers premiums will disguise underlying risks and result in less mitigation efforts to reduce the vulnerability of property to damage and promote inappropriate property development.

However, there is a human dimension associated with the rise in premiums. This is reflected in the submissions to the Taskforce from individuals and consumer groups who say many people in northern Australia are angry and distressed over the sharp rise in their insurance premiums. The change in the way insurance companies have priced their premiums has had a significant impact on a number of people in northern Australia. (The Treasury 2015c, p. 19)

The Australian Competition and Consumer Commission is currently conducting an inquiry into the supply of residential building (home), contents and strata insurance in Northern Australia, and is considering a range of issues including pricing, competitiveness, consumer engagement and regulatory issues (ACCC 2017e).

Despite the upward trend in premiums, profitability in the general insurance industry has experienced a downturn in recent years and representatives from APRA have noted that they are not observing excessive profits.

APRA’s submission to this inquiry noted the general insurance industry’s profitability (measured by return on net assets) rose marginally in 2016-17 but it remains below the industry’s ten-year average (table 11.5).

The lower level of profitability in recent years has been attributable in part 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. (APRA, sub. 22, p. 15)

Table 11.5 General insurance profitability

	<i>2015-16</i>	<i>2016-17</i>	<i>10 year average</i>
Total net profit after tax	\$2.9b	\$3.1b	\$3.8b
Return on investment	4.3%	3.5%	6.0%
Return on net assets	10.4%	10.8%	13.4%

Source: ICA (sub. 32); APRA (sub. 22; pers. comm., 7 December 2017)

APRA made a similar observation to the Senate Economics References Committee Inquiry into General Insurance.

As you would appreciate, we are not the competition regulator, so our primary lens is the prudential soundness of the institutions. That said, our mandate does require us to balance competition, contestability and competitive neutrality, so it is a factor in our decisions. But, as we see the market, it is a well-functioning, healthy market which does not appear to be making excessive returns and is subject to a whole range of external influences that make profitability from one year to another quite variable. (SERC 2017, pp. 23–24)

While the profitability of the big four insurers has exceeded their smaller competitors in recent years, the smaller insurers have actually performed better by a number of metrics (box 11.3).

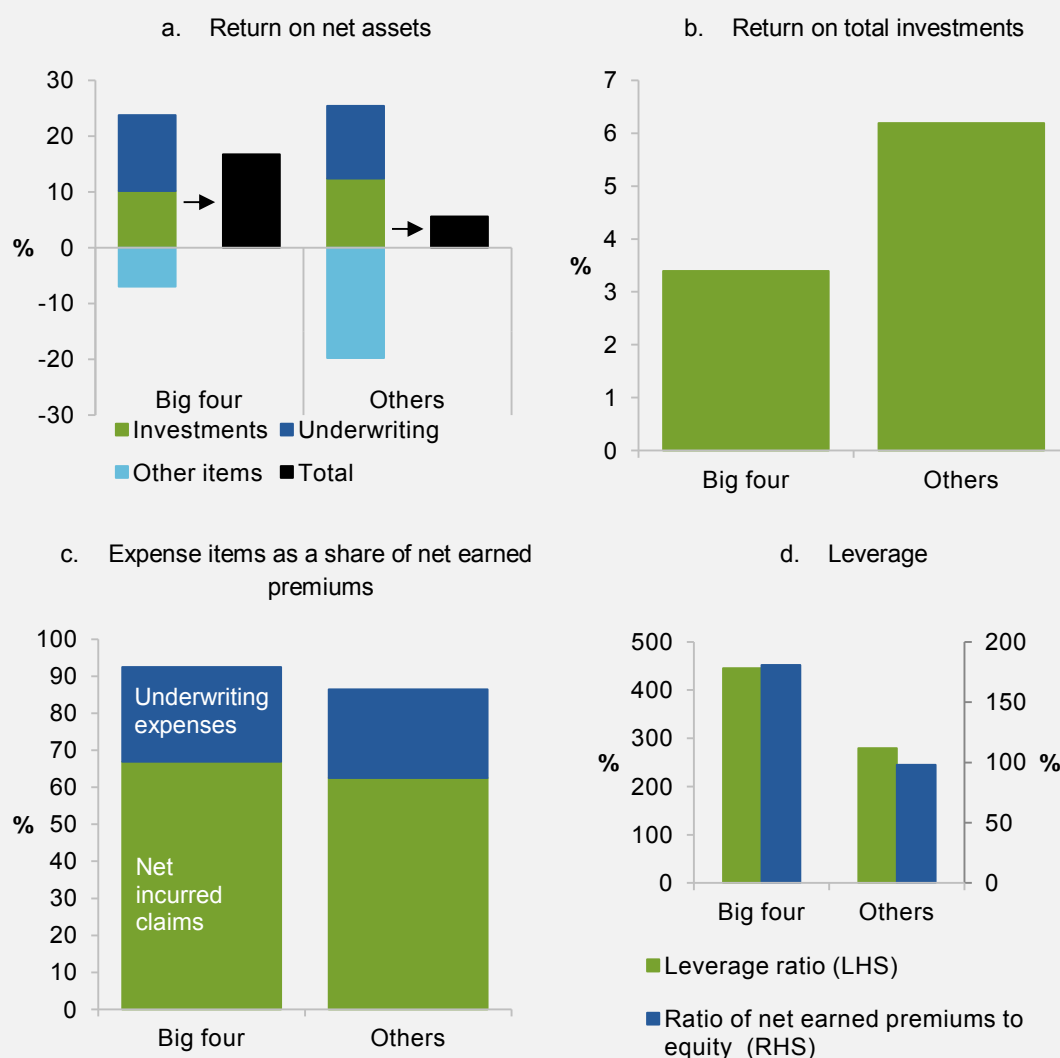
Box 11.3 Size and profitability

The 'big four' general insurers have been significantly more profitable than their smaller competitors in recent years, with aggregate returns to net assets of 17% versus 6% (panel a). Smaller insurers actually earned higher returns from both investment and underwriting activities, but suffered greater losses attributable to 'other items'.

Indeed, the smaller insurers' performance generally exceeded the big four, with higher returns to investment, lower expenses as a share of premiums (underpinned by both lower incurred claims and lower underwriting expenses (panels b and c). The more leveraged position of the big four insurers somewhat compensated for their poorer performance, however (panel d).

The big four vs the others^{a,b,c}

Financial years ended in the 12 months to 30 June 2017.



^a Excludes LMI providers, reinsurers, and insurers in run-off. 'Big four' refers to the level 1 insurers owned by the groups Allianz, IAG, QBE and Suncorp. ^b Data items are aggregated across all insurers in each group before ratios are calculated.

Source: Productivity Commission estimates based on APRA (*General Insurance Institution-level Statistics database*).

Contestability

New entrants and barriers to entry

The existence of new entrants in a market is evidence of contestability, and indeed, as noted in chapter 2, even the threat of entry can have a positive impact on competition.

While the Insurance Council suggests that barriers to entry in the retail short-tail classes such as home insurance are relatively low (ICA, sub. 32, p. 4), many others consider the barriers to entry in Australia's general insurance industry are relatively high, particularly because of the high level of regulatory requirements including APRA authorisation and the need to hold minimum amounts of capital, which can inhibit insurers' ability to take risk (Wu 2017a).

[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. (iSelect 2017, p. 4)

Barriers to entry also appear to have grown, largely as a result of increased regulatory requirements, for example relating to capital adequacy. (Fels and Cousins 2017, p. 7)

We support this view that there are high barriers to entry in general insurance, particularly because of regulatory requirements such as maintaining required levels of capital (box 11.4 and appendix B).

Over the 10 years since 2007, there have been 30 entries and 57 exits from the Australian general insurance markets (APRA, pers. comm., 8 January 2018). Some of this movement, particularly in terms of exits, can be attributed to mergers, acquisitions and restructures. In terms of entries, there have been foreign entrants, insurers with links to banks and other large retailers, and some who are niche providers, specialising in particular insurance lines.⁵⁵

⁵⁵ For example, Youi Pty Ltd is a wholly owned subsidiaries of OUTsurance International Holdings Pty Limited which is 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).

Box 11.4 Prudential regulation of general insurance

Prudential regulation of general insurance aims to reduce the chance that a general insurer will be unable to meet its obligations to policyholders.

Through a framework of legislation, prudential standards and ongoing supervision, APRA aims to ensure that the risks undertaken by the institutions it supervises are clearly identified and well managed, and that the likelihood of financial losses to consumers are minimised. (APRA 2015g, p. 1)

General insurance has been prudentially regulated in Australia since 1973. Following the collapse of insurer HIH in 2001, which 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, p. 1), the HIH Royal Commission recommended APRA move from 'light touch' supervision to 'develop a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers' (recommendation 26) (HIH Royal Commission 2003, p. 1). Accordingly, changes were made to the prudential framework:

Minimum entry-level capital requirements for general insurers were substantially increased. Reforms were also introduced to enable APRA to make prudential standards for general insurance. This made standard setting a faster and more flexible process and allowed the prudential regime to more easily accommodate market developments. (The Treasury 2015a, p. 1)

The current regulatory framework is largely the product of these reforms.

APRA's general philosophy is to allow regulated institutions the freedom to conduct their affairs as they see fit, provided they can demonstrate sound governance arrangements, robust risk management capabilities, and adequate financial strength. (APRA 2014a, p. 4)

APRA-authorised general insurers are required to have sufficient capital in place to maintain adequate capital against the risks associated with the insurer's activities, in accordance with the requirements under Prudential Standard GPS 110.

Capital is the cornerstone of a regulated institution's financial strength. It supports a regulated institution's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of such losses, enables the regulated institution to continue to meet its insurance obligations. (APRA 2015h, p. 2)

The required level of capital, the prudential capital requirement, can be determined by applying either the standard method or internal model-based method, or a combination, along with any supervisory adjustment if determined by APRA. Regardless of the outcome of the calculation, there is 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) (APRA 2017f). The prudential capital requirement is intended to take account the full range of risks to which a general insurer is exposed, and the insurer must ensure that it always has a capital base in excess of it.

In practice, insurers hold substantially more capital than their prescribed capital requirement. At their the most recent reporting period in the 12 months to June 2017, the big four insurers held a capital base of 168% of their prescribed capital requirement, while the smaller insurers held a base of 213% of their prescribed capital requirement.^a

^a Productivity Commission estimates based on APRA (*General Insurance Institution-level Statistics database*).

Source: APRA (2011, 2014a, 2015h, 2017f); HIH Insurance (2016); HIH Royal Commission (2003); IMF (2012); Treasury (2015a).

While it is a good sign for competition in the general insurance market that there have been 30 entries over the past 10 years, some of the new entrants over the past 10 years have since been acquired by other insurers, including the ‘big four’ general insurers. For example, in 2017, QBE became the underwriter for RealCover, which is a wholly-owned subsidiary of the Real Estate Institute of NSW which joined the market in 2008 and provides professional indemnity insurance. Also in 2017, the Hollard Insurance Company acquired the portfolio of online car insurer the Progressive Direct Insurance Company, the Australian subsidiary of The Progressive Corporation (the fourth largest auto insurer in the US (Progressive 2017a)), which joined the Australian market in 2009 (Lynn 2017; Progressive 2017b; RealCover 2017).

Where a major insurer makes an acquisition, if the firms they acquire are still relatively small, they will not trigger the existing merger provisions in section 50 of the *Competition and Consumer Act 2010* as those provisions only prevent mergers that are likely to substantially lessen competition in the relevant market. However, as the Harper Review noted, concerns about ‘creeping acquisitions’ can arise where ‘a business with a substantial degree of market power acquires many small competitors over time’ (Harper et al. 2015, pp. 322–323). There is some evidence of this.

In addition to the big four general insurers, there are a number of challenger providers that are also growing their market share. These include relatively new entrants: The Hollard Insurance Company (part of the international Hollard Group, which was established in South Africa in the 1980s (Hollard 2017)), Auto and General Insurance Company Limited (part of the international Budget Insurance group headquartered in the UK (Auto & General Insurance Company 2017)) and Youi Pty Ltd (a wholly owned subsidiary of OUTsurance International Holdings Pty Limited which is part of the Rand Merchant Investment Holdings (RMIH) Group and headquartered in South Africa (Youi 2017) (OUTsurance 2017)). While the market share of these challengers across the general insurance industry is relatively small, it is growing. In addition, both Hollard and Auto and General provide insurance under a very large number of brands, indeed more than the big four insurers combined. Between them, Hollard and Auto and General underwrite insurance for 50 brands (table 11.6).

Table 11.6 Some challengers are also underwriting insurance for a large number of brands

Further evidence of the 'illusion of competition' in the general insurance industry

	<i>Year joined Australian General Insurance Market</i>	<i>2012 market share %</i>	<i>2017 market share %</i>	<i>Number of Brands</i>
Youi Pty Ltd	2008	0.5	1.7	1
The Hollard Insurance Company	1999	0.7	1.4	30 ^a
Auto and General Insurance Company Limited	2000	0.7	1.3	20 ^a

^a In addition to the 20 pet insurance brands identified in table 11.3, as at 18 January 2018 we identified the following brands (however there could be others, as there is no comprehensive list of insurance brands available for reference): AI Insurance, ATL insurance group, Blue Badge Insurance Australia, Club 4x4, Fastcover, Huddle, Kogan Insurance, Progressive Direct Insurance Company, Velosure, Woolworths Insurance. ^cAs at 18 January 2018, Auto & General listed the following brands on their website: 1300 Insurance, 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.

Source: Productivity Commission estimates based on APRA (*General Insurance Institutional Level Statistics database*) December 2016 (issued May 2017); Youi (2017); Hollard (2017); Auto & General Insurance Company (2018a; 2018b; 2018c); and the product disclosure statements and websites of individual brands

DRAFT FINDING 11.2 CONSOLIDATION OF GENERAL INSURERS

Australian general insurance markets have consolidated over the past 10 years. Despite some new entrants (including from overseas), mergers and restructures and exits have reduced the overall number of providers. Some of the new entrants have since been acquired by other insurers that are pursuing strategies of growth through acquisition. Of those remaining, many have links with banks and other large retailers, and some are niche providers that specialise in particular insurance lines.

Integration

Consumer groups have expressed concern about integration in the financial system.

The current degree of vertical and horizontal integration in the financial system has had a number of negative implications for competition and consumer outcomes, particularly in the mortgage broking and insurance markets. (CALC, FCA and Financial Rights, sub. 23, p. 9)

Integration is particularly relevant to general insurance, as providers extend across the supply chain with multiple 'brands' which compete against each other and provides the illusion of more competition than actually exists.

In terms of vertical integration, there are some cases where ADIs are both the wholesaler and the retailer of general insurance products through their insurance arms. For example in terms of home insurance CBA provides cover through insurer Commonwealth Insurance and Westpac through Westpac General Insurance; and both Westpac and ANZ also have their own lenders mortgage insurance companies (APRA 2017g).

As noted above (in the section on Distribution Channels), banks have been divesting their wealth management businesses and reducing their exposure to underwriting life insurance risk, as they move away from the ‘bancassurance’ model. While this does not appear to be occurring to the same extent in general insurance, bank involvement in the general insurance industry does not apply across the board. Some banks use existing insurers to deliver their branded products, for example ANZ home insurance is issued by QBE, NAB home insurance is provided by Allianz, Rabobank provides farm insurance through Achmea Schadeverzekeringen N.V. and insurance for Liberty is provided by a variety of insurers, including IAG (home and car), LFI Group (mortgage and loan protection insurance) and QBE Life (life insurance) (ANZ 2017a; APRA 2017g; LFI 2016; NAB 2014; Rabobank 2017).

It’s not clear that integration in the general insurance market is a problem. Whether insurers are part of vertically integrated groups (CBA and Westpac)), or are selling bank-branded products (ANZ, NAB, Rabobank and Liberty), consumer protections and effective product disclosures are the appropriate policy tools to protect against any disproportionate power insurers may have. Reforms to remove the illusion of competition are outlined below and further information on integration in the financial system more generally is contained in chapter 7.

Non-price competition

While price competition occurs when businesses selling the same or very similar goods seek to increase sales by offering low prices (Harper et al. 2015), insurance products tend to be very specific to the particular circumstances including the risks covered and the amount they are covered for, any exclusions, excesses or waiting periods and any additional services that are included such as legal fee cover. This product differentiation results in large number of individual ‘product lines’ which means comparing on price alone is not enough, consumers need to compare like-for-like products.

It is imperative to recognise that pricing is only one aspect of competition; general insurers compete vigorously with diverse product offerings, coverage and claims servicing and performance. Premium increases have been driven by a diverse range of factors, such as the number of natural disasters, and must be seen against the volatile financial performance of the general insurance industry. (ICA, sub. 32, p. 3)

Having such a large number of marginally differentiated products within insurance makes comparisons complex. The recent Senate Economics Reference Committee identified concerns about this in its final report, *‘Australia’s general insurance industry: sapping consumers of the will to compare’*.

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. (SERC 2017, p. 13)

Research conducted by the Insurance Council of Australia has also found that consumers are much more focused on price than in matching their specific needs with the right type and level of cover. The Insurance Council is currently implementing the recommendations of the Effective Disclosure Taskforce and notes that 'Better assisting consumers to assess and compare policies on their coverage will stimulate deeper competition based on product features and not just price' (ICA, sub. 32, p. 14).

As noted above (in the section on distribution channels), the use of comparison websites has been increasing, and concerns have been raised by a variety of participants from industry and consumers representatives about this leading to a focus comparing on price alone (box 11.2). Given the complexity associated with comparing like-for-like products, price alone is not a good indicator of competition in general insurance market, and where consumers do make decisions on price alone, they may find the product does not cover the risks they expected it would.

Pricing for risk

One of the biggest risks that general insurance mitigates is that of natural disasters. As outlined above, many insurers use reinsurers to diversify their risk. The Insurance Council of Australia suggests that for insurance to be economically efficient and commercially viable, rigorous risk assessment should determine the underwriting criteria and pricing.

This allows insurers to offer insurance at a price appropriate to insureds and enables insurers to put aside reserve funding for future liabilities and, importantly, also enables insurers to target important risks and provide a diverse range of insurance products. (ICA, sub. 32, p. 9)

As noted in chapter 2, providers' ability to take risk is restrained by regulators. Under the existing prudential framework, insurance providers are required to maintain adequate capital against risks and maintain assets in Australia of a value that at least equals the amount of the liabilities in Australia (see box 11.4). While these requirements are designed to prevent insurers going out of business, and thus not delivering on their prudential promise to consumers, insurers' ability to take risk is restrained by regulatory requirements.

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 (2016c) — 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. Not all consumers will benefit from innovations that expand insurers' data collection and analysis capabilities, although many will (box 11.5).

As outlined in part 3 of this report, increasing consumers' access to data can help them better assess and manage risks, and thus make better decisions. ASIC has identified general insurance information which insurers currently hold that would be of benefit to consumers — such as natural disaster risk data specific to areas of residence and average insurance claims processing times and/or claim payout rate (which could provide better assistance for decision making than long and complex disclosure documents for insurance products) (ASIC, sub. 40, p. 100).

Box 11.5 Impact of data on insurance market outcomes and competition

As noted by ASIC:

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 both offer increasingly personalised products and mitigate risks by penalising risk-taking behaviour (or, alternatively, rewarding risk-avoiding behaviour) among their customers. This also has another efficiency-enhancing impact on insurance markets — it provides for greater market completeness, and insurers can distinguish between different types of consumers.

That said, not all customers would benefit from this reduction in 'information asymmetry'. Any move toward more personalised products and cost-reflective pricing would see higher risk customers paying 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, reducing competition. However, as the Commission recently noted in its *Data Availability and Use* inquiry, 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 IBISWorld, 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. (Wu 2017a, p. 11)

Most of these recent innovations have 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).

Interestingly, 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. While these innovations 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 (Muio 2017). KPMG suggests this trend will continue, as the rise of autonomous vehicles will lead the personal motor insurance industry to shrink to 40% of its current size within 25 years (KPMG 2015)
- 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:

- car insurance charged per hour for borrowed cars
- coverage for three valuable items for £15
- 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), and
- 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 financial deals to insurtech 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).

Overall, while some innovation has occurred in Australia, it has not been particularly substantive. The presence of foreign suppliers has not seen offshore innovations arrive readily here. Market structure and the high level of concentration may be a factor. Certainly, from the inverse perspective, there is little evidence to suggest that competition has been a strong driving force for innovation in the general insurance industry.

Is Australia’s general insurance market competitive?

The key question to address when considering the supply-side of the framework, as outlined in chapter 2, is whether the extent of rivalry in the Australian financial system and capacity for entry by new firms is such that innovation and efficiencies that improve community (consumers, employees and shareholder) outcomes are possible.

Box 11.6 outlines our findings from examining the concentration and contestability indicators for general insurance. We have observed in this inquiry:

- high levels of concentration across the industry generally
- significant barriers to entry, particularly regulatory barriers
- some new entrants have since been acquired by existing insurers as they pursue strategies of growth through creeping acquisition
- a lack of transparency, including complexity in products but also the ‘illusion of competition’, and
- a lack of innovation compared with overseas markets.

Consistent with the effect of complex product proliferation in some parts of banking, it appears probable that in insurance the inability of consumers to exert competitive pressure on providers in this sector is also an issue:

One of the key areas of the financial system where we see competition failing is insurance... 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. Two current examples which highlight how this lack of competition affects consumers are: add-on insurance sold through car yards and authorised deposit-taking institutions (ADIs); and domestic home and car insurance. (CALC, FCA and Financial Rights, sub. 23, pp. 14-15)

Confusion or lack of engagement often stems from opaque product pricing and the difficulty understanding complex financial products. (Choice, sub. 42, p. 16)

As the consumer protection and conduct regulator of financial services and products in Australia, we have observed a number of ongoing problems in the markets we regulate. These problems have often resulted where complex and systemic supply-side and demand-side factors that are particularly characteristic of financial markets (including market structures and the behaviours of both firms and consumers) lead to poor consumer outcomes. These factors mean that in some retail markets, competition cannot currently fully deliver what it is intended to deliver. (ASIC, sub. 40, p. 65)

In giving evidence to the recent Senate Inquiry into General Insurance, the former Australian Competition and Consumer Commission chair argued that competition in the general insurance market ‘is not fully effective’, and that there is a clear weakness on the demand side of competition in the industry:

Professor Fels highlighted information asymmetry between insurers and consumers, particularly with regard to how insurance is priced, as a primary barrier to effective competition from a demand perspective. (SERC 2017, pp. 24–25)

This weakness in demand side pressure is manifested in the low rates of consumer switching between insurers, and the wide disparity that may be found between insurers in their quotations for identical properties and risks. Further consumer issues are addressed in part 3 including issues specific to consumer credit insurance and other types of add-on insurance that are sold alongside (and in relation to) the product purchase (chapter 14).

Box 11.6 What the competition and contestability indicators tell us about the general insurance market

Market share and concentration: As with the banking industry, general insurance provision is a story of 'the big four'. While they may not be the same companies every time, in key general insurance markets (home insurance, domestic motor, travel, lenders mortgage insurance, reinsurance and general insurance overall) the largest four companies hold in excess of 70% market share (figure 11.4). Using the Herfindahl-Hirschman Index (HHI) to take into account the extent of variation in markets shares between providers, we found the markets for general insurance (in aggregate), domestic motor insurance, lenders mortgage insurance and reinsurance to be highly concentrated. While the domestic home insurance market is less concentrated, the two largest firms account for more than half the market (table 11.4).

Performance: While prices of retail general insurance products have been rising over the past 10 years, particularly home insurance, the level of profitability in the industry has experienced a downturn in recent years, with increased claim costs from severe weather events including cyclones in 2017, 2014, 2011 and 2006. Total net profit after tax, return on investment and return on net assets are all currently below the ten-year average (see section on performance).

New entrants: There have been 30 entries into the Australian general insurance market over the past 10 years. While some of this movement can be attributed to mergers, restructures and name changes, new entrants have included foreign entrants, new entrants with links with banks and other large retailers, and some niche providers, specialising in particular insurance lines. Some of the new entrants over the past 10 years have since been acquired by other insurers as they pursue strategies of growth through creeping acquisition (see section on new entrants).

Barriers to entry: Because of regulatory requirements, including APRA authorisation and capital requirements, barriers to entry are relatively high and many of the new entrants over recent years are Australian branches of large foreign insurers (see section on new entrants).

Integration: Integration is particularly relevant to insurance as providers extend across the supply chain with multiple 'brands' which compete against each other, thus providing the illusion of more competition than actually exists. For example, the four largest insurers provide products using more than 30 brands. Integration also exists where ADIs provide general insurance through their insurance arms (see section on integration and chapter 7).

Non-price competition: Insurance products are not homogenous goods, rather they are specific to the particular circumstances, including the risks covered and the amount they are covered for, any exclusions, excesses or waiting periods. This product differentiation means there are a large number of individual 'product lines'. In the absence of consumers comparing like-for-like products, comparing on price alone will not be a good indicator of competition. Product comparison is not always an easy task for consumers (see section on non-price competition and part 4).

Pricing of risk: One of the biggest risks for insurance to mitigate is that of natural disasters. Many insurers use reinsurers to diversify their risk, however insurers' ability to take risk is restrained by regulators. Under the existing prudential framework, insurers are required to maintain adequate capital against risks and maintain assets in Australia of a value that at least equals the amount of the liabilities in Australia (see section on the pricing of risk and appendix B).

Product innovation: Competitive markets should see product innovation, and while some recent innovation by the large providers has occurred recently, it appears that Australia is lagging behind other countries, including the United Kingdom (see section on product innovation).

11.4 Reforms to promote competition in general insurance markets

Require providers to include more comparative information on insurance renewal notices

Given the annual renewal notice is the switching trigger for insurance, including extra information on it may just be the trigger many consumers need to consider whether the price for their renewal is competitive, and if not, prompt them to switch.

The first piece of extra information that should be included on a renewal notice is last year's premium. Following a large-scale randomised controlled trial, the UK Financial Conduct Authority introduced this requirement across all general insurance markets in April 2017 (FCA 2016). It is also a recommendation of the Senate Standing Committee on Economics Inquiry into Australia's General Insurance Industry (recommendation 3) (SERC 2017) which the Australian Government agreed to in its December 2017 response, noting 'there is merit in further reviewing this recommendation and will task the Commonwealth Treasury with assessing this proposal' (Australian Government 2017b).

[T]he Financial Conduct Authority in the UK has... partnered with home and motor insurers to conduct trials with 300,000 customers to test improved renewal notice formats. They found that placing last year's premium on renewal notices caused 11-18% more consumers to switch or negotiate their home insurance policy. (Choice, sub. 42, p. 12)

Choice notes that similar changes are being made in the retail energy market with reminder notices serving as positive drivers of competition (Choice, sub. 42, p. 16) where 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 MP 2017).

The information about the previous year's premium should be included near the information about the current premium and in a font no smaller than that for the current year's premium. Another piece of extra information that should be included on a renewal notice is the percentage change in price since the previous year's premium

The industry's 2016 effective disclosure taskforce report 'Too Long; Didn't Read — Enhancing General Insurance Disclosure' recommended the Insurance Council of Australia should coordinate trialling of the provision of a reminder of the previous year's premium at each renewal (Effective Disclosure Taskforce 2015). Many insurers are already progressing in this direction 'For example, several insurers have moved to provide year-on-year premium comparisons in the context of Emergency Services Levy reform in NSW' (ICA 2017b).

DRAFT RECOMMENDATION 11.1 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.

Reduce the illusion of competition

As outlined above, because many general insurers provide insurance under multiple brands, this creates the illusion of more competition than actually exists in general insurance markets.

When consumers are looking to purchase insurance, they should know who it is that is underwriting the insurance brand they are purchasing and be aware of any other brands that are underwritten by the same insurer.

DRAFT RECOMMENDATION 11.2 TRANSPARENCY ON INSURANCE UNDERWRITING

On the same part of an insurance brand's website that contains the information about which insurer underwrites their product, a list of any other brands that are underwritten by the same insurer, for that particular form of insurance, should be included.

Insurers should provide an up-to-date list of the brands they underwrite to the Australian Securities and Investments Commission (ASIC). ASIC should publish this information as a transparent list on its website.

Remove distortionary taxes

Taxes can reduce incentives for people to invest or alter their consumption patterns in ways that reduce their welfare. Stamp duties on insurance are particularly inefficient taxes because of their narrow base, the distortions to insurance prices, and reduction in insurance affordability. They create an incentive to not insure.

As stamp duty is applied to the price of insurance, including goods and services tax, it is a tax on a tax.

While the ACT has abolished stamp duty on insurance, it still applies in other states and the Northern Territory, and in one case (NSW) multiple rates apply. There have been some recent moves in some states (including NSW and Victoria) to extend exemptions, including to crop and livestock insurance, however these add to the complexity of the system (box 11.7).

The 2009 Report on Australia's Future Tax System (the Henry review) recommended insurance taxes should be abolished and replaced by more efficient taxes noting '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. 2009).

Box 11.7 Stamp duty requirements vary across the country

- **ACT** — stamp duty on general insurance has been abolished in the ACT (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).

The Commission has previously recommended State and Territory taxes and levies on general insurance should be phased out as part of its inquiry into natural disaster funding.

DRAFT RECOMMENDATION 11.3 PHASE OUT DISTORTIONARY INSURANCE TAXES

Consistent with the Commission's 2014 Natural Disaster Funding Inquiry (recommendation 4.8), state and territory taxes and levies on general insurance should be phased out. This should commence from mid-2018.

ARE CONSUMERS ABLE
TO EXERT COMPETITIVE
PRESSURE?

PART III

Part III Are consumers able to exert competitive pressure?

Consumer satisfaction with product choice, quality and price is the ultimate goal of a competitive market. Driven by fear of losing market share, innovation by providers should deliver a continuously improving product offering on a range of features.

While consumers benefit from competitive markets, they are also a necessary part of the competitive dynamic. For consumers to fulfil their role in this process, they need to be informed and motivated players, making decisions that lead to the best possible outcomes.

Information is overly complex, confusing, difficult to find and compare

Reliable and timely information is crucial. 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 say to a provider, ‘No, thanks mate, I’m off down the road’. This process gives providers a ‘very powerful incentive’ to deliver a choice of products and services that meet the needs of consumers (Harper 2016).

But few consumers actively shop around for financial products and services. Information is often overly complex, confusing, time-intensive to obtain and difficult to compare.

- Consumers are confused by the array of products and providers to choose from, but often this is an illusion of choice and competition (chapters 8 and 12). Bundling, where several financial products are sold as a package, can obscure the price of individual products making it difficult for consumers to assess the value of each individual part (chapters 7, 8 and 13).
- Choosing a financial product is inherently complex, with the possibility of severe consequences (if mistakes are made), and little experience to draw upon to help in the decision-making process (chapter 12). Making these decisions requires a certain level of financial literacy to assess information that is available.
- While consumers seek help from intermediaries (such as mortgage brokers, advisers and comparison websites) to navigate the process of shopping around, they are unaware that the information they receive is influenced by commercial arrangements and ownership (chapters 7, 8, 12 and 13).
- And some information is just impossible to find. Lack of price transparency in the home loan market, for example, means that publicly reported interest rates may bear little resemblance to the individually-negotiated home loan interest rates that are actually paid (chapters 8 and 12).

The vast amount of complex and difficult to understand information leads consumers to adopt strategies to save time and energy (such as opting for the default option, choosing products based on brand loyalty or price alone). But these strategies result in significant and systematically poor outcomes. This does not imply that consumers are incapable of understanding the important features or are apathetic — instead these actions are quite normal when faced with large costs (in terms of effort and fees) in shopping around.

Lack of switching dampens competition

While consumer switching plays a role in the competitive process, the potential scope for gains from pursuing switching strategies should not be overstated.

For some financial products, where consumers can relatively cheaply and easily hold multiple versions of similar products from different providers, there is less scope for increased switching to deliver beneficial outcomes. Two examples include transaction accounts and credit cards of those who pay off their balance every month. Competition for consumers' business can be strong, and consumers can easily choose between the products that they hold, potentially on a transaction-by-transaction basis. That said, even when some consumers hold multiple competing products, financial services providers may attempt to dampen this competition, say through bundling.

Where consumers find it costly (such as loans) or not possible to hold multiple versions of similar products (such as insurance on an item), switching is crucial to the competitiveness of market outcomes. However, there are multiple barriers to consumer switching readily between these forms of financial products and services: switching can take quite a bit of time and effort, some intermediaries have a disincentive to help consumers switch, and consumers may have a preference to stick with the status quo (chapter 13).

Cognisant of immobile customers, providers routinely fail to offer good deals to existing customers, narrowly framing product information and bundling goods in a way that reduces price transparency. This lack of supply-side competition reinforces consumer inertia. Given the current variety in providers and product offerings, for some products, many consumers do not find it worthwhile switching as any benefit would not be worth the effort. In addition, many providers only offer better deals to new customers for a limited time, so the benefits of switching are often short lived.

DRAFT FINDING III.1 CONSUMERS' CAPACITY TO PUT COMPETITIVE PRESSURE ON PROVIDERS IS OFTEN LIMITED

For many financial products, consumers are limited in their responses to variations in price and service and currently cannot be a source of significant competitive pressure on financial institutions. Consumers face information and switching barriers; and they perceive insufficient ongoing difference between providers and product offerings to make the process of switching worthwhile.

Handing power back to the consumer

The growing understanding of consumers' behaviour and increasing amounts of data can be used to design a 21st century disclosure regime that provides useful information, streamlines switching and reduces the personal information power imbalance. When both sides of the market function well, a virtuous circle is created between consumers and suppliers. So regulatory and market reforms recommended in this report to improve supply-side competition also have feedback effects on improving consumer power in the competitive dynamic (chapter 2).

Ensuring sufficient and pertinent information is available

Consumers do not necessarily need more information. Considerable product information currently exists, although some gaps remain. In particular, we identified a substantial gap in consumer knowledge of actual home loan interest rates paid. To address this, the Commission recommended that information be routinely collected by APRA on median interest rates for categories of new residential home loans and made available to consumers by ASIC through an online tool (chapter 8).

For those who seek home loans through mortgage brokers, additional broker disclosure requirements would mean more information would be available to consumers on the types of products that their broker is able to offer and the incentives faced, for example as a result of ownership arrangements between lenders and the mortgage aggregator (chapter 8).

Motivate consumers to reassess their product choices

By providing consumers with the right sort of information, the shopping around process may be more easily triggered. Consumers need information provided in a particular format, time, or location. This information can be new or it may already be publically available. But when presented in a useful form, consumers can have greater understanding of a product's features.

With the enormous proliferation of brands and complexity in understanding differences between products, insurance is an area that the Commission found ripe for improved

consumer outcomes. The Commission has recommended that renewal notices for general insurance products should transparently include information that would prompt, on a regular basis, consumers to consider alternative products and providers (chapter 11). The introduction of a deferred sales model for the sale of add-on insurance — in car dealerships in the first instance, with consideration of an extension to all add-on insurance products and extended warranties — would also allow consumers to think twice about whether they are getting the best value for money in the purchase of such products at the point of sale of other consumer goods (chapter 14).

Consumer Data Right to reduce the information power imbalance

The lack of consumer engagement with the shopping around process is symptomatic of a broader power imbalance. Specifically, for many financial products, the market is dominated by a small number of providers that have significant market power. In the face of this, it is apparent that many consumers feel relatively powerless to meaningfully exercise choice when deciding whether to switch financial products or providers.

Reforms that allow individuals to better exercise their consumer rights could help address the power imbalance between providers and consumers in the market. In its 2017 inquiry report on *Data Availability and Use*, the Commission recommended that consumers should have a Comprehensive Right to their consumer data. Such a right would support consumers in making the most of their data across all types of financial (and other) services.

The Australian Government has undertaken to implement some aspects of the Comprehensive Right, including through the adoption of Open Banking (chapter 13). Notably, however, Open Banking is limited to banking data (whereas the Comprehensive Right is broader) and does not confer rights in relation to editing data or being informed about the trade or disclosure of data. The Australian Government should implement its Open Banking regime in a manner that enables the full suite of rights for consumers to access and use digital data, as specified under the Comprehensive Right (chapter 13).

Supply-side and regulatory reforms to improve competition

A number of pro-competitive reforms currently in train that will drive product innovation in the financial services market, will also have the real potential to improve consumer shopping around and switching. For example, the adoption of Comprehensive Credit Reporting and Open Banking will allow financial service providers to access richer information about consumers' financial characteristics, and match consumers to products of better value (chapter 13). But improved information provision is only part of the solution to a well-functioning competitive process. Other supply-side and regulatory reforms recommended are also crucial.

12 Advice and information

Key points

- Information provision is a key step to improving weakly competitive markets. It is also crucial to helping consumers help themselves.
- Serious problems exist with the quality and the reliability of information in the finance sector.
 - Comparison websites, financial advisers and mortgage brokers do not necessarily solve the information problem. Many consumers consider that financial advisers are too expensive, while mortgage brokers are under no obligation to put the customer's interest first. Websites can offer simplistic comparisons of complex products, such as insurance.
- Faced with an overwhelming volume of often irrelevant material that is difficult to digest, consumers may: base their choices on trust (such as, a known brand); accept the default option; or narrow the decision making criteria to one feature, such as price — completely normal strategies given the information haze, but ones that do not promote competition.
- There is a great abundance of 'information' about financial products. But less complex, more targeted and strongly reliable information is in short supply.
- 21st century information disclosure should:
 - take full advantage of the benefits of digital technology in conveying information to consumers
 - exploit the depth of information held by banks and insurers by requiring the publication and release of pertinent information in digital formats
 - use actual information on prices currently paid for your product
 - show the trade-off between price and risk
 - facilitate comparisons across products and providers.
- The ultimate aim of enhanced information disclosure is to improve consumer outcomes. Therefore, new information provision should be tested both before policies are introduced and after to ensure consumers *do* benefit, and that well-meaning policies do not result in unintended outcomes for consumers and competition more generally.
 - In line with this, the Commission recommends that 'general advice' should be renamed, based on consumer testing of alternative terminology, to ensure that misinterpretation and excessive reliance on this type of information is minimised.
- Reforms in this area are likely to be amongst the most visible to the general public. And they may have the greatest capacity to engender changes by individuals.

12.1 Information is crucial to competition

The provision of information and advice plays an important role in overcoming information asymmetries in the financial products and services market, and promoting effective competition (chapter 2).⁵⁶ For consumers to exert demand-side pressure that drives effective competition they need to be able to:

- *access* information about the products and services available in the market
- *assess* the information available about these products to compare them
- *act* on this information by purchasing or switching to a product that offers the best value to them (ASIC, sub. 40; Fletcher 2016a; OFT 2010).

This chapter examines the sources of information that consumers use to help make decisions about financial products and services. It uses the first two criteria (access and assess information) to evaluate if existing information sources are engaging and empowering consumers to apply competitive pressure on providers of financial products and services. It then outlines the principles for 21st century information disclosure and how these have been applied to the recommendations in this report to improve competition. (Consumers' ability to act on information by switching products is covered in chapter 13).

12.2 Are the sources of information empowering consumers?

For financial products and services, the need for consumers to have access to advice and information is motivated by:

- the complex nature of these products and services
- the level of financial literacy of consumers
- the limited experience consumers have to draw upon to make a decision due to the infrequent nature of many of these purchases
- the severity of consequences if things go wrong, compared with other types of purchases
- the desire to make decisions that lead to better outcomes (and to avoid highly detrimental wrong ones).

⁵⁶ The term advice is used throughout this chapter to generally mean guidance or a recommendation. At times, the term is as defined in the *Corporations Act 2001* (Cth), and is generally labelled with the terms 'financial', 'personal' or 'general' advice to indicate the legal context.

What are the problems consumers face when accessing information?

When consumers start searching for a financial product or service the process of finding information needs to be relatively easy — with the information actually available and not too time consuming or costly to find.

Information is available, but it is complex, opaque and often not used

Product disclosure statements have been the main regulated source of information for consumers. They were intended to provide information to consumers to help empower them in the decision making process. Providers are generally required to give consumers a product disclosure statement when they recommend or offer a financial product. It must include information about the product's key features, fees, commissions, benefits, risks and the complaints handling procedure (ASIC 2016g).⁵⁷

However, product disclosure statements tend to be complex and lengthy documents that do not enhance consumer understanding of the product (Murray et al. 2014b; ING, sub. 20; ICA, sub. 32). The Australian Securities and Investments Commission (ASIC) found that 'disclosure regulation has focused on what information about the product must be disclosed by issuers, rather than how the disclosure can help investors understand the product' (ASIC 2014e, p. 16). ING submitted that it is the prescriptive regulatory measures that have created documents that can be difficult to read or overlooked by consumers (sub. 20).

In many cases, consumers do not read or understand the material, but they are bound by the terms and conditions contained in them.

- The Murray Financial System Inquiry (FSI) found that the effectiveness of disclosure as the main source of consumer protection can be limited when consumers are disengaged, products are complex or financial literacy is low (Murray et al. 2014a).
- A survey about insurance policies after the 2011 Queensland floods found that of participating consumers:
 - 51% read the policy, but misunderstood important exclusions or limitations.
 - 12% received the policy, but never read it.
 - 4% tried to read the policy, but gave up as they could not understand it (Caxton Legal Centre 2011).
- Federation of Ethnic Communities' Councils of Australia submitted that people from culturally diverse backgrounds may not have access to information if the material is not provided in their preferred language (sub. 13).

⁵⁷ Licensees under the consumer credit framework must give consumers a Credit Guide, setting out their services and costs. Licensees also have to provide key fact sheets for home loans and credit cards, and for credit products, must disclose key information in a financial table in the contract document (Murray et al. 2014b).

-
- Even professionals encounter problems in evaluating complex financial products based on the information providers supply. The Financial Planning Association of Australia noted that it is ‘becoming increasingly more difficult for financial planners to compare products’, largely owing to the ‘lack of comparable information from product providers’ (sub. 26, p. 17).

In the current regulatory framework, product disclosure requirements should be viewed as a necessary first step in making information available to consumers. However, it should be supplemented with information that is presented in ways to help the consumer or with consumer access to their own data (ASIC, sub. 40; Fletcher 2016a; Murray et al. 2014a; PC 2017c). These policy options are outlined below and in chapter 13.

Regardless of the nature of the product disclosure statement and supplementary information, it will not be enough to rely on it solely to ensure competitive pressure in the market.

A good example of poor information: the implausibility of knowing actual home loan interest rates

As outlined in chapter 8, consumers are generally able to obtain information about the standard variable interest rate. However, it can be unclear to consumers what the standard variable rate represents and what a typical discount on the standard variable rate is. For example, a broker or bank employee could offer a borrower a 0.5% discount off the standard variable rate, which may appear to be a good deal. However, the borrower cannot be sure that everyone else in his or her situation is not getting the same or a better deal.

We do know what the standard variable rate is not: a real time representation of what the class of borrowers seeking the same loan received from that institution last month. Such information would be far more helpful to a borrower than today’s dated and opaque single comparator. Digital data management in the 21st Century is able to provide such information to consumers. But banks are not required to do so, and so do not. The RBA highlighted these issues:

... 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)

Our draft recommendation 8.4 deals with this issue.

Pricing structures and bundling can increase complexity of information

Bundling, whereby several financial products are sold as a package, contributes to product complexity (chapters 7 and 8). Through bundling, providers can obscure the price of individual products and make it difficult for consumers to understand the value of each individual part (ASIC, sub. 40; RBA, sub. 29). For example, ASIC found that ‘bundling of

add-on insurance products with vehicle finance caused confusion about the total cost for some consumers' (sub. 40, p. 72).

Similarly, participants identified the credit card market as an area where complexity is common. For example:

... complex pricing structures in their marketing and product information, which makes the overall costs difficult for the average consumer to understand. (Consumer Action Law Centre (Consumer Action), Financial Counselling Australia (FCA) and the Financial Rights Legal Centre (Financial Rights), sub. 23, p. 25)

The complexity of credit card product features such as discounted balance transfers, annual fees, interest-free periods, and rewards programs can render product comparison extremely difficult' (ASIC, sub. 40, att. 1, p. 21).

Consumers resort to making decisions based on trust

Despite the increasing importance of advice, only 20 to 40% of consumers access the services of a financial planner, with 48% of Australian adults indicating unmet advice needs. Amongst the barriers to accessing financial advice is the high cost of advice and lack of funds to pay for advice (ASIC, sub. 40, attachment, p. 85; MLC, sub. 52). Estimates of the average cost of financial advice range from \$1250 for scaled advice to \$2500 for comprehensive advice. In contrast, Australian adults were only willing to pay, on average, \$780 to receive financial advice (ASIC, sub. 40, attachment).

When decisions are complex, consumers resort to using strategies to help make the decision making processes simpler (for example, Fletcher 2016a; ASIC, sub. 40; COBA, sub. 21). 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 2014d, p. 172)

In some cases, consumers may turn to trusted sources of information when it is difficult for them objectively to assess the information available to them. Although, these sources may provide sub-optimal outcomes.

Family and friends, for example, are a traditional starting point for information, filling the gaps that consumers lack from their own experience by drawing on the past involvement of people they know and trust. And they can also become by default the only source of information, particularly in situations when consumers are confused and overwhelmed by other channels of information and advice. But sometimes this advice perpetuates common misconceptions and leads 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 consider ‘adequate’ and 39% ‘poor’ (ASIC, sub. 40).

Information provided by intermediaries is constrained by vertical integration

Some consumers seek assistance in purchasing financial products and services from intermediaries such as comparison websites and mortgage brokers, in part, to gain greater access to information and make the search process easier.

However, consumers are often not able to assess the extent to which they are gaining access to a wide range of products on the market or the extent to which the range of products that an intermediary (such as a broker or adviser) chooses from is limited by the vertically integrated ownership of product provider and aggregator. (Mortgage brokers usually have access to loans through an aggregator, who in turn has a relationship with lenders. Chapter 8 discuss this in more detail).

Mortgage brokers

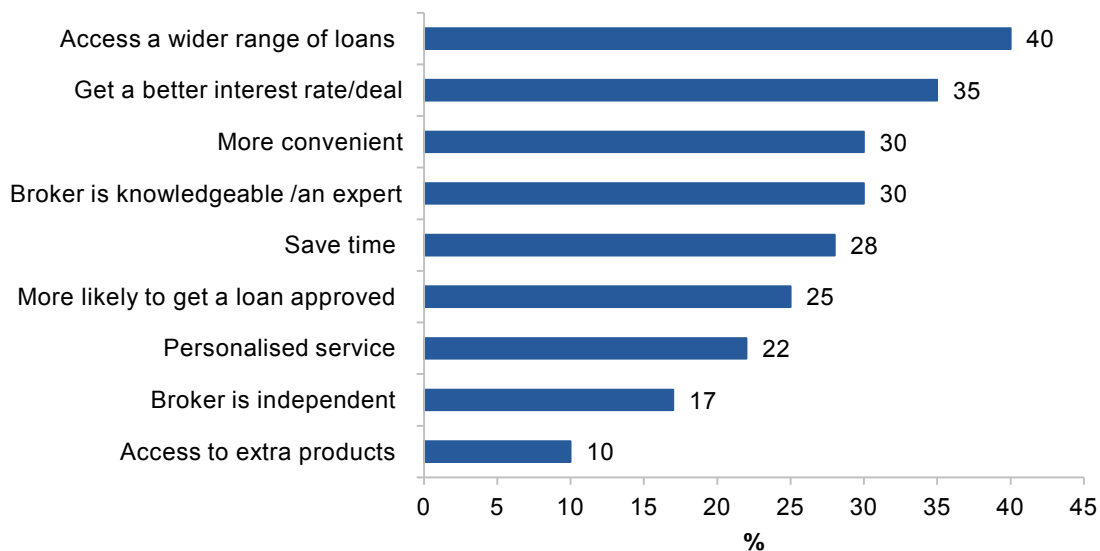
It is becoming increasingly common for consumers to seek specialised assistance when choosing and applying for a home loan, with over 50% of home loans sourced through mortgage brokers (ASIC 2017ac).

The primary motivation 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 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) (figure 12.1). For first home buyers, brokers can demystify the process of applying for a home loan or help wade through the plethora of choices. For those looking to refinance a loan, brokers may (rightly or wrongly) be perceived as acting on the side of the consumers, in what is viewed as a complicated transaction requiring negotiation (MPA 2017). The extent to which mortgage interest rates vary under brokers compared with those direct from lenders are detailed in chapter 8.

A mortgage broker investigates and selects potential home loans for clients from a panel of lenders, which is established by the aggregator. However, the information that consumers access from the panel is influenced by the vertical integration between lenders and aggregators as this integration potentially:

- restricts the degree to which competing lenders’ products are placed on the panel.
- gives the impression of access to more products and suppliers with the inclusion of white label mortgages — a mortgage distributed under the aggregators name, but financed by the owner-lender (ASIC sub 40).

Figure 12.1 **Consumers use mortgage brokers to get better outcomes^a**



^a Responses from consumers with recent experience/future intention to use mortgage brokers.

Source: ASIC (2017ac)

The Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre raised concerns about the objectiveness of advice when there is vertical integration in the sector, especially in broking and insurance markets:

Alignment or vertical integration of advisers risks limiting effective competition by making it more difficult for advisers to consider products which may be more suitable for a client but not included on an Approved Product List. It may also mislead consumers — many consumers will not expect advisers to be limited to providing advice about products from certain providers. (sub. 23, p. 9)

CHOICE highlighted the conflict of interest that vertical integration creates, with consumers lacking the information and implications of such arrangements:

If someone is using, for example, a mortgage broker thinking they are receiving an independent service, one that will act in their best interests and recommend the best loan for their needs, that may not be the case. The reality is that most consumers are only shown a limited amount of the market, and the broker often receives incentives to act as a sales channel in a way that increases the significant levels of concentration in the mortgage market. (sub. 42. p. 22)

Accreditation requirements of mortgage brokers by aggregators and banks, may also lead to a further narrowing of the possible options presented to consumers, if a broker chooses not to seek accreditation. Around 80% of brokers are free to choose who they are accredited with, but that does not ensure that they do in fact gain wide accreditation (ASIC 2017ac). This situation was highlighted by a mortgage broker:

Without holding a bank accreditation, a mortgage broker is banned from introducing any new business to that bank. If a consumer wants to use a bank that the broker has been refused accreditation from, because they are not a member of one of these industry bodies, the consumer must find a mortgage broker that does hold an accreditation or they must go directly to the lender themselves. (Maria Rigoni, sub. 46, p. 6)

In the case where brokers choose not to seek accreditation with some lenders, brokers are not able to recommend consumers request a home loan from those providers. But there is no obligation for consumers to be made aware that the broker is suggesting home loans from a narrower market than presented by the aggregator (which is already a constrained representation of the market). Comparison websites (discussed below) have a similar weakness.

Financial advisers

A vertically integrated financial advice business, where the business engages in both the delivery of financial advice services as well as providing (or manufacturing) the financial products, creates an inherent conflict of interest. The law allows such a conflict to exist but requires vertically integrated financial advice businesses to manage this conflict 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).

It is not clear, from first examination, that vertical integration of financial businesses necessarily restricts the information available to consumers.

- On one hand, financial advisers, like mortgage brokers, recommend products to clients from an approved product list (APL), which is a representation of investment products available on the market.
- But on the other hand, unlike mortgage brokers, financial advisers are not restricted to recommending products on the APL — a measure that provides an avenue for financial advisers to ensure they fulfil their duties and obligations. Furthermore, to manage the conflict of interest, a thorough approval process for selecting products would ensure greater objectivity of products on the APL.

Information about the actual 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. But currently these are not publically available. Whether or not the vertical integration of financial advisers reduces the information available to consumers, in practice as observed by the behaviour of advisers, and results in poorer outcomes, is an open question.

Forthcoming ASIC research, which is to be released around the same time as this draft report, will shed light on this issue. The results will be incorporated into the final report.

Comparison websites

Comparison websites provide an interactive comparison tool for many financial products from many different retailers and allow consumers to search and compare products based on price, features, reviews and other criteria. They are generally a free service to consumers. They provide consumers with a relatively easy avenue to compare financial products across providers, in contrast to approaching individual product providers.

However, the commercial arrangements between comparison websites, the issuers and distributors of financial products mean that consumers are accessing information that only covers a portion of the market, or is framed in such a way to influence outcomes in a particular direction (that is not always consistent with consumer interests). Examples of such conduct include:

- the use of commission payments leads to these products appearing ahead of others in consumer search results (that is, particular products are prominent to the consumer)
- only products from commercially related parties are included in search comparisons
- offering comparisons based on one or a limited number of features (such as the reward points available on a credit card), when other feature should also be considered (such as annual fees and interest free periods) (ASIC, sub. 40).

In their joint submission, the Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre (sub. 23) concluded that, in the insurance market, comparison websites do not increase transparency of the products available on the market. Instead they offer simplistic comparisons of complex products, usually based on price alone and disregarding differences in policy coverage, product options and claims service capabilities. They also expressed concern about remuneration arrangements between the website owners and insurance providers:

‘Free’ comparison sites can earn commissions from insurers. These commissions can make up a big portion of a consumer’s total insurance premium. Additionally, some comparison sites are misleading about how much of the market they compare and some sites are actually owned by the insurance companies they’re supposedly comparing. (sub. 23, p. 21)

Financial advisers are constrained on the products they can advise on

Financial advisers are licensed to provide financial product advice on a wide range of products (as defined in the *Corporations Act 2001* (Cth)). However, there are a range of products that are considered not to be financial products, and as such financial advisers cannot advise on them. These include credit facilities (among others) which are subject to a different regulatory regime.

Where financial advisers do provide advice on credit facilities, particularly mortgage broking services, they must both 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)). Some view this as a duplication of regulatory requirements, although ASIC has provided guidance to avoid duplicating processes (ASIC 2014c; Freeman 2014).

To increase the information available to consumers, the Commission is considering the benefit of allowing financial advisers to be able to provide advice on some credit facilities.

The separate regulation and processes appear to be an historical legacy, restricting the flow and potentially the quality of information available to consumers when they seek financial advice from an adviser. The benefits of having a single or hybrid licence would appear, at least on first principles, to allow greater flexibility of service provision, overcoming the need for two licences.

There would also be benefits to consumers receiving more holistic advice in one professional relationship. Currently, consumers need to go to a third-party when they require recommendations on credit products (such as a home loan or credit card). This could introduce an inconsistent or conflicting approach, reducing the ability of a consumer to meet their financial goals. Being able to receive such recommendations from the same adviser appears to have value. An industry provider highlighted the benefits to clients of being able to receive both financial product advice and consumer credit recommendations from the same adviser ‘... being able to provide the service themselves instead of referring the client onto a third-party gives us more certainty with regard to outcomes’ (Freeman 2014, p. 1).

Allowing financial advisers to provide advice on some credit products would also introduce contestability in the provision of advice. For example, mortgage brokers would no longer be the primary providers of information on mortgage products.

In addition to the increase in the sources of information available, consumers could potentially benefit from the best interest duties that apply to financial advisers, if that duty was to apply to credit products. CHOICE (sub. 42, p. 32) provided a comparison of the regulatory obligations of mortgage brokers with financial advisers, concluding that ‘brokers are being held to a relatively low standard’. CHOICE is supportive of increasing the obligations of mortgage brokers, or extending the best interest duty protections of the Corporations Act to mortgage broking services (sub. 42).

Allowing financial advisers to provide advice on some credit products would also introduce contestability in the provision of advice. For example, mortgage brokers would no longer be the primary providers of information on mortgage products.

INFORMATION REQUEST 12.1 POTENTIAL TO INCREASE THE SCOPE OF FINANCIAL ADVICE TO INCLUDE SOME CREDIT PRODUCTS

The Commission is considering recommending that ASIC-licensed financial advisers be able to provide advice on some credit products, in particular home loans, personal loans and credit cards. We seek views on:

- the merits of such a proposal*
 - which credit products should be included in this increased scope to provide advice*
 - the nature of any duty advisers would have to their clients*
 - different licensing approaches including the form of the licence*
 - the regulatory costs and impact on the industry.*
-

What are the problems consumers face when assessing information?

While product information may be available, consumers face difficulties in understanding the information presented to them, causing them to resort to a range of behaviours and strategies to help assess the information available (table 12.1). While these behaviours can be useful in making decisions under constraint, they can also introduce significant and systematic biases into decision making (ASIC 2017ae). 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 does not imply that consumers are incapable of understanding the important features or are apathetic. 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 2016a, p. 17)

Too much choice leads to narrowing of information, default options or status quo

Individuals can face, within a product or service, an array of options 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).

Table 12.1 Behavioural biases in financial markets

<i>Bias</i>	<i>Example</i>
<i>Decision-making shortcuts used when assessing available information</i>	
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'
<i>Preferences that are influenced by emotions and psychological experiences</i>	
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
<i>Rules of thumb that can lead to incorrect beliefs</i>	
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 (2014d)

The need to decide between a large number of options can lead to 'choice overload, with around 40% of survey respondents agreeing that there is often too much choice when making financial decisions (Fear 2008). When faced with a large number of products to choose from consumers tend to look for one or two pieces of information to make decisions rather than considering a wider range of benefits and costs of a product or service. 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, often advertising and marketing products in a way which highlights or downplays certain prices or features for commercial gain (ASIC, sub. 40; ACCC, sub. 17). As noted above, comparison websites 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 choice requiring expert information, 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. This issue is examined in chapter 13 Consumer switching.

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 suppliers with 22 brands offering pet insurance, and 20 of them being provided by the one insurer (chapter 11).

Optimistic behaviour, overconfidence, present bias

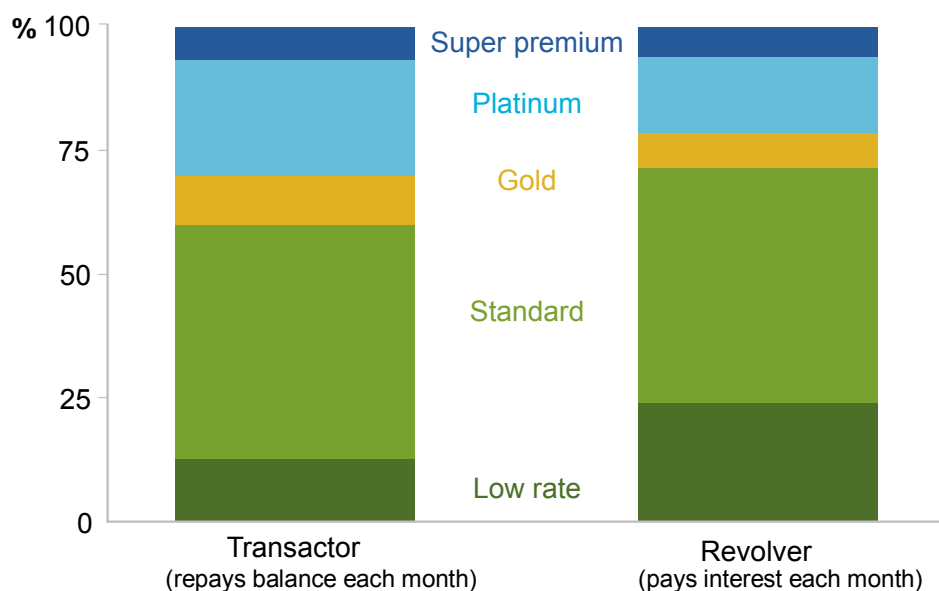
Consumers' ability to assess the information available is also influenced by general tendencies to focus on the present time while being overconfident about the future. This can lead to consumers focusing on costs that are incurred up front, down playing those incurred in the future, or to miscalculate 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 by the end of each statement and not incurring interest, making the interest rate charge irrelevant (ASIC, sub. 40; Consumer Action, FCA and Financial Rights, sub. 23). Yet 40% of credit card holders are 'revolvers' incurring interest on their credit card balance, with three quarters using a standard, gold, platinum or super premium card that incurs a higher interest rate than low rate credit card products (figure 12.2).

How do consumers know the product is 'good'?

The nature of financial products and services is such that performance and quality is not always apparent even after purchase, or it may take a long time before the quality or unsuitability is apparent (this is otherwise known as a credence good). For example, the quality and suitability of insurance policies are often unknown until a household or business makes a claim against a policy.

Similarly, when consumers seek advice from brokers or advisers, the same problems exists with assessing the quality of advice. As noted above, the quality of advice may be limited by vertical ownership between product providers and mortgage brokers with consumers unaware of this arrangement and how to assess this information (RBA, sub. 29).

Figure 12.2 Many credit card holders who pay interest, have higher interest rate cards



Source: RBA submission to SERC (2015) inquiry

Financial literacy is important to assess information

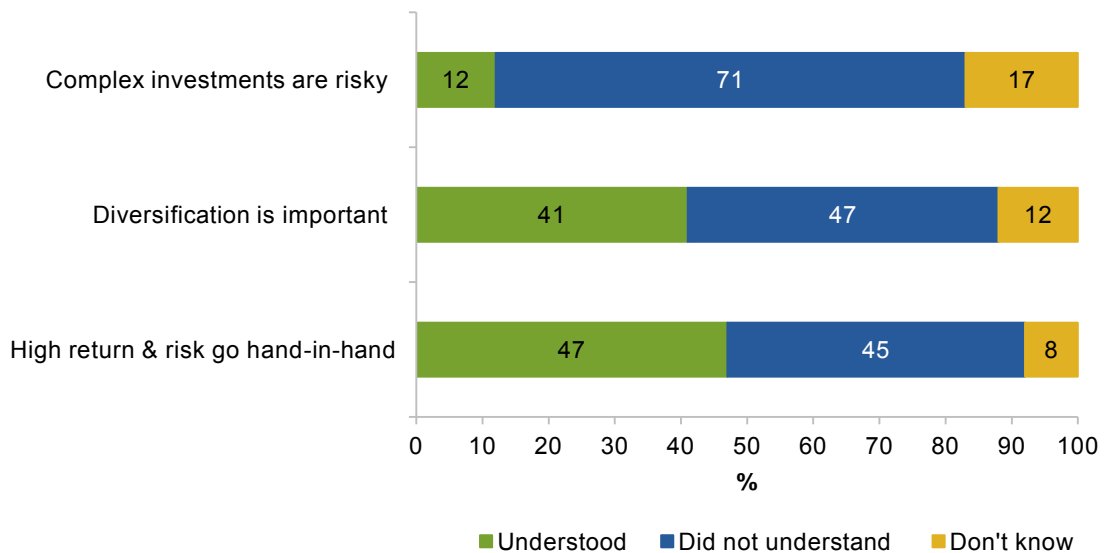
Consumers need a reasonable level of financial literacy to be active agents in the competitive process: to be engaged and motivated to seek out information and to have the knowledge and skills to assess the information gathered. There is evidence that some in the community do not fully understand certain financial products and services.

- Many financial decisions, for example, require choices involving risk and uncertainty, with people 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, believe consumers do not understand that higher reward often means higher risk, and 71% believe that consumers fail to fully understand the risk involved in complex products (figure 12.3).
- 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% had ‘no understanding’ of interest-only repayments (Yeates 2017c).

The infrequent purchase of some financial products and services also inhibits the development of financial literacy, as it leaves consumers with little experience to 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).

Figure 12.3 **Consumers have limited understanding of the role of risk**



Source: ASIC (2013a)

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 2014h). 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)

12.3 Principles of 21st century disclosure

The growing knowledge of how consumers behave and how they are influenced not only informs policy makers that traditional information provision may not always be effective, it can also be used to design disclosure material to help consumers exert competitive pressure.

It is not the lack of information that is necessarily stopping consumers from applying competitive pressure. It is the vast amount of complex and difficult to understand information that is leading consumers to give up before they even start. It is also the techniques used by providers in presenting information that can overwhelm consumers and guide them to an incorrect or less than ideal product choice. Why would consumers bother spending time comprehensively searching for and collecting information when they will be presented with a complex and overwhelming volume of material, much of it irrelevant to their specific need, that is difficult to digest?

And paying for assistance is still not sufficiently accepted, with ASIC finding people are only prepared to pay something less than half the current cost of comprehensive advice for financial advice.

Behavioural strategies that substitute for tailored advice save energy and time but can result in consumers making less than ideal choices.

21st century disclosure — using the advantages of digital data collection and presentation via mobile applications — aims to help consumers overcome this aversion by making the information easier to find and assess, with information presented in a way that is meaningful and digestible. By making this process less burdensome, consumers are less likely to need to resort to behavioural strategies and be able to make more informed decisions. 21st century information disclosure should:

- take full advantage of the benefits of digital technology in conveying information to consumers
- exploit the depth of information held by banks and insurers by requiring the publication and release of pertinent information in digital formats

-
- use actual information on prices currently paid for your product or in your area
 - show the trade-off between price and risk
 - facilitate comparisons across products and providers.

The following sections outline practical improvements for disclosure in the financial service industry, highlighting how these information principles have been imbedded in the Commission's recommendations.

The ultimate aim of these changes is to improve consumer outcomes. But this should be tested as consumers may behave differently to the way regulators and policy makers expect, and to ensure that the information is useful to the consumer (Fletcher 2016b; CHOICE sub. 42). Post implementation evaluation should also be undertaken to confirm that the desired outcome is being achieved or that there are not detrimental outcomes as a result of disclosure requirements.

With more informed and financially literate consumers, there is more likelihood that consumers will start to play a sufficiently active role in applying competitive pressure on providers of financial products and services. But improved information provision is only part of the solution to a well-functioning competitive process. Recommended supply-side and regulatory reforms are also crucial.

Disclosure to address lack of relevant information

Effective disclosure involves ensuring relevant and helpful information about financial products and services is in the public domain. While there is always considerable 'information' available to consumers regarding financial products and services, frustration with its opaque and complex character has been a well-known factor for consumers, not addressing their own needs effectively.

In the financial system, the Commission has recommended greater disclosure in a number of key markets.

- To remove the illusion of competition in the insurance market, insurers should also provide up-to-date information to ASIC on the brands they underwrite, and ASIC should publish this information (chapter 11). With the publication of this information, consumers could seek this information themselves or consumer advocacy groups can make this information more broadly available to consumers, providing guidance to consumers on issues to look out for when seeking insurance.
- Consumers currently lack information on how the home loan market works and the factors that can influence a broker's recommendation. They should also know as close to real time as possible what price others in similar situations are paying for their loans. This type of information will help consumers evaluate the advice given to them, or even anticipate whether they need a different form of advice. Consumers should also have this

information before a mortgage broker's recommendations are made, so that they have a framework with which to evaluate such advice (chapter 8).

Disclosure to facilitate consumer awareness and understanding

To be active agents in the competitive dynamic, consumers need to be engaged in the information search process. By reducing the time and effort of searching (and frustration when useful information is not in practice available at all), collecting and absorbing information, consumers are more likely to access and assess objective product information rather than resort to simplified decision-making processes (such as choosing a product based on trust, or brand recognition).

This type of disclosure, therefore, provides information in a way that makes it easier to access and assess the information. This may mean that certain types of information are provided in a particular format, time, or location.

- In general insurance, for example, consumers need greater price transparency as to how their premiums are changing year to year. As the annual renewal notice is a potential trigger to prompt the consumer to consider whether they are receiving value for money on their policy, it should include the previous year's premium, and percentage change in price since the previous year's notice (chapter 11).
- When purchasing add-on insurance, consumers have poor understanding and insufficient time to consider the policy they are obtaining, limiting their ability to apply competitive pressure on insurance providers. The Commission recommends that a deferred sales model would enhance consumers' ability to consider these products and to shop around for alternative providers (chapter 14).

Improvements to consumers' understanding of general advice

There is evidence that consumers do not fully understand the nature of the information provided in general advice, when seeking guidance on investment, superannuation, insurance and taxation, among other matters.

Consumers can receive 'general advice' which is information regarding financial products and services that is not tailored to take into consideration an individual's circumstance. General advice covers a wide range of activities such as media commentary, analyst reports, internet comparison sites, opinions by credit ratings agencies and advertising by product issuers.

But the boundaries between general and personal advice may be difficult to draw, and the label of 'advice' adds to this confusion, opening up the possibility that consumers will unduly rely on this information (Murray et al. 2014b). Consumer research indicates terminology affects consumer understanding and perceptions (for example, ASIC 2013d, 2014i). Furthermore, the Financial Ombudsman Service noted in its annual review that it

receives ‘many instances of confusion between personal and general advice’. Disputes concerning ‘financial advice given’ are disproportionately larger (55%) than other types of disputes (FOS 2017a).

The Financial Planners Association argue that it is the way general advice is framed, combined with its label, that causes the confusion among consumers.

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. 4)

ASIC research highlights that sales and marketing material 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 2014i, p. 32)

In the insurance industry, for example, ASIC’s research has indicated potential for harm when insurers sell add-on insurance and the representatives are under no obligation to sell a product that meets the needs of the consumer.

We have concerns about the sales practices used to sell add-on insurance products, given the conflicts of interest created by high commissions and the lack of information to assist consumers in making informed decisions. This is exacerbated because all insurers sell add-on products under general advice or ‘no advice’ distribution models, where sales staff can promote the product but cannot tell the consumer whether or not it is suitable or meets their needs. (ASIC, sub. 40, attachment, p. 53)

The Murray FSI recommended renaming ‘general advice’ to reduce consumer misinterpretation and excessive reliance on this type of information, advising that the new label should be consumer-tested prior to its introduction (Murray et al. 2014a).

The Commission agrees with the general approach to improve consumer understanding of the nature of this information and is mindful that there will always be boundary issues about what constitutes general or personal advice. The Commission, however, seeks advice on how transition costs could be minimised and whether there would be any barriers or unintended consequences of this change. The Commission is also considering whether the regulatory requirements of some conduct under ‘general advice’ could be reduced.

DRAFT RECOMMENDATION 12.1 RENAME GENERAL ADVICE TO IMPROVE CONSUMER UNDERSTANDING

General advice, as defined in the *Corporations Act 2001* (Cth), is misleading and should be renamed. The Commission supports consumer testing of alternative terminology to ensure that misinterpretation and excessive reliance on this type of promotional information is minimised.

The term ‘advice’ should only be used in association with ‘personal advice’ that takes into consideration personal circumstances.

INFORMATION REQUEST 12.2 RENAMING GENERAL ADVICE AND MERITS OF FURTHER CHANGES

In implementing draft recommendation 12.1, we request feedback on:

- *how the scale of transition costs associated with renaming general advice could be minimised, including the effect of varying the transition timeframe*
- *barriers or unintended consequences of such a change, including licensing implications.*

We also seek information on the merits of:

- *redefining the activities that are currently regulated under general advice and providing a more customised regime for some activities*
- *removing licensing and regulatory obligations currently associated with some or all forms of general advice.*

Disclosure to facilitate comparisons across products and suppliers

In obtaining and assessing information, consumers need to be able to make comparisons across different products and suppliers such as key fact sheets in a table or new information in digital form to aid comparisons. Alternatively, information could be published by a third party, such as a regulator or a consumer group. Third party disclosures are known as sunlight or transparency measures as the benefit of the information to consumers comes from public debate when they are published (Fletcher 2016a). Consumer advocacy groups play an important role in this regard by publishing articles using this information on their websites and in the media. Regular publication of new information is useful in maintaining consumer engagement on an issue over time, which in turn may be important if consumer habits are to be altered (Fletcher 2016a).

To improve price transparency in the home loan market, the Commission recommends that monthly data be collected by the Australian Prudential Regulation Authority (and made available by ASIC via an online tool) on median interest rates for new residential home loans, adjusted by loan and borrower characteristics. By making this data publically available, the aim is to bring ‘sunlight’ to the lack of price transparency in place of the

opaque standard variable interest rate, creating greater awareness in the public domain of the actual price of a variety of home loan products, and allowing consumers to more easily compare actual offers from lenders (chapter 8).

Better product information that enables comparisons also assists experts to provide information and advice to consumers. The Financial Planning Association (sub. 26) argued that the existence of ‘fair and accurate’ information that is sufficient to ‘enable comparisons with other products’, assists financial advisers meet their best interest duty under the Corporations Act (appendix D).

13 Consumer switching

Key Points

- Consumer switching between products and providers is integral to competition: the prospect of consumer switching exerts demand-side pressure by inducing providers to compete with each other to gain new customers or retain their existing ones.
- However, for competitive processes to work, it is not necessary that consumers switch *per se* — a credible threat is enough. Nor is it necessary for switching to involve severing a relationship with an institution; for example, many consumers hold multiple transaction accounts and increase or decrease their reliance on each at different points in time. What is essential is that consumers are able to exercise meaningful choice about the products and providers that they use.
- It may also not be necessary that *all* consumers threaten to switch — a critical mass of consumers who do so may exert sufficient competitive pressure. However, the extent to which a subset of consumers can drive effective competition in the market as a whole depends on whether providers are able to price discriminate between different types of consumers.
- The evidence suggests that many consumers do not think about switching and that the proportion of consumers shopping around is low. It also appears that many consumers do not switch, even when they are aware that superior alternatives are available.
- There are multiple barriers to consumer switching, which can make it difficult to determine why consumers do not switch and whether a particular policy response is likely to be effective. These barriers include:
 - informational barriers that make shopping around more difficult
 - conflicts of interest that can prevent intermediaries acting in the best interests of consumers
 - upfront and ongoing costs associated with making a switch, both perceived and real
 - consumers' cognitive and behavioural biases.
- There is no silver bullet to revitalising consumer switching. In recent years, there have been some attempts by government to remove barriers to switching, but these attempts have only partly or half-heartedly addressed the problem.
- It can be difficult to predict how consumers will respond to specific interventions and so testing, monitoring and evaluation of reforms is crucial to the success of government initiatives to remove or lower the barriers to 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)

However, switching can be costly for consumers. These costs include the monetary and non-monetary costs of shopping around and performing a switch. Banks and government can also impose bureaucratic or administrative restrictions that inhibit consumer switching. Together, these impediments can dampen consumer switching, limiting the extent to which consumers exert demand-side pressure.

That said, switching is only one of the ways that consumers can exert demand-side pressure — competitive pressure is also generated when consumers:

- acquire new financial products
- exit relationships with financial service providers (without necessarily entering into a new equivalent relationship)
- choose to use or not use the financial products they currently hold
- renegotiate prices or terms while remaining with an existing financial service provider.

This chapter examines the role of switching as one of the sources of demand-side pressure. It begins with a discussion of the motivations underlying switching behaviour and examines the interdependency between consumer switching and competition. It then reviews the evidence about the level of switching in financial service markets in Australia. Finally, the chapter considers impediments to consumer switching and examines remedies for those barriers.

13.1 Why switch?

At its core, switching behaviour is motivated by consumers shopping around for a better deal. The decision to switch products is motivated by whether the benefits of switching (such as financial gain or improved services) exceed the costs (such as search costs and the implicit and explicit costs of switching).

This means that, to induce a switch, the 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. Similarly, the low costs of maintaining multiple versions of some financial products (such as transaction accounts and term deposits), can reduce the need for consumers to switch providers.

Switching for a better price

In some (but not all) instances, the ‘best deal’ is determined by price. For example, in the home loan market, consumers consistently report that price is the most important factor when choosing a home loan (Deloitte 2016a). This implies that, in principle, 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. 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 2016a). 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)

13.2 Switching and competition

The relationship between switching and competition is a symbiotic one. The prospect of consumer switching exerts 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 switch.

Switching creates competitive pressure

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. Even so, a critical mass of active consumers may exert sufficient demand-side pressure so as to increase competition in the market overall. 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.

While consumer switching plays a role in the competitive process, that role is limited in some financial markets and the scope for gains from pursuing switching strategies should not be overstated. In general, the potential for demand-side pressure to drive improved market outcomes depends on the potential for increased competition in the market — including competition on prices as well as in relation to product features. This means the role of switching in increasing the level of competition may be limited in:

- markets where providers do not extract much profit from consumers, such as transaction accounts and credit cards for ‘transactors’ (customers who pay off their balance every month)

-
- markets where there is limited scope to compete on product features (for example, transaction accounts). This is in contrast to markets where product features are important to consumers (such as home loans) or there is broader scope for product differentiation (such as insurance).

Nonetheless, a baseline level of ongoing pressure is required to maintain the existing level of competition in those markets. And, while consumer switching may not be able to increase the level of competition among providers, the ability of consumers to freely switch between products and providers remains important from the perspective of individual consumer choice.

Price discrimination

The competitive pressure generated by switching behaviour can also be restricted where providers are able to price discriminate in response — that is, charge different prices for what is essentially the same product. This entails the segmentation of consumers into different sub-markets based on their propensity to switch. In this way, providers are able to confine competition for consumers who are likely to switch to the sub-market that they are in.

Providers may be able to gauge the propensity of a customer to switch using information about how ‘active’ they are, including their recent account activity. In addition, to attract consumers who are likely to switch, financial service providers often offer favourable upfront prices for new customers (box 13.1). The Commission estimates that consumers who switch to take advantage of introductory rates could save \$66 to \$87 per month on the average home loan balance.

The extent to which a minority of active consumers will be able to drive competition in the market as a whole depends on how well providers are able to isolate those consumers into a separate sub-market.

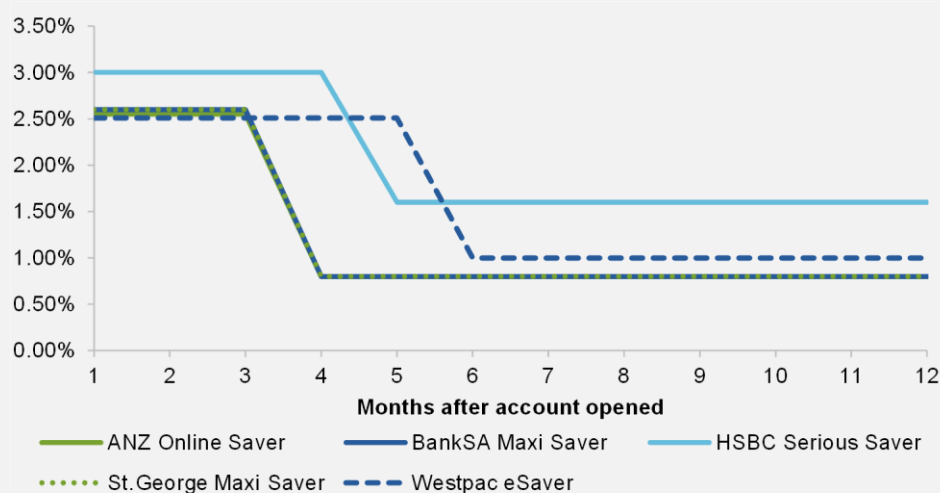
While price discrimination can benefit some consumers (such as those likely to switch), it can also result in inequitable outcomes. The Reserve Bank of Australia (sub. 29, p. 8) noted that price discrimination between existing and new customers means that ‘established and less mobile customers are subsidising 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 13.1).

Box 13.1 Upfront and ongoing prices

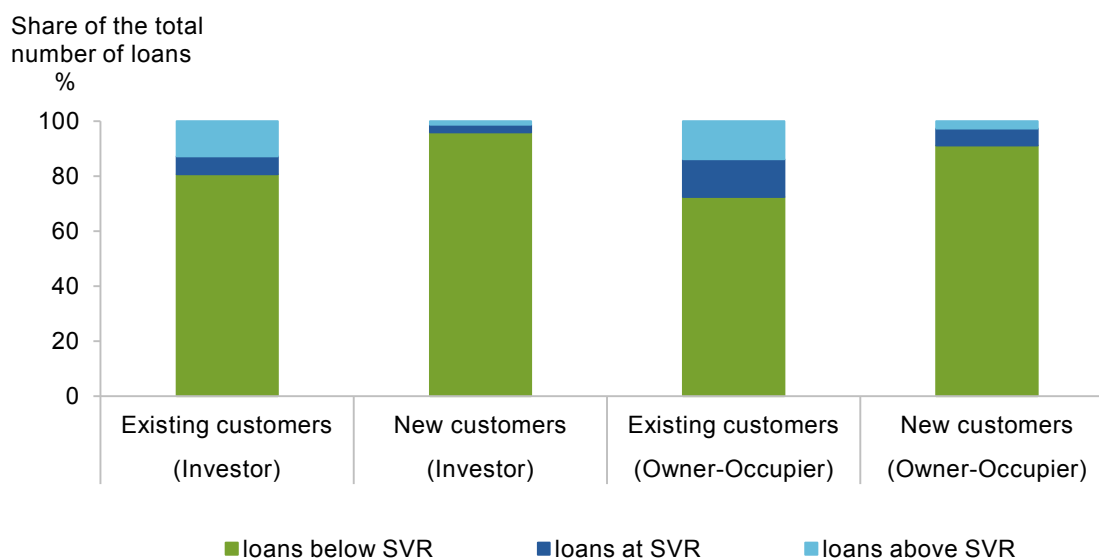
Many financial service providers offer favourable upfront prices for their products, which are designed to attract new customers. Once the introductory period has lapsed, these prices usually revert to 'ongoing' rates that are less favourable to the consumer.

- 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.'

Figure 13.1 New home loan customers pay lower interest rates
 2016-17 for the average lender, compared with the standard variable rate (SVR)



Source: Unpublished ADI data

Competition in the market induces switching

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.

For this reason, the level of consumer switching is an indicator of the level of competition in a market. 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.

However, as discussed in chapter 3, the financial system in Australia is dominated by a small number of large players. In many markets, price competition is constrained by regulation and product differentiation stems from providers’ ability to price discriminate rather than from competition. Low levels of competition amongst providers has deterred some consumers from shopping around, because they do not perceive there to be benefits from doing so.

In particular, some consumers report that they do not consider switching because they do not perceive there to be sufficient variety in providers or product offerings. For example, 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.

13.3 Evidence about switching behaviour

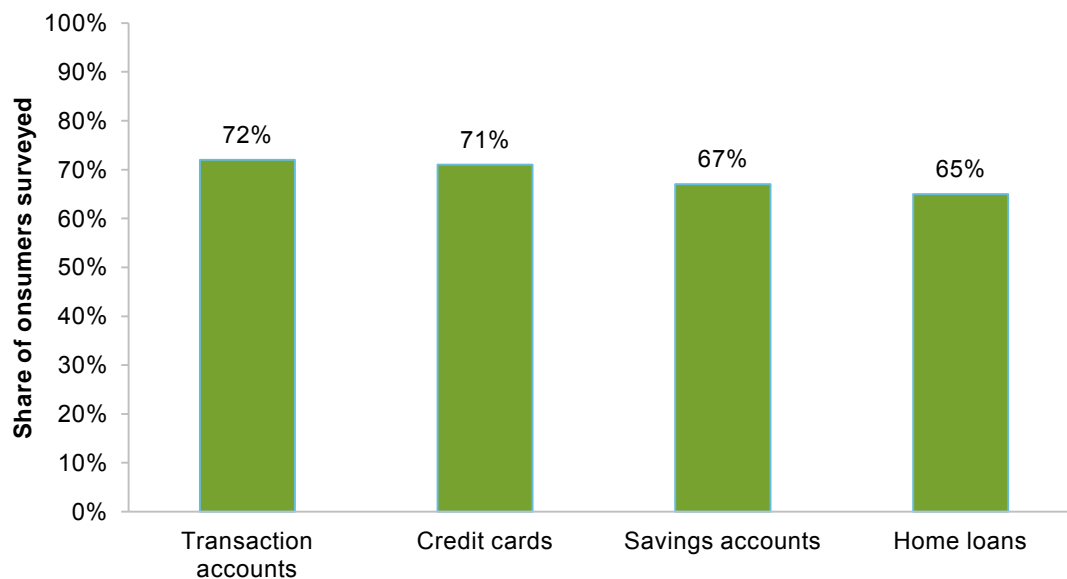
Do consumers consider switching?

There is evidence that, 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 13.2).

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).

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%).

Figure 13.2 **Most consumers do not consider switching products**
For the two-year period 2015–2017

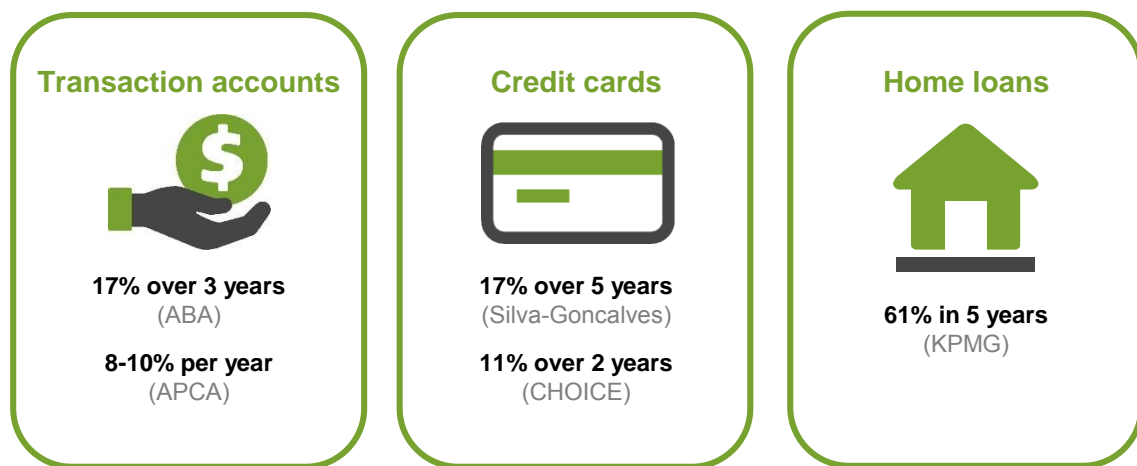


Source: CHOICE (sub. 42)

How many consumers actually switch?

Financial products are often described as ‘sticky’ (CHOICE, sub. 42; Consumer Action, FCA and Financial Rights, sub. 23; 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 13.3).

Figure 13.3 **Rate of switching across different financial products**



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)

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. 32).

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 2015).

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)

In addition to the mixed evidence, it can be difficult to estimate how many consumers actually switch because data is incomplete or indirect. For example, some evidence about switching relates to whether consumers have opened or closed an account; however, in practice, consumers who open a new bank account may not necessarily close an old one, and vice versa. In other words, consumers sometimes hold multiple of the same financial product — 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). That said, some of the evidence about the rate of switching comes from survey data, where consumers are usually asked directly whether they have switched. These data are likely to reflect whether consumers have functionally switched between products or providers, rather than whether or not they have actually closed their old accounts.

INFORMATION REQUEST 13.1 TO WHAT EXTENT DOES HOLDING MULTIPLE ACCOUNTS REDUCE OR ENABLE SWITCHING?

We are seeking information about consumers who hold multiples of the same financial product, such as payment cards and deposit accounts. This includes information about:

- how product holdings are distributed across the Australian population*
- how many of these products are inactive or not being used*
- the extent to which consumers ‘switch’ providers or products without closing old accounts.*

In addition, ‘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, such as the extent to which providers can price discriminate (as discussed above).

However, according to the ACCC, low levels of switching are indicative of weak competition in the financial services market:

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. The following sections consider reasons why this might be the case and how this problem can be addressed.

13.4 Impediments to switching

For financial markets to be competitive, it is essential that consumers are able to identify the product most suitable for them and switch lenders or products. As discussed in chapter 12, this means that consumers must be able to:

- (a) *access* information about the products and services available in the market;
- (b) *assess* the information available about these products and services to compare them; and
- (c) *act* on this information by purchasing or switching to a product or service that offers the best value to them. (ASIC, sub. 40, p. 4)

However, there are many reasons why consumers do not switch, even when it would be beneficial to do so, which can be attributed to difficulties in accessing, assessing or acting on information about products and services. Recent research by CHOICE found:

- 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)

Consumers also have limited resources (in terms of time, money and energy), which they must allocate to a variety of tasks and responsibilities — not just switching.

This section discusses some of the main impediments to consumer switching. These include monetary and non-monetary costs associated with shopping around and switching, as well as difficulties associated with obtaining or acting on relevant information or advice.

Search costs and informational barriers

Search costs are the costs associated with shopping around and deciding whether to switch. They include monetary costs (such as fees paid to a broker) as well as non-monetary costs (such as the time taken to research product offerings).

It can be difficult for consumers to find reliable or essential information to help them decide whether to switch. Often, consumers are faced with a steep learning curve because they start out with limited knowledge or awareness about the range of providers and offerings (COBA, sub. 21). These costs are compounded when there are barriers to accessing or assessing information, particularly when consumers have low levels of financial literacy (chapter 12).

For consumers to switch, it is essential that they are able to access clear and up-to-date information about financial products. This requires sufficient transparency around market offerings (ASIC, sub. 40) — but several inquiry participants suggested that there is insufficient transparency in financial markets (ASIC, sub. 40; COBA, sub. 21; RBA, sub. 29). The importance of clear and up to date information for consumers is discussed in more detail in chapter 12.

Conflicted intermediaries

When comparing financial products, many consumers rely on intermediary services — such as financial advisers, brokers and comparison websites — as avenues to help them shop around. This could be due to the difficulties consumers face in assessing the quality of information on offer, particularly in the home loan market.

Borrowers' capacity to source the best deal and assess the benefits of switching providers has been assisted by the introduction of brokers and comparison websites. However, it is not clear that there is sufficient transparency in the mortgage market for existing borrowers to easily assess whether they have a good deal or whether they should consider refinancing. (RBA, sub. 29, p. 25)

A common perception is that intermediary services are provided with the interests of the consumer at the forefront. This view is a reasonable one, given that consumers often pay for these services, even if not directly.

However, arrangements or relationships between providers and intermediaries can create perverse incentives for intermediaries and prevent them from acting in the best interest of consumers (Consumer Action, FCA and Financial Rights, sub. 23; ING, sub. 20). As a result, consumers may not receive impartial advice or information, which can hamper decision-making about whether or not to switch.

Ownership relationships between providers and intermediaries can create conflicts of interest that act as disincentives for intermediaries to act in the best interests of the consumers they purport to service. For example, in the home loan market, a number of lenders have ownership interests in home loan intermediaries, including mortgage brokers and aggregators (chapter 8).

Similarly, comparison websites may be controlled or influenced by financial service providers and as a result may only cover a limited range of products.

While the increasing prevalence of comparison websites may assist consumers in comparing credit card products, these websites may not compare all products in the market, and in some

cases are remunerated by the credit card providers for successful conversions. (ASIC, sub. 40, att. 1, p. 21)

Contractual arrangements between providers and intermediaries can also mean that the information provided to consumers is incomplete.

Alignment or vertical integration of advisers risks limiting effective competition by making it more difficult for advisers to consider products which may be more suitable for a client but not included on an Approved Product List. It may also mislead consumers—many consumers will not expect advisers to be limited to providing advice about products from certain providers. (Consumer Action, FCA and Financial Rights, sub. 23, p. 9)

For some products, the payment of commissions by financial service providers can undermine the ability of intermediaries to give impartial advice or recommendations in the interest of consumers. For example, in the home loan market, mortgage brokers are remunerated via commissions paid by lenders, which could create disincentives for brokers to act in the interests of consumers (chapter 8).

In particular, mortgage brokers often receive trail commissions from lenders (CHOICE, sub. 42). Trail commissions are paid on the basis of how long the customer remains in the same loan, which rewards brokers for the ‘loyalty’ of customers. Compared to the payment of an upfront commission only, trail commissions weaken the incentive for mortgage brokers to help their customers switch home loans. This is especially true when the commission paid increases over time, as brokers stand to lose the higher trail commission rate that has been ‘earned’ over time.

In addition, brokers are often required to pay back some or all of the commission they receive if the loan is paid off or refinanced within a certain time period (a ‘clawback’) (ASIC 2017ac). This creates a direct disincentive for mortgage brokers to help their customers to switch within that time period.

Tying mortgage broker remuneration to whether customers remain in the same loan creates perverse incentives for mortgage brokers and is an encumbrance on consumer switching. For this reason, there is likely to be merit in removing trail commissions and commission clawbacks from mortgage broker remuneration structures. Alternatively, this conflict of interest could be addressed by imposing upon brokers a legal duty to act in the interests of consumers, as discussed in chapter 8 (draft recommendation 8.1). This could involve extending that duty to require brokers to continue to act in the interests of their clients so long as they continue to receive commission payments from lenders.

Costs of making the switch

Once a consumer has decided to switch, they may also face costs in the course of, or as a result of, executing that decision.

DRAFT FINDING 13.1 MORTGAGE BROKER COMMISSION STRUCTURES WEAKEN CONSUMER SWITCHING

The payment of trail commissions creates perverse incentives for mortgage brokers by rewarding them for keeping customers in their existing loan. Broker loyalty appears skewed towards the institution, not the customer, and thus likely discourages refinancing.

The inclusion of commission clawbacks in the remuneration structure for mortgage brokers acts as a direct disincentive to consumer switching of home loans.

INFORMATION REQUEST 13.2 *IS THERE A RATIONALE FOR THE STRUCTURE OF MORTGAGE BROKER COMMISSIONS?*

The Commission is considering making a recommendation to the Australian Government on the matter of trail commissions and commission clawbacks. We are seeking feedback on the rationale for how mortgage broker commissions are structured. This includes the contractual or other obligations imposed on brokers in connection with:

- *trail commissions*
 - *trail commissions that increase over time*
 - *commission clawback.*
-

Transaction costs

Consumers incur transaction costs from performing a switch (Klemperer 1995). This includes both monetary and non-monetary costs associated with closing existing accounts 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).

While there are some transaction costs inherent to performing a switch, some transaction costs are imposed by service providers or regulation. In a recent survey, the Customer Owned Banking Association (COBA) found that for home loans:

- more than one-third of people say they haven't switched because the process is painful, and
- one in five gave the reason of paperwork or it not being worth the effort. (sub. 21, p. 36)

CHOICE also argued that banks sometimes impose unnecessary transaction costs on closing a credit card account:

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. The ANZ say you have to cut your card in half diagonally and send it back to them as a condition before they will even cancel your card. (Mr Alan Kirkland, Chief Executive Officer, CHOICE, Official Committee Hansard, 27 August 2015, p. 51)

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 the cost of dealing with multiple providers to be a significant factor in why consumers do not switch.

32% of people who had not switched said they wanted to keep all their accounts with the same institution (sub. 42, p. 15)

One of the main reasons consumers give for not switching to a better credit card is that they want to keep all their accounts in the same place. In a 2015 CHOICE survey on credit card use, 26% of people said the most important factor behind their current choice of credit card was that it was provided by the same bank they had other accounts with. Twenty-four per cent hadn't switched cards because they want to keep all accounts with the one bank. (sub. 42, p. 17)

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 collected by the Commission 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.

Behavioural barriers

In addition, there are ‘behavioural’ barriers to consumer switching (Nicholls 2017; OFT 2010) (chapter 2). This includes cognitive and behavioural biases that affect the ability of consumers to make decisions about whether to shop around and whether to switch.

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 2017i). And according to CHOICE (2017b, p. 10), it is especially difficult for consumers to assess what insurance products a best meet their needs because ‘the nature of the product means it is usually only relied upon in the future, if at all’.

Collectively, these biases and patterns of behaviour are often said to manifest as ‘consumer inertia’ (ABA, sub. 11; ASIC, sub. 40; COBA, sub. 21) — that is, consumers sometimes do not switch, even when it 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.

Consumers prefer 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. 72)

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. That said, public policies designed to offset consumer inertia need to recognise that not every instance of inaction is evidence of poor decision making.

Consumers tend to overestimate 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).

13.5 Revitalising consumer switching

In recent years, there have been some attempts by government to remove barriers to switching (these initiatives are discussed later in this section). Some of the major banks also argued that recent industry initiatives have also encouraged consumer switching. For example, the Commonwealth Bank of Australia said that it:

... understands that the ability to quickly and cheaply switch between products and providers is key to customers harnessing the benefits of competition. As such, the industry has made significant strides towards enabling seamless and rapid switching. (sub. 25, p. 35)

Similarly, Westpac said:

In recent years, industry-led initiatives, together with developments at an individual bank level, have helped empower customers to switch quickly and easily. (sub. 28, p. 31)

In addition, several broader reforms that could impact consumer switching behaviour are in train. For example, the adoption of Comprehensive Credit Reporting (box 9.3) and Open Banking (box 13.2) will allow financial service providers to access richer information about consumers' financial characteristics. By using richer consumer data, existing financial services providers may be able to expand product and service offerings to individual consumers, and make shopping around or switching 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.

However, many inquiry participants argued that further steps need to be taken to encourage consumers to engage with decisions about 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'. And ING stated:

Competition will thrive when informed customers can and, do easily switch between alternative products and services. It is a fact that Australians don't switch banks readily. It is still too hard and there has not been the will to date to make it easier. (sub. 20, p. 2)

As discussed in section 13.4, the reasons consumers do not shop around and switch are numerous. A corollary of this is that there is no silver bullet for revitalising consumer switching and several reforms may be needed.

Testing, monitoring and evaluation is crucial to the success of government initiatives to remove or lower the barriers to consumer switching. The use of evidence to formulate policy responses is important because:

- it is not always clear why consumers do not switch
- behavioural factors can make it difficult to predict how consumers will respond to specific interventions.

This section discusses initiatives underway and potential solutions for revitalising consumer switching. These include:

- improving the efficiency of shopping around
- reducing the effort involved in making a switch
- reforms that give consumers additional rights that can be leveraged to help them switch.

Facilitate shopping around

Consumer switching is supported by initiatives that help consumers shop around. For example, the ability of consumers to find products that best match their needs relies on whether they can access up-to-date information about financial products. Government interventions can assist in this regard by mandating disclosure of certain information. Chapter 12 puts forward principles for disclosure to improve consumer engagement.

Shopping around can also be facilitated by tools that provide advice or help consumers search for and compare products (Fletcher 2016a). This includes private intermediaries and comparison websites that collate information provided by financial service providers (discussed above), as well as government-provided services — for example ASIC’s MoneySmart provides impartial guidance and online tools to help consumers make financial decisions (ASIC nd).

The move to Open Banking (box 13.2) represents a major shift in attitude to data use and opportunities for customers. It has the potential to improve search and comparison tools further, as it would allow search results to be tailored to an individual’s financial situation. By giving individuals the ability to easily share their data with a competitor or third party, individuals will find it easier to identify and switch to better deals. It could also allow for more meaningful comparisons between different products, especially if tools are developed by genuinely independent third parties.

Box 13.2 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. The advent of Open Banking is consistent with the Commission’s recommendations in its inquiry into *Data Availability and Use*, which advocated a Comprehensive Consumer Right to data sourced from them across the Australian economy.

The Australian Government commissioned a review into Open Banking in Australia, which considered:

- what data should be shared, and between whom
- how data should be shared
- how to ensure shared data is kept secure and privacy is respected
- the regulatory framework needed to give effect to and administer the regime
- implementation issues.

The review reported to the Treasurer in December 2017.

Source: The Treasury (2017c); PC (2017c)

Streamline switching processes

Timely and easy switching

Consumer switching can also be encouraged by making switching processes quicker and easier (Fletcher 2016a).

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) is also considering reforms to the Code of Banking Practice, which would include obligations to close transactions 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 (chapter 15).

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. 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.

Redirecting recurring payments

Transferring recurring payments from one account to another is 'one of the most significant barriers to switching' (HoRSCE 2016d, p. 48). Across the world, various initiatives have been introduced to try minimise the consumer effort required to redirect recurring third party payments (box 13.3).

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). To facilitate this, banks are required by law to provide a list of a consumer's regular direct credits and debits for the previous 13 months to a new bank. 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)

Box 13.3 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).
- In the Netherlands, Dutch payment service providers had implemented the Switching Service (Overstapservice). 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).
- In Sweden, consumers can choose to receive 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 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 2017a). Consumer Action, FCA and Financial Rights (sub. 23) also suggested the low take-up rate was 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.

DRAFT FINDING 13.2 TICK AND FLICK HAS NOT BEEN EFFECTIVE

The 'tick and flick' account switching facility has not been effective at facilitating bank account switching for customers due to low awareness about the reform and delays in actioning a switch.

The low cost of retaining duplicate transaction accounts may also be a factor that reduces the importance of facilities such as tick and flick.

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 discussed in this section (such as the New Payments Platform, 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. 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. The effectiveness of this reform is discussed further in chapter 10.

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 10). When assessing the NPP, the House of Representatives Standing Committee on Economics recommended:

... that the Government, following the introduction of the New Payments Platform, consider whether additional account switching tools are required to improve competition in the banking sector. (HoRSCE 2016d, p. 22)

In response, the Australian Government (2017f, p. 2) has agreed to 'consider account switching issues further once the NPP is in place and well established'. The Commission agrees that an evidence-based approach is essential to facilitate consumer switching. This should include a consideration of whether making transaction account switching easier and more timely is genuinely necessary for improving competition, or if its benefits mostly lie in improved consumer experience.

Credit cards

Consumers also need to redirect recurring payments when they switch credit cards. 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. 41–41)

Additionally, 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).

Nevertheless, other inquiry participants saw merit in streamlining the process further. For example, 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, as discussed above).

However, the Australian Bankers’ Association (sub. 11) said there are difficulties in developing a solution of this type. 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).

Removing ‘red tape’ barriers to switching

Unnecessary obligations or regulations that apply to opening or closing accounts can also discourage consumer switching.

This includes contractual restrictions on switching — such as cancellation fees, exit fees and waiting periods (such as in the case of some types of insurance). According to Fletcher (2016a, p. 65), interventions to remove of these restrictions can be ‘powerful in cases where switching [is] limited by a clear contractual restriction’. 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 2017o).

But, as noted above, 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.

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. Incumbent providers may support these regulations because they may benefit from restrictions on switching that lessen competition. Therefore, policymakers and regulators need to be proactive in identifying and removing these barriers to improve competition. The crucial role of regulators in supporting competitive outcomes is discussed in more detail in chapters 15–17.

The Commission is seeking feedback on the extent to which ‘red tape’ restrictions on switching persist unnecessarily in Australia and the extent to which those restrictions affect switching behaviour.

INFORMATION REQUEST 13.3 WHAT RED TAPE BARRIERS TO SWITCHING PERSIST?

To what extent do ‘red tape’ barriers to consumer switching persist in Australian financial markets? Such barriers may include:

- *contractual restrictions on switching*
- *unnecessary administrative or bureaucratic processes imposed by providers*
- *regulatory requirements that add unnecessary costs to switching.*

What can be done to lower or remove these barriers?

Consumer rights and access to data

The lack of consumer engagement with switching decisions is also symptomatic of the broader structure of financial services markets. As discussed in chapter 3, for many financial products, the market is dominated by a small number of providers that have significant market power. By contrast, consumers are numerous and individually hold limited market power. As a result, there is an inherent power imbalance between financial institutions and consumers.

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 address the power imbalance between providers and consumers in the market.

In its report about *Data Availability and Use*, the Commission recommended that consumers should have a Comprehensive Right to their consumer data (PC 2017c). This would give consumers greater control over the data by allowing them to:

- access a copy of certain 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 across all types of financial services. Rights to access and direct the transfer of data will also bolster consumer mobility between different service providers, because it mitigates the risk of information being ‘lost’ when consumers switch.

The Australian Government has undertaken to implement significant aspects of the Comprehensive Right in parallel with the adoption of Open Banking (box 13.2). Notably, however, Open Banking appears to be limited to banking transactions data (whereas the Comprehensive Right is broader) and does not appear to confer rights in relation to editing data or being informed about the trade or disclosure of data.

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).

DRAFT RECOMMENDATION 13.1 DATA ACCESS TO ENABLE SWITCHING

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’s inquiry report, *Data Availability and Use*).

14 Add-on insurance

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).
- 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).
 - Only 85% of consumer credit insurance claims are accepted. This is well below the average rate for retail insurance policies of 96%.
- Generally, consumers do not actively seek out add-on insurance, and they are often poorly informed of its value when they purchase it. This is exacerbated by the pressure-selling techniques used by some providers.
- Most add-on insurance products are sold through the product retailer, with some only available through this distribution channel. This limits scope for competition.
 - 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 higher commissions to car dealers. This phenomenon, known as 'reverse competition', leads to consumers paying higher premiums for add-on insurance.
- Several insurers have now issued (or will issue) refunds for add-on insurance policies that were of little or no value to the consumers they were sold to.
- A 'deferred sales model' for sales of add-on insurance — involving a mandatory delay prior to the purchase of add-on insurance — would empower consumers to impose competitive pressure on providers.
 - The Australian Securities and Investments Commission has recently proposed and consulted on the introduction of a deferred sales model for add-on insurance sold by car dealerships, and the Australian Bankers' Association has committed to mandating a deferred sales model for credit card-related consumer credit insurance (CCI) sold over the phone and in branches.
 - The Australian Government should look to extend the deferred sales model to all sales of add-on insurance.

Add-on insurance is insurance that is sold alongside (and in relation to) another product. Hence, the insurance is sold by an *intermediary* acting on behalf of the *insurer*. Examples of add-on insurance 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 or disabled, or die. Various parties play the role of the intermediary — 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.

Rather than analysing each add-on insurance product in isolation, this chapter delineates the analysis on the basis of the intermediary that sells the insurance product to the consumer. It focusses on:

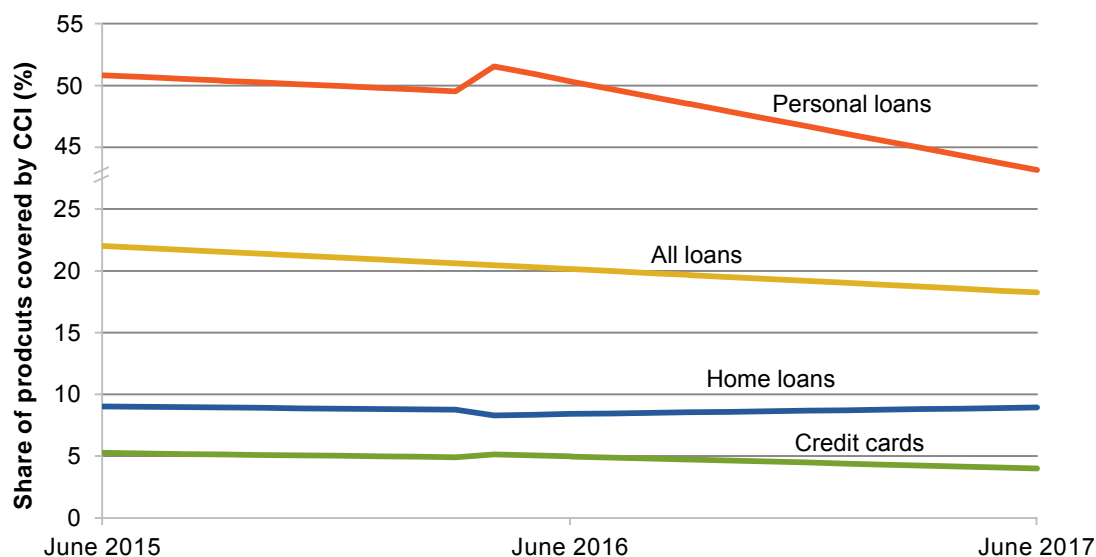
- add-on insurance sold by car dealerships
- add-on insurance sold by authorised deposit-taking institutions (ADIs).

Size of the add-on insurance sector

To the extent that CCI policies are a proxy for all add-on insurance policies, the add-on insurance industry 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 0.99 million by 2015-16 (Financial Ombudsman Service Code Compliance and Monitoring Team 2015; General Insurance Code Governance Committee 2017).

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 14.1), and that 6 of the 18 respondent ADIs do not offer CCI with credit products. The data also indicate that the share of personal loans covered by CCI remains significantly higher than the share of credit cards and home loans covered by CCI.

Figure 14.1 **ADI-provided consumer credit insurance coverage^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. Excludes ADIs that did not offer CCI.

Source: Unpublished data provided by ADIs

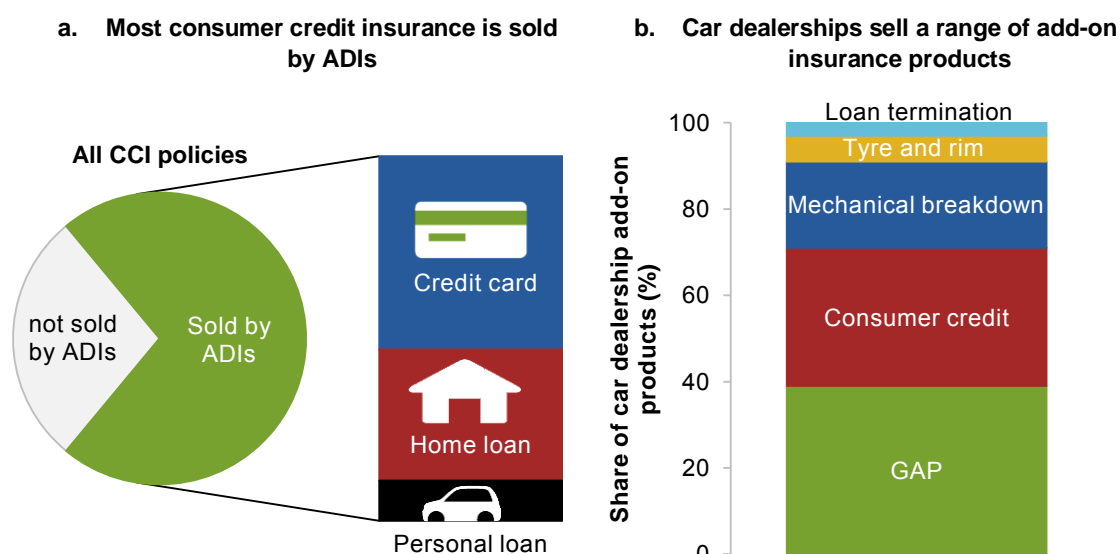
Most CCI policies are sold by ADIs (figure 14.2, panel a). Of the (approximately) 0.9 million CCI policies sold (both new business and renewals) in 2009:

- 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 loans⁵⁸
- the remainder were sold by other ADIs, non-ADI credit issuers and businesses such as car dealerships.

While CCI is the primary form of add-on insurance sold by ADIs, car dealerships sell a wider range of add-on products (figure 14.2, panel b). Based on premium values and the sample studied by ASIC (2016a), the car dealership add-on market comprised GAP insurance (39%), CCI (32%), mechanical breakdown insurance (20%), loan termination insurance (6%), and tyre and rim insurance (3%). 75% of these products are sold through car dealerships, and many are only available for sale through the dealership.

⁵⁸ While a higher percentage of personal loans and home loans are sold with add-on insurance (figure 14.1), ADIs issue sufficiently more credit cards than loans that the majority of ADI-provided CCI is with credit cards.

Figure 14.2 Add-on insurance products and providers



Source: Productivity Commission estimates based on ASIC (2011a, 2016a)

14.1 Competition concerns

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 intermediaries engage in pressure-selling tactics, which inhibits consumers' ability to make informed decisions.

In some instances, consumers have been sold insurance policies that are of no value to them whatsoever (box 14.1).

Second, the distribution channel for add-on insurance — the intermediary — serves to lock out competition from other insurers. In some instances add-on insurance can only be purchased from the intermediary, 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, which places further upward pressure on premiums.

Box 14.1 Insurance for nothing

ASIC and the Consumer Action Law Centre have identified the following examples of insurance policies that provide no value to the consumer to which they have been sold:

- Sales of policies to consumers that duplicated existing coverage under another insurance policy.
- Sales of home loan CCI to customers that did not have a home loan.
- Sales of GAP insurance where there was 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.
- Sales of policies to cover situations that the insurer did not cover — for example, the sale of policies at a dirt-bike riding club to cover medical costs from injuries sustained while riding; the insurer did not, however, offer such cover.
- Door-to-door sales of sickness and accident policies to consumers not eligible for such cover.

Source: ASIC (2016a); Kell (2016)

Add-on insurance sold by car dealerships

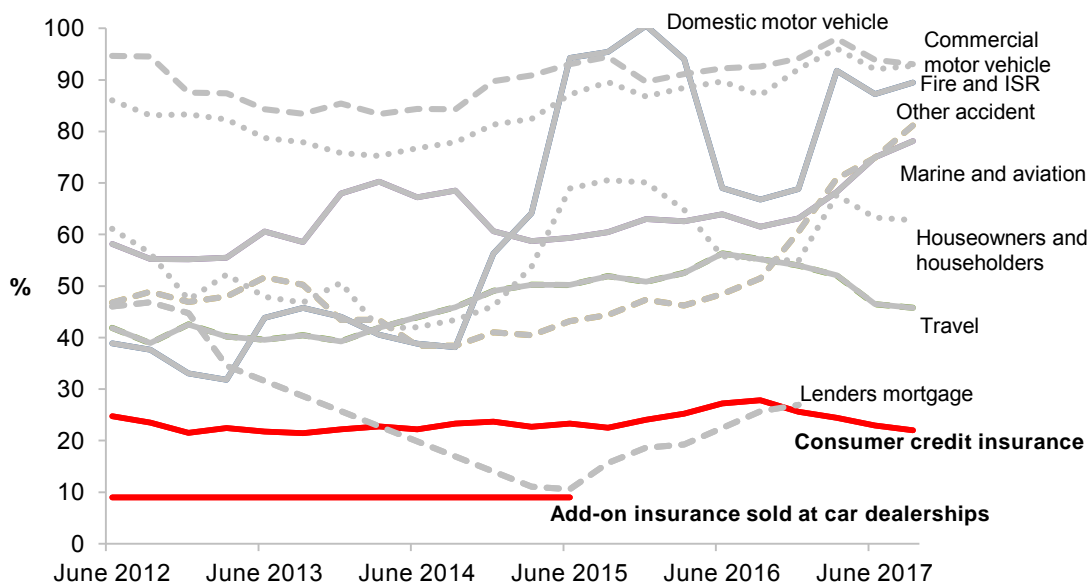
Outcomes in markets for add-on insurance from car dealerships have been especially poor for consumers. ASIC (2016a) found that these insurance products were designed in a way that offered very little value to consumers. Examples include:

- *Negative and low value policies* — policies where the average claim is less than or similar to the average premium paid. In some instances, consumers paid more in premiums than they could ever claim back.
- *Restrictions in cover* — policies that include broad exclusions for pre-existing medical conditions and limitations under unemployment cover.
- *Unnecessary additional ‘extras’ cover* — for example, 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 was strong evidence that consumers were 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 14.3). 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 of a lack of effective competition, because otherwise these profits would be competed away by existing firms or new entrants offering better value insurance.

Figure 14.3 Add-on insurance products are relatively poor value for money
Annual share of premiums returned in claims by class of insurance, June 2012 to September 2017^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 *Quarterly General Insurance Performance Statistics* database, September 2017

Consumers’ poor understanding and insufficient consideration of the policy they are purchasing limits their ability to assert competitive pressure on insurance providers. ASIC (2016d) found that many consumers had no awareness of add-on insurance products before entering the car dealership, were actively sold — and sometimes pressured to buy — add-on insurance products while they were in the dealership, but after they had left the dealership had very poor recollection of the products they had purchased (box 14.2).

Furthermore, the car dealership distribution channel does not provide consumers with adequate capacity to compare different products. As noted by ASIC (2016a, p. 19), ‘... consumers cannot easily compare the cost of an add-on product sold by one car dealer to the same or a similar product sold by another dealer’. This gives insurers and intermediaries price-setting power — ASIC (2016a) found instances of discretionary pricing between customers at different car dealerships, with different consumers charged nearly 10 times more for the same product in one instance.

Box 14.2 ‘Would you like fries with that?’ — consumers’ experiences of purchasing add-on insurance through car dealerships

Surveys conducted by ASIC (2016d) 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 (2016d)

Other factors, such as reverse competition, place upward pressure on premiums. ASIC (2016a) found that insurers paid commissions and volume bonuses to car dealers 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) as a share of total premiums varied between 36 to 58% across insurance product lines, and one insurer paid commissions as high as 79% of the premium value. In addition to increasing the consumers’ premiums (box 14.3), this provides incentives for car dealerships to engage in pressure selling tactics.

Box 14.3 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 (2016n). 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 (2017ah) 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 been also been poor. Based on data from the Australian Prudential Regulation Authority, the Commission has 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 2017.⁵⁹ While this is substantially higher than ASIC's estimates for the car dealership add-on insurance market (9 cents), it has

⁵⁹ As a delineation by intermediary 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 4-IV.1).

consistently been amongst the poorest value insurance class over the past several years (figure 14.3).

Consumer credit insurance policies also feature low claim acceptance rates, limiting their value. In 2015-16, 85% of consumer credit insurance claims were accepted — the lowest among reported categories of retail insurance and well below the retail insurance average rate of 96% (General Insurance Code Governance Committee 2017). ASIC (2011a) found a claim acceptance rate of 84% among 15 ADIs when reviewing their CCI sales practices 2009. CCI sold with credit cards had the lowest acceptance rate (79%), followed by home loans (87%) and personal loans (88%).⁶⁰

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 and 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 14.4). And some of those who try to make a claim are unaware of the tight eligibility criteria.

Box 14.4 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 because 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 2017) 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.

⁶⁰ 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 of 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 2015b).

14.2 Improving competition and consumer outcomes

Recent progress

Several efforts have already been made to improve the operation of add-on insurance markets, and more are in the pipeline.

Some progress has been made in the market for ADI-provided CCI. Following its 2011 report, ASIC undertook action to improve ADIs selling practices (box 14.5). More recently, ASIC has set up a ‘CCI Working Group’ that includes representatives from ASIC, the Australian Bankers’ Association, ADIs and consumer advocacy groups. Australian Banker’s Association has since committed to introducing a ‘deferred sales’ model for credit card-related CCI sold over the phone and in branches, to take effect in the first half of 2018 (ABA 2017b). Under the new rules, ADIs will not be permitted to sell CCI until at least four days after a credit card account has been opened. ASIC notes further that:

While the forthcoming deferred-sales model will not apply to CCI sold on-line, or with home loans and personal loans, other measures will be introduced to promote good consumer outcomes in these areas. Importantly, the success of these measures will be monitored by ASIC to determine if further reforms are required. (ASIC 2017j)

Further, some ADIs have refunded mis-sold CCI, including the following examples:

- Following a 2015 ASIC surveillance, Westpac 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 refunded over \$10 million in CCI premiums to 65 000 consumers after it discovered that it sold credit card CCI to consumers who would be unable to claim under the insurance. It also refunded \$586 000 to around 10 000 consumers as it had over-insured them with home loan CCI (ASIC 2017i).
- Latitude Insurance is currently refunding approximately \$1.1 million to 905 consumers after it discovered 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 2017v).

Box 14.5 ASIC's actions to improve outcomes in ADI-provided consumer credit insurance (CCI)

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 2017aa), Swann Insurance is refunding \$39 million to almost 68 000 customers (ASIC 2017af), Allianz \$45.6 million to around 68 000 customers (ASIC 2018a) and Suncorp \$17.2 million to over 41 000 customers (ASIC 2018b). 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 2018).

Consumer groups are also working to force refunds of poor add-on insurance policies, for example the Consumer Action Law Centre is currently running a campaign called 'Demand a refund' (box 14.6).

Box 14.6 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 more than 340 consumers reclaim more than \$700 000.

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. 23)

Future reform — the deferred sales model

Governments, industry and consumer groups in Australia and abroad have proposed ‘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 (2017ah) proposed a deferred sales model for add-on insurance products sold by 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 14.7).

ASIC received submissions on the consultation paper in October 2017, and commenced further consultation in December 2017.

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.

As noted above, a deferred sales model is expected to apply to credit card-related CCI sold over the phone and in branches by ADIs that adopt the new Code of Banking Practice (due to commence in the first half of 2018), with ADIs not permitted to sell CCI until at least four days after a credit card account has been opened. The Consumer Action Law Centre, the Financial Rights Legal Centre and Financial Counselling Australia (sub. 23) supported the proposal, but recommended that it be extended to CCI sold with home loans and personal loans.

The Commission considers that a deferred sales model would enhance consumers’ ability to impose competitive pressure on insurers and intermediaries. It would allow consumers to more carefully consider the merits and appropriateness of the add-on product, and to shop around for alternatives from outside of the intermediary distribution channel.

Box 14.7 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, financed 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)

Whether four days is sufficient time for the 'halo effect'⁶¹ of a recent loan or credit card application to dissipate and for a consumer to be able to dispassionately assess their need for insurance is arguable. The exposure of the consumer to risk in such a short period is small.

While ASIC's proposal and the model contained within the new Code of Banking Practice are sector-specific, *all* add-on insurance products could benefit from the introduction of a deferred sales model. While this chapter has studied particular add-on insurance markets that have been examined by ASIC, competition in each market has been found lacking for similar reasons, and it is likely that other add-on insurance markets would feature similar shortcomings. For example, Pedersen-McKinnon (2017) 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.

That said, 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 can be pursued at little cost (box 14.8). For example, the deferral mechanism linked to the sale of

⁶¹ A form of behavioural bias where the consumer attributes the qualities of the main product (in this case, the credit card) to the add-on product. Chapter 2 contains more information on the behavioural biases of consumers.

add-on travel insurance 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.

Box 14.8 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 intermediary) 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
- *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 be not 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 Commission considers that the Australian Government should establish a Treasury-led working group to extend the deferred sales model to all add-on insurance products, adjusting it as necessary to meet product-specific demands. As the guiding principle, the policy development should prioritise enhancing consumers' ability to more carefully consider the add-on product at hand.

DRAFT RECOMMENDATION 14.1 DEFERRED SALES MODEL FOR ADD-ON INSURANCE

The Australian Securities and Investments Commission 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.

Following implementation, the Australian Government should establish a Treasury-led working group to extend the deferred sales model to all add-on insurance products in a practical timeframe.

ARE REGULATORS
SUPPORTING
COMPETITIVE
OUTCOMES?

PART IV

Part IV Are regulators supporting competitive outcomes?

More than in many other parts of the economy, the level of competition in the financial system is influenced — and some cases, determined — by regulatory interventions. And yet in the existing system of financial regulation, there is no one organisation responsible for promoting competition.

All three financial regulators — the Reserve Bank, the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) — state that competition plays a role in the way they design their regulatory interventions. All have an interest in competition, but none is required to lead the way.

APRA is the only *regulator* whose mandate requires it to consider competition and competitive neutrality, while promoting financial stability. It is not well placed to balance stability and competition, while also crafting regulation in a global environment that prioritises resilient financial institutions (chapter 15), where the phraseology ‘unquestionably strong’ is constantly being applied to the regulated parties.

The regulators do seek to work together to achieve their objectives, and their work is coordinated through the Council of Financial Regulators (CFR). Although decisions made in the CFR can have far reaching implications for the Australian economy, very little is known about the discussions of this Council.

To the extent debate of competitive effects occurs, it is internalised to APRA or informally taken up at the CFR, but without an obligation on any entity to lead the debate for competition. The Australian Competition and Consumer Commission (ACCC) has no power to review financial regulators’ actions either before they are implemented or afterward. And such post hoc action may not be desirable, for regulator credibility and where solutions for damage to competitive behaviour are unlikely. Overall, at present, the end result is a regulatory system that emphasises stability over competition, and the ongoing price for this approach is paid by the community. We estimate some of that cost.

The regulators’ skew to financial stability may be warranted in some cases, but a lack of transparency around the way they operate and interact makes it difficult to reach an informed conclusion. While some confidentiality is required when regulators deal directly with financial institutions on matters that are commercially sensitive, a regulatory culture that lacks transparency can erode community trust and accountability.

Some regulations attempt to support competitive outcomes

Regulators and policy makers do recognise the importance of encouraging competition in the financial system, and have introduced a number of reform initiatives to support competitive outcomes.

- APRA and the Treasury are developing policies to lower barriers to entry, as well as supporting mutuals (chapters 4, 5).
- The Payments System Board is reforming aspects of the payments system, such as interchange fees charged by banks (chapter 10).
- The Open Banking Review, undertaken for Treasury, is one of a number of policies aiming to improve the use of data for competitive purposes by individuals and new providers seeking to expand market share (chapter 13).
- The Australian Government has committed to implementing the Consumer Data Right, recommended by this Commission in its Data Availability and Use Inquiry, which will allow consumers to more readily switch banks or obtain better product offers, among other pro-competitive outcomes (Taylor 2017).
- ASIC has put in place processes intended to support fintech companies (chapter 4).

In some cases, policies are attempting to address imbalances in market power, which have an effect on competition, by raising operating costs for major players (chapter 5). As discussed in part II of this report, the Commission considers that such policies are misguided and unlikely to lead to any improvements in competition.

But many others erode competition

At the same time, many regulatory interventions — primarily prudential interventions — work against competition. There is a view, particularly within APRA, that competition is a possible risk to financial stability:

APRA is of the view that, with the right balance, stability and competition are mutually reinforcing objectives. However, competition can also lead to instability in the financial system and there are times where it is important for APRA to actively temper competitive forces. Periods of excessive and unsustainable competition can result in financial institutions inappropriately pricing risk or unintentionally accepting excessive risk in order to gain or retain market share. (APRA, sub. 22, pp. 6-7)

This is driven to a large extent by global reform efforts aimed at building more resilient financial systems and a strong desire to ensure Australia continues to avoid the sort of catastrophic financial meltdowns that were evident in other countries during the global financial crisis. But on occasion the way Australia has been implementing these reforms has had significant effects on competition and consumer outcomes (chapter 6). Reforms mostly affect banks, but APRA takes a similar view of competition in insurance markets (see, for example, APRA 2017a).

Prudential policies, which focus on maintaining the resilience of individual financial institutions, have long been recognised as having the potential to restrict competition. Recent years have seen increasing use of macroprudential tools, aimed at the resilience of the financial system as a whole.

It seems probable that such actions may not be simply a short term feature of the regulatory landscape, while the cash rate is on hold. And they have had material effects on competition — in fact, APRA’s stated intention when intervening in home loan markets in recent years was to temper competition it saw as promoting weaker lending standards (chapter 6). In our view, other or more refined macro-prudential policy tools could potentially have yielded similar results, with a less dramatic impact on competition and consumer outcomes (chapter 16).

It is not only prudential requirements that affect competition. Past reviews have indicated that the 15% ownership cap included in the *Financial Sector (Shareholdings) Act 1998* (Cth) has a material effect on newly established authorised deposit-taking institutions (ADIs) (HoRSCE 2016d). The Australian Government announced it will examine ways to reduce the impact of the cap on fintechs (chapter 4). However, the cap continues to apply to existing ADIs, and reduces the discipline on poor management that can be delivered by threat of takeover. Such a threat has been shown to promote efficiency among market participants (Burkart and Panunzi 2008).

It also limits equity financing opportunities for innovation, again potentially creating a restraint on competition. This in turn carries the risk of lowering the incentive for existing ADIs to become more efficient and competitive.

For Australia’s major banks, takeover threat has been almost completely eliminated by the Four Pillars policy, combined with foreign investment restrictions. Although the Four Pillars policy was created in the interests of competition, and ensuring that market concentration does not rise further, this policy must be stifling competitive dynamics. The protection from takeover by each other (or a foreign bank) has allowed the big four banks to continue operating free from one of the ultimate market sanctions for failing to rapidly respond to consumer interests.

For nearly three decades, while financial markets in Australia and overseas have been transformed, the Four Pillars policy has remained unchanged and without a strong evidence base for its continued operation. The Commission considers that over time, this policy has become a redundant convention. There are strong safeguards in existing competition and governance regulatory frameworks to stop mergers that have the potential to harm consumers, and protect depositors if banks encounter difficulties (chapter 16 discusses the Four Pillars policy in detail).

Yet we cannot argue to our own satisfaction that a merger would add to competitiveness. The question is then whether relaxing share ownership restrictions might offer discipline without loss of competitiveness.

A way forward for Australia's financial regulators

The current regulatory system relies on each agency reviewing its own actions for their pro- and anti-competitive risks. This process generally lacks transparency, and, in APRA's case, is affected by a legislated preponderance of weight towards system stability. ASIC is more focused on consumer welfare, and despite Government acceptance of a Murray Financial System Inquiry (FSI) recommendation, has yet to receive a mandate to act as champion of competition in product markets. The ACCC's powers to monitor competition and intervene do not extend to any authorised role to review regulator actions, even where they may prospectively and substantially affect competition.

What is needed in the financial regulatory system is a strong voice for competition, within the regulator circle.

A central government body should be tasked with allowing this voice to be heard and ensuring other regulators act only after full and rigorous consideration of impact on competitive opportunities. We consider there are two candidates for this role — the ACCC and ASIC.

The ACCC has the expertise to assess and make policy recommendations on competition issues. What it lacks is a strong presence and authority inside the circle, and the specific skills required to monitor the financial system, in particular the effect of regulatory interventions on competitive behaviour.

ASIC's powers to licence market participants and protect consumers' interests in the financial system could enable it to act as a champion for competition. It has more of the necessary expertise and is a known entity via its present role in finance as the *product regulator*. But it has no authority to act in support of competition in a broad sense.

The Murray FSI leaned toward such a role for ASIC — recommending that ASIC be given a competition mandate — but was not as explicit as we are about the interaction with other regulators. For ASIC to act as a champion of financial system competition would require a clear change that could be mandated via a revised and specific Statement of Expectations from the Australian Government, and a change in its regulatory culture.

To promote competition, the designated voice — the ACCC or ASIC — should be tasked with reviewing the proposed interventions of other regulators before they are implemented and assessing their expected effects on competition. The CFR provides a forum where such analysis should be discussed, and proposed regulatory interventions amended *by agreement* to minimise their influence on competition. The analysis of competition effects, as well as the minutes of CFR discussions, should be made public. No legislation need change to allow this to occur, as we are not proposing that one party might formally direct another.

The overarching goal of the Commission's recommendations is to create a transparent regulatory system. Such a system would recognise its potential to inhibit competition and actively work towards minimising any damage to competition and innovation that may otherwise result from regulator actions.

15 Where does competition fit in the current regulatory system?

Key points

- Australia has a well-established system of financial regulation, which has served the country well in times of recent crisis.
 - However, financial regulators are expected for the most part to judge their own performance, despite a recent plethora of reviews examining aspects of the financial system and regulator actions therein.
- The regulatory system aims to ensure stability within financial markets. Although regulators are required to consider competitive issues in their decisions, this is not a primary focus.
- As a result, competition is occasionally curtailed intentionally to maintain or improve financial stability. But more importantly, it may be too readily ignored, even if unintentionally.
- The priority given to stability by Australia's regulators is in line with the current global approach to financial regulation, and in particular prudential regulation.
- This approach can perceive stronger competition as encouraging providers of financial services to take on excessive risk. A former Governor of the RBA has said as much.
- Competition and stability in the financial system can — and should — coexist. But expecting a regulator to internally balance the two, while also crafting regulation in a global environment that prioritises resilient financial institutions, is at best hopeful.
- The weight of evidence shows that the policy and regulatory settings, as well as the regulatory culture, are not focused on improving competition in the financial system. Prudential regulation tends to err on the side of financial stability at the expense of competition.
- Due to a lack of transparency, it is difficult to establish whether this approach is justified in all cases. But a method of achieving transparency without complicating governance is available, in our view.

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 increasingly important outcome in the wake of the global financial crisis (IMF 2012). However, for the purposes of this inquiry, a key question 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 financial system with minimal barriers to *both* entry *and* innovation, and are able to provide effective scrutiny of the way market power is used or abused (chapter 2).

15.1 Australia's system of financial regulation

Australia has a unique system of financial regulation, which was put in place following the Wallis Financial System Inquiry (FSI) in 1997, and refined since that time in response to evolving challenges. Put another way, we *do things differently* compared to developed nations similar to ours. Their thinking should form an important element in ours, when systems are up for review.

Our three regulators share the financial markets system as follows:⁶²

- The Reserve Bank, *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 of payments regulator (chapters 6, 10).
- 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, 16).
- The Australian Securities and Investments Commission (ASIC), *the product regulator* — is responsible for regulating market conduct in the financial system, including consumer protection (appendix B). ASIC ensures that competing institutions comply with responsible lending requirements, and disclosure alleviates some of the information asymmetries in the financial system (chapter 12).

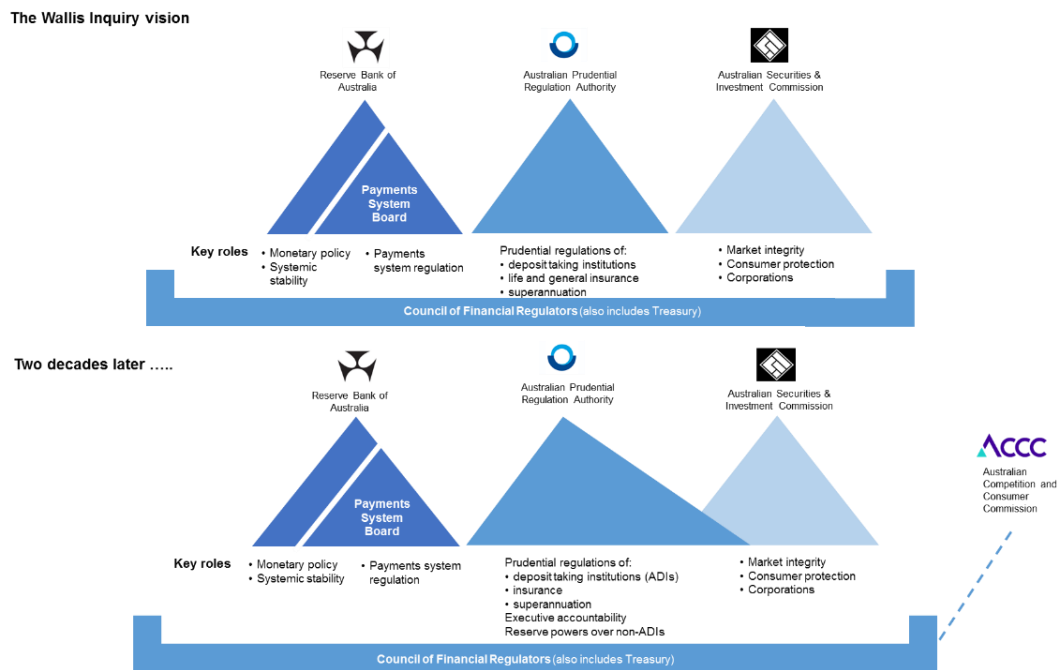
The regulatory design created by the Wallis FSI in 1997 reflected a determination at that time that it was not necessary to give responsibilities for competition in the financial system to a specific entity, such as the Australian Competition and Consumer Commission (ACCC). The ACCC still plays an important role in financial system competition, through its reviews of mergers and other activities, and its recently established financial services unit.

However, there is no entity in Australia's current system with clear ability to do more than *react* to abuses of dominant firm behaviour. Little wonder then that when persistent apparent abuses occur, external review is eventually imposed. But our contention in this inquiry is that it need not be this way. The system has the capacity to re-balance in favour of *proactive* competition reform.

⁶² 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. Numerous other regulators have roles in the financial system — appendix B contains a full discussion. Chapter 10 discusses the role of the Payments System Board in detail.

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 15.1).

Figure 15.1 The lines between Australia’s financial regulators are increasingly blurry



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 2017d, p. 4).

While the responsibility for overall financial stability remains shared between APRA and the RBA, only APRA can enforce prudential rules (Murray et al. 2014a). Both regulators have repeatedly stated that they view macroprudential policy — system-wide policies intended to manage risks to the stability of the financial system, which is notionally APRA’s responsibility — as ‘subsumed within the broader and more comprehensive financial stability policy framework’ (RBA and APRA 2012, p. 1) (chapter 16 discusses macroprudential policy in detail).

This 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 key agencies.

How the regulators work together

Australia's financial regulators work together to ensure they fulfil their separate mandates. The key regulators — the RBA, APRA and ASIC — and the Treasury have developed strong informal networks of cooperation. This is particularly the case for APRA and the RBA (the former having originated within the latter) (box 15.1). In addition, the Council of Financial Regulators (CFR) is a more formal forum for coordination of policy and consideration of proposed regulatory changes.

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 broader 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 attend meetings and presentations, intended to discuss their work
- staff secondments
- senior staff at both agencies are expected to maintain and build a close relationship 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 CFR is the most senior coordinating forum, which involves 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). The CFR 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).

Chapter 17 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 an opportunity for regulators to assess the implications of actions proposed by their peers, and make their conclusions public.

Box 15.1 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 2014d, 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 2014d, 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 2017u, 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. 11)

15.2 Who regulates the regulators?

The regulatory architecture envisaged by the Wallis FSI in the late 1990s did not include an oversight body for the financial regulators, such as a system-wide policy board.

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 more recent 2014 Murray FSI found that the Australian Government does not have a framework or a process for effective external review of the performance of its financial regulators. The oversight provided through Parliamentary Inquiries does not readily examine the regulators' strategic priorities and the way they balance their competing priorities (Murray et al. 2014a).

The ASIC Capability Review too found that the Parliamentary oversight function lacks focus on long-term strategic issues and comprehensive accountability (ASIC Capability Review Panel 2015). In the case of APRA, these Parliamentary Inquiries raised questions about the way APRA views the implications of its decisions on competition, but generally accepted the regulator's views despite this (see, for example, HoRSCE 2016c, pp. 9–13).

The Murray FSI made a series of observations and recommendations to address this, as well as to improve the way regulators address competition (Murray et al. 2014a). While the Australian Government agreed with the objective of strengthening the regulator accountability framework, actions to date have resulted in little change (table 15.1).

The regulator Statements of Expectations — which, despite reported government intentions, have not been updated since 2014 — 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)

The Commission considers 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 Australian Treasury should therefore update them — in clear language as far as practicable — as a matter of priority.

Table 15.1 Progress in implementing the recommendations of the Murray FSI to improve regulator accountability

<i>Financial System Inquiry recommendations</i>	<i>Australian Government response</i>	<i>Progress since 2014</i>
<ul style="list-style-type: none"> • Establish a new Financial Regulator Assessment Board, to review how the regulators are balancing the various components of their mandates. 	<ul style="list-style-type: none"> • The Government considered that existing mechanisms, such as the Regulator Performance Framework, were sufficient to strengthen regulator accountability. • The Government decided to reconstitute the Financial Sector Advisory Council, to provide advice on the performance of regulators. 	<ul style="list-style-type: none"> • 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, but there is no information available publicly on its actions since that time.
<ul style="list-style-type: none"> • Provide more clarity around its expectations of regulators. • Regulators to develop better performance indicators. 	<ul style="list-style-type: none"> • Statements of Expectations for APRA, ASIC and the PSB to be updated by mid-2016. 	<ul style="list-style-type: none"> • ASIC provided comments to Treasury on a draft Statement of Expectations in November 2016. There is no available information on further progress. • There has been no public indication on progress towards Statements of Expectations for the PSB and APRA.
<ul style="list-style-type: none"> • Conduct capability reviews for ASIC, APRA and the PSB every six years. 	<ul style="list-style-type: none"> • The Government agreed to periodic consideration of regulators' capabilities (timing as appropriate) and noted the capability review for ASIC had commenced in mid-2015 	<ul style="list-style-type: none"> • 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 other financial system regulators.

Source: APRA (nd); ASIC (2016l, 2017b); Australian Government (2015); Murray et al. (2014a); O'Dwyer (2016); The Treasury (2015b)

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 on the actions taken that are in line with their Statements of Intent in their annual reports, so they remain accountable to government and the community.

As both documents should be future-oriented, it should be accepted by the public that they are indeed about expectations and intents, and not guarantees. But if any area of public policy is experienced with the use of expectations, it is surely the area dealing with monetary policy.

DRAFT RECOMMENDATION 15.1 STATEMENTS OF EXPECTATIONS FOR REGULATORS

Regulator Statements of Expectations and Statements of Intent, as agreed in the response by the Australian Government to the Murray Financial System Inquiry, should be urgently implemented. They should be written in clear language and updated at regular intervals thereafter.

Statements of Intent should be published by regulators 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.

Limited transparency compounds lack of commitment to competition

The financial regulators publish a wide range of reports and other papers (appendix B). But although there are numerous ongoing reporting requirements and reviews being undertaken, there is only limited information provided on how the 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 not from reporting by the two bodies but from other types of documents, such as the RBA's periodical publications, as well as speeches and conference papers.

It is through such documents that the RBA and APRA have shared with the community details of some of their most influential regulatory moves, such as the interventions in residential property investment and interest-only lending. A paper presented at a RBA conference provided 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 made available only in response to a Freedom of Information request.

While APRA complies with the requirements for consultation imposed on all regulators, many of its consultation papers and Regulation Impact Statements leave the impression that the direction of prudential policy is a *fait-accompli*. The lack of transparency around its decision making means it is difficult to find evidence of how different policy options are

developed, considered and prioritised. Few, if any, policy actions with such far reaching implications are subject to so little external scrutiny and evaluation.

This lack of transparency was also 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 2016b, pp. 17–18)

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 activities. 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, 2017t).

Various reviews of Australia's regulatory arrangements have suggested that there is a need for increased transparency around the CFR's deliberations. The IMF (2012, p. 28), for example, acknowledged the major role played by the CFR in planning Australia's response to the global financial crisis (GFC), 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.

Confidentiality is very important for some prudential interventions, in order to prevent misinterpretations by the community that could have far reaching consequences. For example, an increase in prudential supervision for a specific institution can be interpreted by the markets as an indication that its performance is inadequate, and lead to substantial drop in the share price for a publicly listed company and a loss of community confidence in the banking sector. 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 community confidence in the regulator's actions.

Prudential regulators in other jurisdictions have taken a different approach. The Reserve Bank of New Zealand, for example, released consultation papers and asked for submissions before it set restrictions around high LVR lending in 2013, and then prior to changing these

restrictions in 2015 and 2016. A Regulatory Impact Statement was also published in 2013 (RBNZ nd).

Australia's financial regulators should adopt a much more transparent approach (chapter 17), and in particular should show how they assessed competition effects of their decisions or actions — rather than allow only guesses.

15.3 Competition — the missing piece of the regulatory puzzle

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.

Competition regulation refers to laws which ensure that all markets are competitive. Two main areas of concern are market concentration and collusion which can lead to overpricing of financial products and underprovision of services essential to economic growth and welfare.

While financial products are complex and any assessment of competition requires detailed analysis of markets, the key features relevant to competition assessment in this sector are not unique. The application of economy wide competition regulation to the financial system ensures regulatory consistency. 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).

To date, the financial markets have been another part of the wider economy as far as competition policy is concerned. As it does in other parts of the economy, the 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's oversight of the financial system is set to expand. In the 2017-18 Budget, ACCC received funding for a new Financial Sector Competition Unit (appendix B). The unit has already commenced an inquiry into pricing of residential mortgages, and it has a mandate to examine specific financial system competition issues (ACCC 2017f).

Compared with ASIC and APRA, the ACCC has different enforcement powers. It can issue public statements and warnings about competitive developments (Murray et al. 2014a). The ACCC also has the power to issue infringement notices, in some circumstances. It relies on litigation and enforceable undertakings to regulate, in the event of market power misuse.

The ACCC believes 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). Nonetheless, the

ACCC may find itself in a position where it may require stronger legal powers as it expands its role in the financial system.

While the ACCC has responsibility for policing actions that may substantially lessen competition (and some other monitoring roles), it has no formal role in reviewing or providing proactive input into the actions of regulators that may impede competition.

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). However, the ACCC is not a permanent member of the CFR, whose members remain able to dictate competitive conditions in the financial markets. Even if it were a member, the ACCC has no specific remit to consider whether regulators themselves are inducing (or providing the opportunity for) less vigorous competition.

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.

The Murray FSI (2014a) accepted the Wallis FSI 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 consider the effects of their actions on competition. The most important recommendation — giving ASIC an explicit mandate to consider competition — is yet to be implemented (table 15.2).

Table 15.2 Progress in implementing the recommendations of the Murray FSI to improve regulators' consideration of competition

<i>Financial System Inquiry recommendations</i>	<i>Australian Government response</i>	<i>Progress since 2014</i>
<ul style="list-style-type: none"> • Add an explicit requirement to consider competition to ASIC's mandate • 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. • Through annual reports, APRA, ASIC and the PSB to demonstrate explicit consideration of competition in their regulatory design. 	<ul style="list-style-type: none"> • A commitment to introduce competition into ASIC's mandate by the end of 2016. • The Government did not address this part of the recommendation specifically in its response. • The Government planned to address this issue in the updated Statements of Expectations, which were promised by mid-2016. 	<ul style="list-style-type: none"> • Changes to ASIC's mandate have not yet been made. • No public information available • Statements of Expectations have not yet been updated.

Source: Australian Government (2015); Murray et al. (2014a)

This inquiry takes as one of its primary opportunities to lift competitive behaviour in finance the resolution of a choice between the two regulators — ASIC or the ACCC — in explicitly being awarded the responsibility for persistent proactive review of competition (chapter 17).

The ability to advance a competition objective in the existing regulatory framework is further inhibited by the different views regulators hold on the state of competition in the financial system (box 15.2). This would make it difficult for them to formulate a consistent and effective strategy to address systemic issues.

Box 15.2 Regulators' view of competition in the financial system

In their submissions to this inquiry, the financial system regulators have expressed disparate views on the current state of competition in the financial system.

APRA, ASIC and the RBA pointed to competitive behaviour in 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. (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)

APRA aims for competitive neutrality — but misses the mark

In the absence of a voice within the regulatory array charged with caring for system-wide competition (ASIC being a *product* regulator, primarily), the role of considering competition and financial stability falls to APRA, as specified in the *Australian Prudential Regulation Authority Act 1998* (Cth).⁶³ 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 2017c, p. 3).

From the limited information available on how APRA makes decisions, it is evident that *some* implications for competition are considered when the intent of the policy is specifically to *limit* competitive dynamics, such as placing limits on expansion in parts of the market (chapter 6). Consideration is also given to competition when a regulatory change is intended to lower barriers to entry (APRA 2017j). However, in documents relating to the ongoing regulatory intervention to promote financial stability, competition is rarely mentioned (see, for example, APRA 2017z).

In its submission to this inquiry, APRA (sub. 22, p. 7) contended that its actions are often motivated by competitive neutrality:⁶⁴

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.

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 make a strong case that the lack of precision in directions has had negative effects on competition (chapter 6).

The form of competitive neutrality most evident in the inquiry’s review of APRA activities 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 well implemented.

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

⁶³ Other Acts that apply to APRA’s objectives and operations have various references to competition, and in some cases do not mention it at all (for example, the *Banking Act 1959* (Cth))(Murray et al. 2014a).

⁶⁴ 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.

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 16 discusses this issue in detail).

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. 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. The fact that borrowers bear the cost when banks need to respond to an increase in prudential requirements is not given substantial weight. In its Regulatory Impact Statements on the proposed implementation of Basel III, APRA has only limited consideration to the costs it expected the community to bear (box 15.3), and that have indeed been passed on to borrowers as implementation has progressed (chapter 6).

The consideration of impacts on 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 2016d). This is not an uncommon complaint against regulators but here — given the very substantial influence that the cost of money has in the economy generally — it is the Commission's judgment that greater transparency of how views received were ultimately treated would be wise.

Can APRA balance competition and financial stability?

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, is to promote financial system stability in Australia.

The interaction between competition and financial stability is a conceptual and practical challenge for financial regulators. Some see competition as a risk, because it has the potential to erode standards of conduct across the banking industry and lead to systemic instability. Therefore, a lack of competition has the potential to insulate financial institutions from crises. 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)

Box 15.3 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 didn't 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 (2012c, p. 9) 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.

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 decision to implement Basel III increases borrowing costs, and lowers GDP growth, in exchange for a more stable banking system, which would incur lower losses in a financial crisis. This is clearly a major policy decision — and hardly one that could be justified without robust quantitative analysis, which has been done by other inquiries (for example, Murray et al. 2014a).

Others 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 for APRA.

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). Prudential policies (in Australia and overseas) have expanded beyond direct supervision of specific institutions intended to ensure they are resilient to shocks, to take a systemic view of the financial system. These systemic macroprudential policies are based on the notion that risks to financial system stability can have substantial implications for the real economy, and should be addressed across the entire system — rather than at the institution level (Orsmond and Price 2016).

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). Hence, macroprudential tools have been used by regulators with the express intent of tempering competition (chapter 6).

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.

But APRA does not operate in isolation from global regulatory reform. 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, and 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, based on its view of the local market, but 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 can hardly be faulted for deliberately giving precedence to financial stability. Its legislation is structured to favour that. At times, however, this may not be in the wider public interest, but by internalising the debate to the organisation primarily preoccupied with stability, we are not serving the wider public interest as well we might.

Regulating the regulators is generally a poor option in response to this problem.

A more preferable course is to see the draft regulatory decision better exposed to rigorous and informed debate before it is made. The CFR can do this, but there is no specific obligation to do this, nor a designated champion for competition among regulators. The opportunity thus is open to redress this via the CFR and without altering the final legal ability of APRA to make the necessary call. This option is discussed in detail in chapter 17.

DRAFT FINDING 15.1 APRA NOT WELL PLACED TO CONSIDER COMPETITION IN THE FINANCIAL SYSTEM

The Australian Prudential Regulation Authority (APRA) is not well placed to balance the cost to competitive behaviour in its regulatory actions. The preponderance in its remit favours system stability, even at a significant cost to competition.

The Commission does not propose to alter APRA's ability to consider competition in making its risk assessments and actions, but it is evident that a debate on the question of whether the public interest is served by restricting competition could be better authorised. The Council of Financial Regulators is a valuable forum for a rigorous and informed competition debate.

In the absence of such a debate and of a party specifically authorised to take on responsibility for representing competition, consideration of competitive effects inevitably will continue to be subordinate to stability.

16 Prudential regulation, systemic stability and competition

Key points

- Competition issues arising from regulatory settings or from the actual or perceived interventions of Government are a primary focus of this inquiry.
- Recent times have seen regulatory measures lifting costs for larger banks apparently because they are larger, and too big to fail. Focusing on big banks because they enjoy scale advantages is mis-targeted and will harm consumers.
 - By adding to operating costs, inevitably some consumers will pay more.
- While the expectation appears to be that smaller banks must gain an advantage from such regulatory measures, the data indicates that competition is not strong enough to see this benefit consumers, at least not via price shifts.
- Preferably, regulatory measures should seek to *reduce* costs. If relative risk weights are wrong, lowering them for smaller authorised deposit-taking institutions (ADIs) is more desirable than lifting them for others.
- And where costs must necessarily rise to achieve a desired gain in system stability, interventions should be finely targeted in their design in order to ensure they impose the least necessary cost.
- Lower costs for smaller ADIs may be possible via better regulatory efforts. The regulatory capital requirements for residential mortgage loans that apply to the majority of ADIs could be more closely aligned to risk and accompanied by guidance from the regulator, to let the benefits flow through to consumers.
- The major banks have an advantage in accessing capital markets by the ratings that the credit ratings agencies assign. This reflects their fundamental characteristics, such as size, ability to manage risk and balance sheet strength, but is also due to the expectations that government support may be provided in times of stress. The advantage can become substantial when financial markets are disrupted. From a competition perspective it is not wise to attempt to nullify advantages that derive from good business practice.
- Exposing bank executives and boards to the threat of takeover can heighten competitive pressure and thereby improve efficiency. On the other hand, takeovers can reduce competition by reducing the number of participants in the market.
- The Four Pillars policy may have protected instances of poor management performance. Moreover, the policy was intended to maintain the current competitive environment but is now redundant. Competition is better protected through the general competition laws.
- Competition (and its positive effect on corporate governance) can also be enhanced by lifting the restrictions on foreign investment, for large and small institutions alike.

Regulation for the protection of depositors and financial stability is an inherent part of the Australian financial system landscape. This regulatory focus on stability has created 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 impede competition include:

- prudential standards
- macroprudential policy
- implicit and explicit government support, and
- the Four Pillars policy.

Regulator perceptions of systemic stability and competition

Internationally, prudential regulators have to balance the potentially conflicting outcomes of stability and competition. Many regulators consider elevated competition may lead to undue risk-taking behaviour, threatening the viability of individual financial institutions and systemic stability (box 16.1).

Box 16.1 Systemic stability in the financial system and D-SIBs

Financial system stability is not a strictly defined term with universal meaning. In broad terms, a stable financial system is one where 'financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors [borrowers] and, by doing so, help promote growth in economic activity' (RBA 2001, p. 1). This manifests itself in a number of ways including: reliable payment systems; safe deposits; the extension of credit to creditworthy borrowers on reasonable terms; and, where applicable, the effective management of vulnerable financial intermediaries (Littrell 2013). With the global financial crisis (GFC) exposing multiple vulnerabilities across the domestic and global financial systems, the stability of financial systems is increasingly defined in terms of the resilience of those systems to stress, external shocks and cyclical forces.

Many countries have adopted the Basel committee's approach to identifying banking institutions which pose a systemic stability threat given failure, 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 (OTC) 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).

In the past, this concern has manifested as prudential regulation that put tight controls on financial institutions (such as credit rationing and direct controls on the interest rates applied to loans and deposits) and limited competition within the sector. For example, after the Great Depression, many industrialised countries regulated the banking sector with an explicit goal of limiting competition, thinking it would preserve the stability of their financial systems (Beck 2008). Australian prudential controls were somewhat relaxed from the 1980s onward and the focus of governments turned toward encouraging competition within the financial system for a time. In the wake of the global financial crisis (GFC), prudential regulators around the world have shifted their focus back to the potential trade-offs between securing prudential outcomes and delivering competition within the financial system (Anginer, Demirguc-Kunt and Zhu 2012; Beck 2008).

The extent to which regulators pursue both competition and stability objectives is a matter of judgment. Such judgments are complicated by the challenge of determining the benefit from avoiding financial failures or crises and estimating the future benefits from greater competition. 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)

The view of the prudential regulator is that competition and stability are not necessarily inconsistent. 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 2017 at PC roundtable hearings).

However, regulators are wary of the potential for undue risk-taking to undermine financial stability and harm the broader economy (and community):

There is a clear parallel in finance, as risks to the community from instability in the financial system are not fully borne by those that generate them. In the absence of effective regulation, financial firms acting in their own interests, and in a competitive marketplace, have the potential to create financial instability and thereby impose costs on the wider community. (Byres 2015)

16.1 Prudential standards

Prudential regulation of authorised deposit-taking institutions (ADIs) is intended to address:

- the inability and lack of incentives of depositors to adequately assess and monitor the risks ADIs take with funds deposited
- concerns over the stability of the banking system in the case of system-wide shocks.

APRA has developed a range of regulations known as ‘prudential standards’ to ensure financial institutions deliver on their financial promises to customers (including depositors, insureds and superannuants). These standards prescribe minimum requirements in relation to matters such as: holdings of regulatory capital (liquid capital held for regulatory requirements, see box 16.2); holdings of 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 (internalised) 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 ratio (LVR) or 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 16.2). 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.

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 and Macquarie use IRB models in Australia. Though varied at the institution level, the costs of IRB accreditation for the big four 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.

Box 16.2 Regulatory capital requirements and funding costs

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.

	<i>Examples (lists are not exhaustive)</i>	<i>Purpose</i>
Tier 1 Capital		
<i>Common Equity Tier 1 Capital</i>	<ul style="list-style-type: none"> • 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.
<i>Additional Tier 1 Capital</i>	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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 6).

The 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 (2017b); Prudential Standard APS 110

The right level of prudential regulation

Determining the optimal level of prudential regulation is a constantly evolving process based upon recent lessons (such as the GFC) and improving data. Finding the right balance between the Australian public's appetite for a reliable financial system that protects against failure in the financial system and the risk of increasing prices or reducing the availability of financial products is the goal.

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 would be an unrealistically constraining objective, particularly as the Australian economy inherently depends on importing capital. This interconnectedness and the confidence of foreign capital sources also make adherence to the Basel system very important for Australia. Beyond international effects, any banking system, like ours, that is based 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.

This intermediation is critical to the success of any modern economy. But not every risk can be fully mitigated and adding to regulation despite this obvious conclusion 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) however such models have been shown to suppress innovation and adaptability. The latter are at the heart of core productivity gains across an economy. The reason why regulators and designers of public policy allow for the variations and riskiness of multiple market-based participants is to allow for innovation to emerge. This can be forgotten in the pursuit of ever-stronger, ever-safer institutions. Moreover, a lack of innovation can lead to stagnancy and inefficiencies over time, to the ultimate detriment of consumers.

Prudential regulation often has the explicit objective of reducing lending to market segments or risk profiles. However, broad rules restricting classes of loans are imprecise, and the evidence shows that such regulations result in a slowdown in economic growth (Martynova 2015). More broadly, 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.

There is no definitive evidence to indicate Australia has stricter than optimal prudential settings *overall*. Stress testing on ADI loan portfolios by the Australian Prudential Regulation Authority (APRA) in 2014 found that 'we would have survived the stress

[scenario], but the aftermath might not be entirely comfortable’ (Byres 2014, p. 10).⁶⁵ And regulated parties, some of which have issues with aspects of its standards, have for the most part told us that they are supportive of APRA’s overall efforts.

Some market analysts have nevertheless told the Commission that Australia has a conservative interpretation of Basel rules relative to international peers.

And at the other end of the spectrum, Cline (2016) used data from a variety of countries (including Australia) to identify the socially optimal level of bank capital and found that regulatory requirements need to be tightened to achieve optimality.

The Commission’s approach has been to consider the overall balance of individual regulatory settings with respect to their effects on competition and the costs and benefits they impose. For example, in chapter 9, we indicate that it appears that current prudential settings for SME lending and low loan-to-value housing lending may be more conservative than would be reflective of the relative risk levels of these activities. Consequential costs may be unnecessarily imposed on both SMEs seeking debt finance and low risk mortgagees. Similarly, we consider the implications for non-ADIs to pose a credible competitive threat as a result of higher capital requirements applied to warehouse funding in chapter 7.

This is different to making a judgment on whether the overall level of prudential regulation is sufficient or excessive in and of itself.

Where our competition analysis leads to views on Australia’s broad systemic approaches, they are covered in this chapter.

Basing risk weights on risk

The Murray FSI (2014b) 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, stating that such an approach would:

- reduce the incentive to improve risk management practices in standardised ADIs and create an incentive to increase mortgage lending as a share of their balance sheet
- reduce the regulatory capital held by standardised ADIs which could weaken their prudential position and increase their chance of failing
- be inconsistent with the Basel framework (box 16.3).

Instead, the Murray FSI (2014b) argued for a 25–30% floor on the average risk weight applied to residential mortgages by IRB banks. APRA implemented a 25% floor in 2016.

⁶⁵ APRA tested two scenarios. Under the first, Australia’s gross domestic product falls by 4%, unemployment rises to over 13% and house prices fall by almost 40%. Under the second scenario, the RBA increases the cash rate significantly as global growth weakens and there is a sharp drop in commodity prices. This leads to higher unemployment and higher borrowing costs driving a significant fall in house prices.

There are limits to continuing to focus on differences in the *average* risk weights of ADIs using the standardised and IRB approaches. Mandating average risk weights will be detrimental to the economy when it results in ADIs holding more capital than they need for the risks they are taking and lending less as a consequence. More generally, increasing the operating costs of any market participant is counterproductive for competition and consumer outcomes. In contrast, increasing the precision of the standardised risk weights is more likely to create the environment for improved competition without detracting from prudential outcomes. Currently, the same risk weights apply to standard eligible residential mortgages with LVRs of between 0% and 80%, yet risk weights are calibrated in bands of 10% once the LVR exceeds 80% (table 16.1).

The Basel Committee on Banking Supervision (BCBS) (2017) has recently finalised risk weights based on narrower LVR bands (a subset of which are presented in table 16.3) but notes that any risk weights need to be tailored to, and informed by, local conditions. In the (new 5%) zones immediately above and below the 80% LVR level, loan characteristics could be more easily extracted now via digital data and artificial intelligence algorithms. These may tell a story that allows informed, cautious reassessment of risk weights for IRB and non-IRB institutions alike. These considerations could be added to data already held by APRA, along with that available from the likes of the ratings agencies and possibly the LMI providers.

Box 16.3 Why compliance with the Basel framework is important

While APRA has adapted elements of the Basel framework to suit local circumstances, it is inclined generally against departing too far from (specifically, weakening its application of) the Basel framework as:

- Australia has made a commitment to the G20 to implement the Basel III reforms
- a departure would likely see ADIs face increased funding costs in overseas wholesale markets because Australia's regulatory regime would be considered less robust than international best practice and investors would require higher returns to compensate for associated risk
- foreign bank branches operating in Australia could be at a competitive disadvantage if the Australian regulatory regime were more relaxed than the Basel-based regime to which they are subject in their home jurisdiction (APRA 2012c).

Greater data collection processes and analytics are helping to better identify risk profiles of specific customer sub-classes. The regulator can better target prudential regulation by using this information to nuance risk weights as allowed in the Basel framework. Such targeted risk profiling is worthwhile pro-competitive innovation, decreasing the costs of prudential regulation which may otherwise unnecessarily increase costs for safe loans and even under-provision risky ones.

The 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 an LVR of 30%, whereas a 25% fall in value could see the lender exposed to loss on a loan with an LVR of 80%.

Table 16.1 Standardised risk weights for standard eligible mortgages
Loans not covered by lenders mortgage insurance^a

	Currently enforced %	Finalised Basel III	
		Where repayment is <i>not</i> dependent on cash flows generated by property %	Where repayment is dependent on cash flows generated by property %
LVR ≤ 50%	35	20	30
50% < LVR ≤ 60%	35	25	35
60% < LVR ≤ 80%	35	30	45
80% < LVR ≤ 90%	50	40	60
90% < LVR ≤ 100%	75	50	75
LVR > 100%	100	70	105

^a Assumes the borrower is not in default of their loan agreement.

Source: BCBS (2017)

Improving the risk sensitivity of risk weights may not result in a decrease in the risk weights applying to all mortgages written by standardised ADIs. As noted above, the IRB banks are holding more capital against some loans compared to their standardised peers. That means there may be cause to increase the standardised weights where the current requirements do not accurately reflect risk.

DRAFT RECOMMENDATION 16.1 REVIEW STANDARDISED RISK WEIGHTS FOR RESIDENTIAL MORTGAGES

The Australian Prudential Regulation Authority should commence and complete a review of the standardised risk weights for residential mortgages set out in Australian Prudential Standard APS 112 by June 2020.

The review should be focused on more finely calibrating the risk weights to better reflect the risk inherent in individual mortgages.

In particular, consideration should be given to replacing the single risk weight that applies to standard eligible residential mortgages with a loan-to-valuation ratio below 80% with risk weights defined in more narrow bands.

Lenders mortgage insurance and risk weighting

The regulatory treatment of LMI forms a subset of the concerns around risk weighting differences. Regulatory recognition of LMI is different for IRB and standardised ADIs:

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- 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 but APRA (2014b) has set a 20% floor on the modelling of loss given default (LGD, see box 16.4) for those using IRB models. The introduction of a 25% floor on the average risk weight for the residential mortgages of IRB banks has further embedded the lack of capital benefits of LMI for IRB banks.

The 20% floor on LGD estimates was a more conservative treatment than that prescribed under Basel II (which required a 10% floor). While the floor on LGD estimates was driven by APRA's concern over the IRB banks' inability to demonstrate the credibility of their LGD estimates in a downturn scenario, it also had the effect of slightly narrowing the difference between standardised and IRB risk weights at the time.

Box 16.4 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 loan amount that will 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 capital benefit to IRB banks of using LMI, they often continue to do so. For example, the NAB (2017b) requires LMI for the majority of its residential mortgages with an LVR over 80% and has a longstanding requirement for LMI on investor loans against inner city residences with an 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 2014b) and the transfer of credit risk to a third party (RBA 2013b). 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.

There will, however, be instances where IRB banks choose not to use LMI for high LVR loans. In this regard, QBE Insurance Group (sub. 34, p. 7) has noted that the 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.

Such outcomes can benefit borrowers. There are real benefits to borrowers from the emergence of (cheaper and/or better) alternatives to LMI for high LVR loans. In this sense, the outcome could be viewed as pro-competitive as it has opened up a another front — better lending terms — on which lenders can compete for borrowers.

QBE Insurance Group (sub. 34, p. 7) had another concern over the long-term future of LMI providers and the resultant implications for competition:

In the absence of such regulatory or structural incentives recognising the use of LMI, QBE LMI is concerned about the ongoing viability of LMI as a product. ... QBE LMI considers that without the support of a strong and stable LMI industry, small and medium ADIs and non-ADI lenders will be at a material disadvantage in this market compared to the IRB lenders.

Genworth suggested two policy options (sub. 44) to better recognise the risk mitigation provided to IRB banks by LMI. The first option is to reduce the risk weight applied to LMI-insured loans written by the IRB banks by lowering the minimum floor for LGD. The second option is to increase the risk weights by making the IRB banks use standardised risk weights for high LVR loans which are not covered by LMI.

The first option may lead to lower funding costs for loans, as it avoids paying twice for the same risk, but is unlikely to significantly benefit customers. That is because a reduction in the capital to be held against mortgage insured loans will reduce the cost to IRB banks of funding those loans but — in the absence of incentives encouraging price rivalry (chapters 8 and 11) — these savings may not flow on to consumers. It would also work against APRA's decision to raise the minimum floor for LGD in response to recommendations from the Murray FSI.

The second option would be anticompetitive as it would seek artificially to raise costs for the IRB bank in order to increase LMI sales. Further, it may distort the average risk weight system imposed on the banks by APRA. Mortgage insured loans would need to be exempt from the pool of loans on which the 25% risk-weight floor on residential mortgages for IRB banks was determined. Otherwise, the 35% (or higher) risk weight required under the standardised approach would be of no effect. IRB banks would 'hold more capital' on high LVR loans but could 'reduce' capital held on other loans and still attain the 25% average. If the risk weights were changed on non-prudential grounds to counter such 'rebalancing' by the IRB banks (with an overall average above 25%) then this would artificially hamper the IRB banks and, in all likelihood, would harm consumers.

Genworth (sub. 44, p. 6) expressed concern about the potential for a 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 2014b). Further, given the stronger credit ratings of the major banks

relative to LMI providers, self-insurance may be a rational (and effective) strategy.⁶⁶ 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. The prudential regulatory settings should reflect as accurately as possible the relative risk of different options so that these decisions can be taken without any distortion. Moreover, given LMI's current extensive use, it is unclear that mandating its use any further would have competition or consumer benefits.

Making it easier to become accredited for the IRB approach

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 cost major banks over one billion dollars, not including any cost borne by APRA and charged to industry (Productivity Commission estimates using data provided by ADIs). The majority of ADIs were not of a scale to make such an investment cost-effective in 2014 (Murray et al. 2014b). Since then, the implementation of a 25% average risk-weight floor on residential mortgages for IRB banks has reduced the potential net benefits to be derived from the IRB approach. This will have further reduced the viability of IRB accreditation for any ADIs considering such a move.

Any regulatory process should only impose the minimum burden necessary to achieve its objectives. Recognising this, APRA (2015f) has announced changes to its IRB accreditation process to make it easier for ADIs to achieve accreditation. These changes include a staged accreditation process and removing the requirement to have advanced modelling to determine the capital held against both credit and operational risks.⁶⁷

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.

Australian ADIs can already use external data (including pooled data) in certain circumstances (APRA 2012b, 2013d) but there may be scope to expand its use and/or provide clearer guidance to ADIs. Further input to this inquiry (such as from non-IRB banks) on the use of data for risk assessment, would be useful.

⁶⁶ The major Australian banks have issuer ratings of AA- from Standard and Poor's compared to the mortgage insurance arms of QBE and Genworth that have financial strength ratings of A+ (the financial strength rating is usually higher than issuer ratings).

⁶⁷ 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.

INFORMATION REQUEST 16.1 WHERE CAN IRB ACCREDITATION PROCESSES BE IMPROVED?

We are interested in any suggestions for improvements to the internal risk-based (IRB) accreditation process to make IRB modelling more accessible to non-major banks. Of particular interest is:

- Information on existing international programs or proposals for alleviating data requirement burdens (such as use of external/shared loan data)*
 - Availability of expertise to develop IRB models outside of major banks and potential to outsource IRB model development (or for external parties to develop ‘off the shelf’ solutions)*
 - Any other recommendations for APRA’s accreditation processes (such as process transparency)*
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16.2 Macprudential policy

Macroprudential policy is the system-wide approach to managing stability risks of the financial system (Orsmond and Price 2016). Ideally, macroprudential policy will reinforce institution-specific prudential regulation (sometimes referred to as microprudential policy) as sound individual financial institutions support a stable financial system. Many of the regulatory tools applied for macroprudential purposes (table 16.2) are also used to achieve microprudential objectives.

Table 16.2 The macroprudential policy toolkit

<i>Nature of tool</i>	<i>Aimed at addressing</i>	<i>Examples</i>
Broad-based capital tools	A broad-based credit boom.	<ul style="list-style-type: none">• Dynamic provisioning requirements• Countercyclical capital buffers• Time-varying leverage ratio caps
Sectoral capital and borrower-based tools	Vulnerabilities associated with specific sectors and asset markets.	<ul style="list-style-type: none">• Restrictions on <i>borrowers</i> such as caps on LVRs, debt-to-income ratios and debt-service-to-income ratios• Restrictions on <i>lenders</i> such as risk-weight floors and sectoral capital requirements
Structural tools	Risks from interconnectedness; limiting contagion effects.	<ul style="list-style-type: none">• Interbank exposure limits• D-SIBS capital requirements
Liquidity-related tools	Any build-up of liquidity and foreign-exchange risks.	<ul style="list-style-type: none">• Liquidity coverage requirements (LCR)• Net Stable Funding Ratio (NSFR)• caps on loan-to-deposit ratios for ADI balance sheets.

Source: Orsmond and Price (2016)

Macroprudential policy in Australia

APRA's use of macroprudential policy is coordinated with other financial stability measures through the Council of Financial Regulators (CFR, chapter 17). The CFR is informed by the information-gathering initiatives of the regulators (the RBA, APRA and ASIC) and Treasury, such as industry-wide stress tests and periodic reviews of emerging systemic risks.

The financial system regulators are not necessarily limited to the tools outlined in table 16.2. APRA's growth benchmarks for investor and interest-only home loans (chapter 15) are recent examples of an approach from outside the standard toolkit. These benchmarks were put in place to counter what was seen as competition-eroding lending standards (APRA, sub. 22).

In implementing these macroprudential measures APRA set out the outcomes ADIs were to achieve and left it to ADIs to decide how best to achieve those outcomes. This approach, known as outcomes-based regulation, would normally be considered best practice for regulatory implementation. But in an environment where licenced participants have substantial market power — and their decision-making can readily be characterised publicly as having been induced (and approved) by the regulator — some of the consequences suggest more rather than less guidance is essential.

APRA's intervention in lending to residential property investors has limited the scope for price competition to those customers. That is because any ADI charging a materially lower interest rate than its competitors will receive an outsized number of loan applications that, if approved, would result in it breaching APRA's growth limit for the investor segment. As a result, ADIs have aligned their pricing for investor lending.

This outcome should not come as a surprise given the policy was intended to reduce the supply of loans below demand; or put another way, could have been readily anticipated that such might be the result. The market power of lenders has allowed them to use pricing as the means of rationing credit to comply with APRA's benchmark growth targets and increase profits.

As no ADI can grow above 10% without breaching APRA's benchmarks and excess demand means they have no trouble growing at 10%, there is no competitive tension in the market for investor lending. This is apparent in the observation from APRA (sub. 22, p. 21):

... since APRA's intervention the market share of the major banks and other ADIs are almost unchanged, with a slight increase for smaller ADIs.

Since implementation of the investor lending constraints, competition has been restrained, which APRA and the RBA view cautiously as a positive (Ellis and Littrell 2017). However, the same effect could potentially have been achieved using different strategies. APRA could have used more targeted approaches, such as influencing lending standards, which would have had less impact on existing borrowers (chapter 8).

At the other end of the scale, some countries have chosen to ban new interest-only loans altogether to prevent unsustainable growth in demand.⁶⁸

The option most intuitively attractive is that APRA could have emphasised that the target was *growth* in the investor loan and interest-only loan category, and explicitly require that ADIs take no action that affects their existing borrowers.

However, the ADIs responded to APRA's benchmarks, repricing affected new and existing loans — the stock, as well as the flow of credit. The repricing of *existing* loans did nothing to reduce heat in the investor market, as it had no effect on demand for *new* investor loans, and instead increased pressure on existing borrowers (APRA 2017u).

Some banks have told the Commission in oral exchange that they had to re-price their back book. The reasons for this were not made explicit. And since banks have a range of investors at quite widely varying rates on their books, it cannot be beyond the scope of banking systems not to raise prices (chapter 8).

In appearance, it seems the policy sought to replicate what has generally been expected in the past when the RBA's cash rate *increased* (i.e. in general, loans were re-priced when cash rates were increased, presumably to reflect the indirect increase in cost of funds – see chapter 5). But in our view one of the more obvious flexibilities offered by macroprudential actions is that they need not replicate the breadth of cost increase imposed across the economy by a move in the cash rate.

The repricing of existing loans may have reduced the overall proportion of interest-only loans, to the extent that some customers were encouraged to switch their existing loans from interest-only to principal and interest by lower rates on such loans. But this switch does not appear to have been the target on this occasion.

The experience of macroprudential policy overseas

Australia is one of many countries using relatively novel macroprudential policy. Like Australia, other countries (such as New Zealand, Canada, Norway and Sweden) have used it to try and address a run-up in housing debt and house prices. The macroprudential responses in those countries have generally focused on two of the tools from table 16.2:

- *Sectoral capital and borrower-based tools* which have centred on LVR restrictions (Canada and New Zealand)⁶⁹, minimum amortisation requirements for high LVR loans (Norway and Sweden), maximum loan-to-income ratios (Norway) and caps on repayment-to-income ratios (Canada).

⁶⁸ Singapore banned interest only residential mortgages in 2009 (Monetary Authority of Singapore 2009).

⁶⁹ 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 macroprudential response to the growing housing market risks in that region.

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- *Broad-based capital tools* which have centred on increasing countercyclical capital buffers (Sweden) as well as raising mortgage risk weights or loss given default (LGD — box 16.4) (RBA 2017u).

Macroprudential 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 (2017u) 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.

Notwithstanding this, there is a common theme from both Australia and the overseas. That is, where macroprudential policy has been applied to ADIs, there has been some increase in the activity of unregulated lenders.⁷⁰

Other lessons are harder to discern. APRA could have been more specific in how it wanted ADIs to limit the growth in investor lending. Allowing credit rationing to occur via increased interest rates (as has occurred, and so may again while interest rates remain on hold) could eventually create other unanticipated perverse outcomes, such as limiting price competition.

This experience highlights 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 macroprudential policy outcomes, particularly on competition, to better understand the effectiveness of these policies, inform future policy decisions, and to clearly communicate policy objective(s).

16.3 Government support

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, the Australian government enacted three key policies to reinforce financial stability:

- the financial claims scheme
- the wholesale funding guarantee
- residential mortgage backed security purchases.

Though the listed policies are clear and intentional interventions, governments also support larger institutions through an implication that they will bail out banks which are ‘too big to fail’ in times of stress (as their failure could cause a financial crisis). 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

⁷⁰ APRA has advised that the non-ADI data collected to date over a 14 year period is not of sufficient quality from which to draw any conclusions. Non-ADIs self-identify and voluntarily report to APRA, although those with total assets in excess of \$5 million are obliged to register with APRA.

examines government interventions and where they may impact competition for banking services.

Implicit guarantee

While the ratings agencies each hold similar expectations on government intervention for ‘too big to fail’, they differ in their assessment of the associated ratings uplift from the expected support (table 16.3).

Table 16.3 Impact of implied government support on credit ratings
Rating uplift from government support

	<i>Moody's^a</i>	<i>Standard and Poor's^b</i>	<i>Fitch^c</i>
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 government support from 1 (extremely high probability of support) to 5 (cannot rely on support).

Source: RBA (2012c); S&P (2017)

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 in table 16.3. For example, Moody's removed the uplift for government support from its ratings for subordinated debt in 2013 (RBA 2015) 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).

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'.

DRAFT FINDING 16.1 RATINGS AGENCIES EXACERBATE THE PERCEPTION OF
'TOO BIG TO FAIL'

By incorporating perceived government support in their relative ratings of Australia's banks, ratings agencies further embed the major banks' 'too big to fail' status, with consequent advantages to these banks in the costs of funds.

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 (2015d) attempted to model the major banks' funding cost advantage from implied government support over the period 2000–2013. They found the advantage to be about 20 – 40 basis points.⁷¹

That modelling and the RBA's literature review strongly indicate that the funding advantage rises and falls over time. For example, the funding advantage was estimated to have fallen to around 10 basis points, and not statistically significant from zero, in late 2014 (a time of relative *stability* for financial markets and the financial system) whereas 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 system).

The widening of the funding advantage in times of instability within the financial system 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 16.2) 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.

⁷¹ 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 (2015d) placed a number of caveats on the model output and associated inferences for the extent of the major banks funding advantage.

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 Australian 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) 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* (Davis and Jenkinson 2013).

At the same time, 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 formal liquidation to recoup these funds. Given this, a better argument for the lack of a fee might be that the fee would add to consumer costs while, even with APRA's careful approach, offering consumers little if any additional benefit.

The FCS does not extend to deposit-like products (such as debentures) issued by non-ADIs (such as finance companies) to retail investors. 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

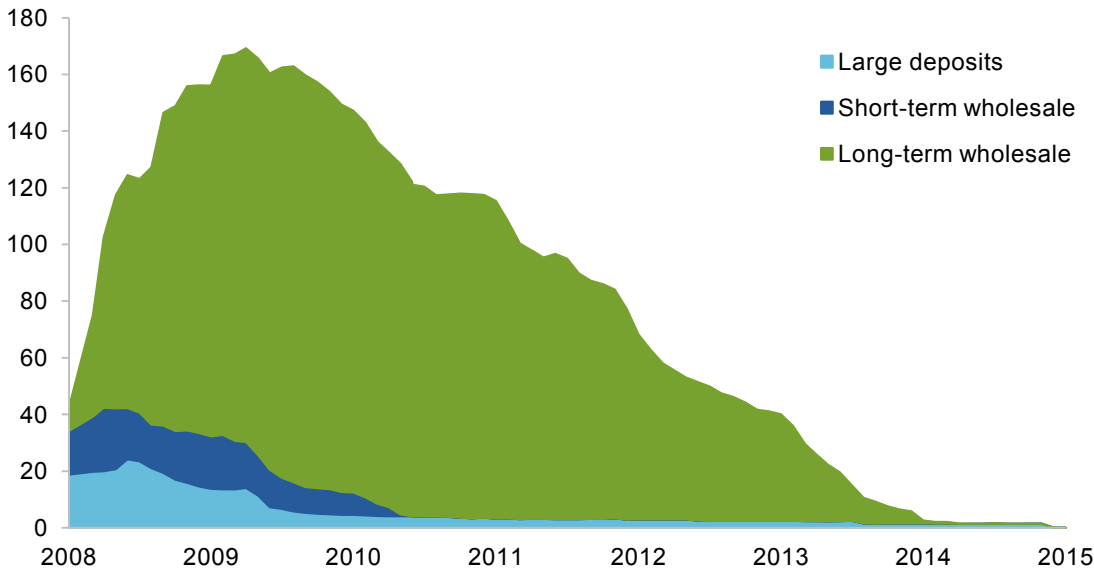
The Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme) commenced in 2008 in response to deteriorating international

wholesale funds markets during the GFC. As part of the scheme, the AAA rated Australian government guaranteed eligible wholesale funding securities, decreasing the perceived risk of Australian ADI funding instruments for better prices 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 16.1). The total fees paid to the Australian Government by ADIs using the facility were \$4.5 billion (Schwartz and Tan 2016).

Figure 16.1 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 (2017a)

Major banks received relatively less assistance 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 (table 16.4) (Schwartz and Tan 2016). Non-ADIs received no support under the Guarantee Scheme.

Table 16.4 Long-term debt guaranteed by the Australian Government
March 2010

	<i>Guaranteed long-term debt \$b</i>	<i>Share of total liabilities %</i>
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.

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, though some uncertainty would inevitably remain.

ADIs should pay for any support they actually 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 16.5) 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 16.5 Fee for the Guarantee Scheme for Large Deposits and Wholesale Funding
2008–2012

<i>Institution credit rating^a</i>	<i>Fee charged on the balance of guaranteed liabilities^b</i>
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)

However, 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 16.3). Of course, if the arrangements were available to all ADIs, the difference in the ratings for this reason would gradually disappear.

An alternative approach would 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, with a consequent deadweight cost on the industry and its customers.

The major bank levy isn’t the solution to any competition concerns

The major bank levy (box 16.5) has been put forward by the Australian Government as part of its effort to level the playing field between the major banks and others. This approach has been endorsed as a step in the right direction by the Regional Banks (sub. 37, p. 53).

Justification for it has included an assessment of the difference between what the major banks, said to be too big to fail, pay to raise funds versus that paid by smaller banks (Joye 2017).

Box 16.5 Major bank levy

The major bank levy was introduced on the 1st of July 2017 for authorised deposit-taking institutions (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 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.

Source: Morrison (2017c); Hawkins (2017)

This difference, however, also reflects market circumstances, such as stronger balance sheets or better risk management practices that the ratings agencies will reflect in their assessments (discussed in chapter 5).

It may leave the perception of unfairness, but as a market reality it is not likely to disappear even if a charge is applied to claw back part of the gain. So from the perspective of a competition analysis, this charge will add to costs and could be recovered from consumers if market power exists.

The lack of price competition is not solely due to the relatively lower cost of major banks, which is an input into determining the floor price for loan products. An increase in the floor price by virtue of the levy isn't likely to be of consumer benefit.

ADIs competing with the major banks will not see their costs fall as a result of the levy. So they are unlikely to offer a more competitive price to consumers (and evidence is that they have not). Even with the best efforts of the ACCC to monitor the pricing of the major banks (ACCC 2017g), there is a myriad of retail, SME and business banking products that can be repriced by a few basis points to offset the effects of the levy. In addition, there are other costs to the major banks that benefit consumers and yet could (and appear to have, although we cannot say this is cause and effect) reduce to offset the levy — such as rates paid on online cash management accounts.

At the margin, the major bank levy could make the perception of government support issues worse. To the extent that capital markets see the levy is a quasi-insurance premium for future government support — which has now been clarified, but nevertheless arose at one point — it reinforces the perception that (unclear and non-transparent) government support will be provided in a crisis.

16.4 The Four Pillars policy

The Four Pillars policy (box 16.6), as it is known and understood today, came into effect with the Australian Government's response to the Wallis FSI (1997).⁷²

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 1997).

Box 16.6 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 (Treasurer 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.

There have been a mix of findings and recommendations across those reviews of the financial system that have considered the Four Pillars policy. The Wallis FSI (1997) 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.

⁷² The Wallis FSI recommended that the Four Pillars policy should be removed, with mergers in the financial system instead considered under the existing merger laws (recommendation 83), and that the policy prohibition on foreign takeover of one of the four major banks should be replaced with assessment under general foreign investment policy provisions (recommendation 85). The Government accepted the Wallis FSI recommendation to remove the blanket prohibition on any foreign takeover of a major bank: any proposed foreign takeover or acquisition would instead be assessed 'on a case by case basis on its merits in accordance with the *Foreign Acquisitions and Takeovers Act 1975*' (Costello 1997).

The policy as originally established was intended to prevent mergers between the largest participants in the banking and insurance sector (though insurers were subsequently removed from the scope of the policy).

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.⁷³

It is important to recognise that the merger restriction under ‘Four Pillars’ is a policy, not a legislated obligation. Despite that, it has become a core element of thinking in the banking market. This has some possible unintended costs to competitive behaviour.

Laws strong enough to protect competition

While recognising 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 which 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. Moreover, the scope for the ACCC to pursue instances of a ‘substantial lessening of competition’ has broadened since past FSIs.

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. Where a merger may ‘substantially lessen’ competition down the track, the strengthening of section 46 of the Act now provides sufficient 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 itself, 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 (Treasurer 2008b) and CBA’s acquisition of BankWest (Treasurer 2008a).

⁷³ Section 50, section 95AN.

Furthermore, 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.

Similarly, a future major bank merger may be in the public interest (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.

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 6) 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 ACCC (sub. 17, p. 10) submitted that 'it could be argued that the [Four Pillars] policy insulates the large banks from competition' by entrenching perceptions of an implicit government guarantee and reinforcing a belief that they are too big to fail. But this is not borne out in the ratings reports of Moody's and Standard and Poor's wherein the Four Pillars policy is not mentioned, let alone held out as part of the reasoning as to why they see government support being provided in a financial crisis. Other Government actions, such as APRA's nomination of ANZ, CBA, NAB and Westpac as Australia's D-SIBS, seem more likely to affect ratings agencies' assessment.

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 suggest that the prudential regime itself and existing banking laws brought more systemic stability than the Four Pillars policy during the GFC.

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 unlike Australia, there does not appear to be a Canadian Government policy of expressly prohibiting mergers between the five major banks (Davis 2007). Instead, Canada has legislated similar controls on bank ownership to those set out in the Financial Sector Shareholdings Act (box 16.6) 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 really possible by a large foreign institution, but it is not clear as to whether this threat of takeover is sufficient to drive competitive behaviour. A major bank foreign takeover would require the approval of the Treasurer and the Foreign Investment Review Board, as well as a willing buyer with surplus capital to deploy. 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 takeover would be subject is under the Financial Sector (Shareholdings) Act, which requires the Treasurer to approve any person holding a stake (effectively voting power) of over 15% in a financial sector company (box 16.6). 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.

At best, it is a redundant policy that does not achieve its stated objectives. It could be replaced by a revised limit on an individual shareholding in all Australian banks, as part of the review proposed in draft recommendation 4.1.

DRAFT FINDING 16.2 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 regulator power to intervene to ensure competition, prudential outcomes and the broader public interest are protected.

It is also not clear that the Four Pillars policy has met its stated objective of preserving competition, or whether instead it has eroded competition by embedding a fixed market structure.

17 Reforming the regulators to support competition

Key points

- Changing the way the financial regulators interact to address competition is highly desirable.
- Weighing up competition and stability requires financial regulators to give serious consideration to the competitive effects of their prudential measures, and vice versa.
 - Currently, the presence of the ACCC is not a counterweight to financial regulators' interests in stability. The ACCC's primary power lies in responding to evidence of a substantial lessening of competition in a market. It does not extend to knowing in advance of a financial regulator's proposed actions or reviewing the competition consequences of such actions.
 - Thus, there is no agency currently tasked with monitoring and enhancing competition and hence supporting innovation in the financial system.
- 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 decision making processes at the Council of Financial Regulators (CFR). From the Commission's perspective, there are two contenders for this role — the ACCC and ASIC.
- The ACCC has the expertise to assess competition issues, and its activity in the financial system is expanding.
 - To take on the role of the champion for competition, the ACCC would need to build on its expertise in the finance area, to allow it to make a credible assessment of the proposed actions of regulators, and to shift from a reactive to proactive stance on competition. It would also need to balance these activities with its economy-wide responsibilities.
- ASIC's role in the financial system gives it a deep understanding of both supply and demand issues at the product level and experience as a regulator in the relevant markets. It would be well placed to promote competition and assess proposed actions of other regulators.
 - Expanding ASIC's mandate to explicitly include competition, recommended by the Murray Financial System Inquiry, is overdue. ASIC's regulatory culture and skills base would need to be aligned with this new mandate.
 - The UK Financial Conduct Authority can serve as a possible example of a proactive financial regulator that has refocused its internal culture on the promotion of competition, alongside market conduct and consumer protection.
- APRA should retain its current legislated ability to consider competition issues, in order to allow it to respond at the CFR before it implements its proposed actions.
- The CFR should become a more transparent forum.
 - To minimise adverse competitive consequences, the regulator designated to promote competition should review other regulators' interventions before they are implemented. Its analysis should be discussed by the CFR, and the responsible regulator should consider amending their policies, taking into consideration competition effects.
 - The Council should publish the competition analysis as well as the minutes of its meetings.

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. While systemic stability is clearly a very important goal for the financial regulators, the cost that it imposes on competition can be very high. This cost is borne by the community, in the form of higher interest rates and reduced availability of credit.

The Commission considers that competitive effects of regulator actions should become more robustly and openly considered, alongside stability. 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 pro-competitive action.

The Commission proposes achieving this by strengthening existing organisations and processes, rather than creating new regulators. This would entail identifying an organisation that would act as a champion for competition; and creating mechanisms for transparent reviews within the Council of Financial Regulators, that will enable the regulatory system to support more competitive outcomes.

17.1 A champion for competition

In the existing system of financial regulation, there is no one organisation responsible for promoting competition. No current regulator of the financial system is required to give even weight to competition outcomes. All have an interest in it, but none is required to lead on the topic (chapter 15).

For example, there appears to be no systemic oversight of the effects of integration on competition in the financial system. Vertical and horizontal integration can reinforce market power, and have the potential to substantially lessen competition and efficiency, or impose barriers to entry (chapter 7).

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. Such a champion for competition would be able to address the existing gaps in the regulatory system, and may take a public stance more generally on competition issues in the financial system as required.

The Commission recommends designating the competition champion by giving a broader mandate to one of the existing regulators that interact with the financial system; or to the ACCC.

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. It was established to fulfil a specific role, which currently focuses on third party access to services provided by monopoly infrastructure (NCC nd), and is not closely related to the financial system. As the Council no longer employs its own staff, its ability to undertake large scale analysis as it currently operates is very limited (PC 2017d). 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 2016d).

Other than taking a wholesale reform approach to the Australian ‘twin peaks’ approach to financial system regulation, the only other method of simply and effectively ensuring competition is given robust consideration prior to a regulatory action is for the co-ordinating body across the regulators (the Council of Financial Regulators) to formalise a review of the market implications of proposed actions.

Such a review *could* take place quite readily between the three primary regulators — ASIC, APRA and the RBA — prior to regulatory interventions. But this type of review is not currently a standard feature of the regulatory system. The Australian Government has not authorised any entity to take up such a review role, even though a vehicle to broaden regulators’ consideration of competition — Statements of Expectations — has been recommended and accepted following the Murray Financial System Inquiry (FSI).

The Commission envisages that the role of the designated competition champion will not be to act as a competition regulator, but to be the party that leads consideration of the impact that interventions planned by regulators will have on competition. It will analyse the competition implications in order to promote a discussion in the Council of Financial Regulators (CFR) and make that analysis public.

Thus there are two possible candidates already in place that could champion competition in the financial system: the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investments Commission (ASIC).

The other two financial regulators (APRA and the RBA) have not been included in the list as their primary focus is, and should remain, financial stability (chapter 15).

DRAFT RECOMMENDATION 17.1 NEW COMPETITION FUNCTIONS FOR A REGULATOR

To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, an existing regulator must be given a mandate to take the lead on matters related to competition in the financial system.

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

There would 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 all members of the CFR the practice of reviewing, before they are implemented, regulator actions that may have material effects on competition.

The competition-related functions of the designated Council member would include:

- transparent analysis of competition impacts tabled in advance of measures proposed by regulators
- testing of the impacts of competition and community outcomes of additional provider integration.

Option 1 — ACCC as a champion for financial system competition?

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 strives to improve competitive outcomes — and could be well placed to take on the role of competition champion in the financial system.

There are, however, a number of challenges that the ACCC would need to overcome. The ACCC has an economy-wide responsibility and must prioritise its work across all sectors (Murray et al. 2014a). Taking into account the sheer size of the financial system, and the pivotal role it plays in the Australian economy, fitting this new role within the ACCC’s existing work program may be a substantial challenge. Unless dedicated resources are made available, there is a risk that paying greater attention to competition in the financial system will skew the ACCC’s focus towards financial services at the expense of other parts of the economy, or limit the regulator’s ability to monitor the financial system as closely as required.

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. At present, no such legislated power exists and we

do not propose one. Rather, we seek a proactive and committed party to robustly analyse a proposed action. This is a culture shift for a body such as the ACCC. It would need to be clearly authorised in this task.

The ACCC's position among the financial regulators

Although its powers extend to some parts of the financial system (see below), the ACCC is neither a strong nor continuous presence in financial system regulation or policy setting:

... [D]espite the Australian Competition and Consumer Commission's (ACCC's) clear concerns about the level of banking competition, it has acknowledged not closely monitoring the sector because 'the RBA, APRA and ASIC are...observing the banks.'

None of these regulators, however, have a clear mandate to promote competition in the financial sector. The ACCC does. (HoRSCE 2016d, p. 23)

The ACCC has no power to affect the regulatory decisions made by APRA and ASIC, or the legal mandate to intervene in order to lower barriers to entry or competition imposed by other regulators (Murray et al. 2014a). Further, the ACCC is not a permanent member of the Council of Financial Regulators, which limits its ability to exert a pro-competitive influence on regulation. That said, becoming a permanent member of the CFR would not create the right to take the lead on competition analysis of a CFR member's proposed actions. Membership is not a solution to the lack of an entity to lead on behalf of competition.

We assess that the inability to act in anticipation of other regulators implementing policies that could materially affect competition imposes limitations on the ACCC's capacity to be an effective champion for competition. To overcome this, the ACCC's mandate would need to be extended to include the right to review the proposed actions of the financial regulators at the CFR. It follows that to do this it must then become a permanent member of the Council, particularly as the CFR becomes a forum for discussing and publishing analysis on the competition effects of proposed regulation (see below for a discussion on the new CFR processes recommended by the Commission).

ACCC's financial system capabilities and regulatory toolkit

The ACCC already 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 2010* (Cth). 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' (ACCC, sub. 17, p. 4). The ACCC believes this amendment will 'significantly improve [its] capacity to tackle anti-competitive conduct in the financial services sector' (sub. 17, p. 4).

Further, the ACCC's recently established Financial Services Unit has been tasked with undertaking regular inquiries into competition issues in the financial system. The ACCC

received additional funding of \$13.2 million over four years⁷⁴ for the new unit's operations — this funding would need to increase and become a permanent part of the ACCC's budget if it were to effectively promote competition in the financial system. The unit currently has only a small number of staff, representing less than 2% of the ACCC's employees (in addition to staff who are involved in issues relevant to the financial system on an ad hoc basis) (ACCC, pers. comm., 6 December 2017). This number would have to grow substantially to give the ACCC sufficient resources to promote competition in a sector as large, diverse and complex as financial services.

The ACCC already has the expertise to assess competition issues across many parts of the financial system, as evidenced by their merger reviews. However, if its role expands to take on a more proactive stance of promoting competition, it would need to expand its knowledge into additional areas of the financial system, such as prudential compliance.

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. Analysing the implications of regulator actions on competition would need to become a major part of the role played by the ACCC in promoting competition in the financial system, and one it would need to be well equipped for.

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.

Option 2 — ASIC as a champion for financial system competition?

ASIC is tasked with ensuring that financial service providers develop and sell products that align with consumer needs, as well as licensing providers of financial services, and taking action when it identifies poor conduct in the market (ASIC 2017g). It already has a strong implied responsibility in its authorising legislation to address competition within the financial system.

While we are not a competition regulator, our regulatory framework, policies and decision making play an important role in shaping competition in the financial system. Where possible, we consider competition in carrying out our work.

We think that competition considerations generally underlie our current mandate to:

- (a) maintain, facilitate and improve the performance of the financial system and the entities

⁷⁴ An additional \$1.2 million was provided in 2017-18 for the unit's current inquiry into home loan pricing (ACCC, sub. 17).

within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and

(b) promote the confident and informed participation of consumers and investors in the financial system. (sub. 40, p. 27)

There is a strong case for designating ASIC as the regulator that would promote competition in the financial system.

First, unlike the ACCC, ASIC operates primarily within the financial system. About 60% of its staff are working in areas relevant to the financial system (ASIC, pers. comm., 5 December 2017). It already has the expertise and capability to analyse competitive behaviour across a broad range of markets for financial products, and it can do so within its existing scope of operations. There is considerable synergy between its existing responsibilities and the need to advance competition in the financial markets.

Second, ASIC's existing mandate within the financial system covers licensing, provider conduct and consumer outcomes. This gives it a strong understanding of the issues pertaining to competitive pressures both on the demand and supply side of the financial system. (ASIC 2014e). Therefore, it is well placed to promote competition in a part of the economy it is already very deeply involved in. The UK's Financial Conduct Authority is a well-established example of a conduct and consumer protection regulator that has also been tasked with promoting competition. It has taken numerous steps to emphasise the central role that competition plays in its policies, including publishing annual reviews on the state of competition in the financial system (FCA 2017a).

Finally, ASIC is a member of the Council of Financial Regulators and has the clearest orientation towards advancing consumers' interest in financial products. Hence, it is in a position to influence the actions of other financial regulators without the need to change existing institutional arrangements.

However, and similarly to the ACCC, the culture of becoming a critic of regulatory actions on behalf of competition is a new task and culture for ASIC. Unlike the ACCC, ASIC does not have a strong history of acting in support of competition per se. It has a sound track record of analysis in consumer protection, which is an allied trait. But still, a new cultural approach would be required.

Turning ASIC into a strong competition champion will require changes to its culture, structure and objectives. The Statement of Expectations proposed earlier (chapter 15) should become the foundation for the exercise of this judgment role.

Updating ASIC's mandate

In its response to the Murray FSI, the Australian Government (2015) has already committed to adding competition to ASIC's extensive mandate. This is yet to occur, and that may offer an opportunity for ASIC to use such a mandate in an active, rather than passive, way.

As ASIC (sub. 40, p. 84) pointed out, simply adding competition to the existing mandate may not be enough to reorientate its focus towards competition:

Adding a requirement into ASIC's statutory mandate to formally consider the effect of our decision making on competition will not make us a competition regulator; however, we think this change will drive a greater focus on the long-term interests of consumers in the financial system.

ASIC's existing mandate is broad, covering a large number of functions and setting out a generic approach to enforcement.⁷⁵ As a first step towards empowering ASIC as a competition champion, the Australian Government could change ASIC's mandate, with a view to focusing on its core areas of responsibility: conduct, consumer and investor protection, and competition.

This would mirror the mandate of the UK's Financial Conduct Authority (FCA), which is suggested by ASIC as a useful example (sub. 40). Specifically in the case of competition, the FCA's objective is 'to promote effective competition in the interests of consumers' (2015c, p. 6). This is a broader requirement than the original recommendation for ASIC's competition mandate, which required it to consider the effect of its decisions on competition. The Commission considers that achieving a pro-competitive balance in the regulation of the financial system would require ASIC to be empowered to take a stand beyond its own regulatory boundaries. Therefore, a broader competition mandate would be required.

A proactive regulatory culture

ASIC's current regulatory culture tends to be reactive, rather than proactive. Its focus is set very much on enforcement action rather than strategic planning and analysing market structures (ASIC Capability Review Panel 2015).

To address this, it has undertaken a series of reviews of its culture, most recently in 2016, and it is working towards improving its capabilities and its processes (ASIC 2017b, 2017g). Nonetheless, supporting competition is currently not a core part of the regulatory culture. Competition issues are only considered on an ad hoc basis as part of ASIC's other activities (ASIC, sub. 40).

The experience of the FCA can provide important lessons to ASIC as it works to refocus its culture on proactive regulation, to achieve both effective competition and consumer protection.

⁷⁵ In its existing mandate. ASIC (sub. 40, p. 84) is required to 'take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.'

Are ASIC's powers and regulatory toolkit fit-for-purpose?

ASIC has a range of direct powers to intervene in the financial system, as the regulator responsible for licensing, conduct and disclosure, and the ability to extend light touch regulation via its regulatory sandbox or self-regulation.

Recognising that disclosure measures are often ineffective, the Australian Government is planning to grant ASIC new intervention powers to issue product warnings, restrict product distribution and temporarily ban some financial products made available to retail clients and credit products regulated by the *National Consumer Credit Protection Act 2009* (Cth) (credit cards, mortgages and personal loans) where there is a risk of significant consumer detriment (The Treasury 2016b). The need for ASIC to act to protect consumers with immediacy is an important addition to ASIC's toolkit. Nevertheless, there is potential for such powers to stifle innovation, and such powers such as banning should be used as a last resort.

Were ASIC to become the financial system competition champion, it may need the power to conduct market studies on specific competition issues in the financial system. As the Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre (sub. 23, p. 14) point out, 'market studies can act as a spearhead for competition advocacy', and could allow ASIC to develop better policies and advise the Australian Government on issues relevant to competition.

The ACCC's legislation and role in relation to competition law breaches would remain undiminished under this option.

A possible restructure of ASIC

The changes proposed by the Commission do not appear to require an update to ASIC's current structure, but the Commission is interested in examining this further. Cultural change often requires a catalyst of this kind. Yet the cost of this change needs to remain manageable.

Since it was established as the Australian Securities and Investments Commission in 1998, ASIC's role has grown significantly in response to a range of reforms and reviews, and additional roles have been added to its list of responsibilities.

ASIC's mandate is extensive, and is not fully replicated by any other conduct regulator globally. It broadly covers three areas:

1. financial markets, financial services and corporate regulation;
2. business and company registration;
3. credit and insolvency practitioners.

ASIC's powers and responsibilities in the first area are broadly consistent with those financial conduct regulators in other jurisdictions, although most peers do not have the extent of ASIC's coverage. ... ASIC's responsibilities in the second area (registry) are unique compared to conduct regulators (ASIC Capability Review Panel 2015, p. 34)

Other efficiency options might be pursued, if ASIC is the preferred lead on competition issues, as the FCA is in the UK. The current breadth of ASIC’s activities and complexity of the legislation it administers has been queried before (ASIC Capability Review Panel 2015). One area that may merit attention in this context is the business and company registries that ASIC currently manages. ASIC itself (2014e, p. 62) suggested that its registry function does not have ‘a clear synergy with financial services and markets regulation’.

While not essential to the primary reform focus of this inquiry, in future the management of ASIC’s registries could be transferred to another public sector entity that already undertakes similar functions — such as the Australian Taxation Office (given that businesses also need to register with the ATO) or the Department of Industry, Innovation and Science.⁷⁶

Interactions with other regulators

The role we have in mind for the entity designated to promote competition in the financial system is to champion 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 the setting of product prices and limiting the ability of firms to take risks (a necessary part of innovation and competition in the interests of better choice and service quality) that a competition champion is required to offset it.

The Commission considers that the CFR should provide the forum for regulators to discuss the competition effects of systemically relevant macroprudential interventions and of failures to licence or provide access to payments systems for innovative, competitive products. The CFR structure seems well-established for this purpose, once supported by Statements of Expectations (the new role proposed of the CFR is described in detail below).

This new process of review is, however, likely to require the regulators to revisit their information sharing arrangements. Currently, their respective acts impose limitations on sharing protected information.⁷⁷

Promoting competition in the payments system

Currently, the only regulatory body that has a clear mandate to promote competition in financial services is the Payments System Board (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).

⁷⁶ An attempt to outsource the ASIC registries in 2016 was unsuccessful (PC 2017c). In 2017, the Australian Government issued a Request for Information, to consider options to create a whole-of-government business registry platform, including the Companies and Business Name registers, administered by ASIC, and the Australian Business Register administered by the ATO (O’Dwyer 2017).

⁷⁷ 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.

The RBA's role in the payments system has two distinct aspects:

- ensuring financial stability through its involvement in the market infrastructure that supports clearing and settlement of large value payments between financial institutions.
- promoting efficiency and competition in the payments system, and in particular retail payment services offered to the community (RBA 2017af).

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 10). These policies are implemented in conjunction with the ACCC.⁷⁸ 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. In future, consideration could be given to shifting the responsibility for retail payments system policy to the designated regulator — both the ACCC and ASIC (through the ePayments code) are already involved in this area.

INFORMATION REQUEST 17.1 WHICH REGULATOR SHOULD ADVANCE COMPETITION IN THE FINANCIAL SYSTEM?

The Commission has presented two possible options for a regulator to advance competition in the Australian financial system and ensure robust consideration of competition in the regulatory decision making processes of the Council of Financial Regulators:

Option 1: that ACCC be afforded new proactive functions to supplement its current reactive role in the financial system

Option 2: that ASIC's existing financial system focus be expanded beyond participant conduct and consumer outcomes to include the advancement of competition.

We welcome feedback on the merits of each option or alternative possibilities.

17.2 A new role for the Council of Financial Regulators

The Council of Financial Regulators (CFR) was established in 1998 as a forum for 'facilitating the cooperation of its three members ... across the full range of regulatory functions, and the attainment of regulatory objectives with the minimum of agency and compliance costs' (Wallis et al. 1997, p. 544).

The CFR remains a mainly informal process, with very limited transparency (chapter 15). It has been argued that existing arrangements — and more importantly, the culture of

⁷⁸ 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).

cooperation — are sufficient to ensure the regulators that participate in the forum work together effectively:

There doesn't need to be a so-called systemic risk regulator issuing public warnings or directions, telling the supervisor what to do. Some jurisdictions might want to set things up that way, but there are other ways that might be better here. In Australia, we think that a culture of cooperation, dialogue and mutual respect is more important than formalised arrangements. The Council of Financial Regulators has proved itself to be a low-cost, flexible way of coordinating between agencies, alongside bilateral relationships. We think we have the essential elements needed to promote financial stability with a holistic frame of mind. (Ellis 2012)

The actions of other institutions overseas that do have formalised processes show that a culture of co-operation is not mutually inconsistent with a formalised structure, one that is legally responsible for decision making. In the UK, for example, the key financial regulators — the Financial Conduct Authority and the Prudential Regulation Authority — work together closely under a Memorandum of Understanding (MoU). The MoU sets out formal processes for coordination and review of policies that affect companies regulated by both authorities. Depending on circumstances, this review may entail an authority seeking the other's consent, consultation or notification of intended policy changes (Bank of England 2013).

In Australia, however, as regulatory and legal frameworks currently stand, there is very limited public communication about the efficiency and effectiveness of the cooperative relationship between regulators.

Positive benefits may not be lost in a move to greater emphasis on formal exchanges. The financial costs of doing so are likely to be small, and as long as the membership remains among the existing group (the ACCC attends at times already), there is unlikely to be a loss of respect or dialogue, based on the inquiry's observation of the CFR and interested parties' views of it.

As a coordinating forum, the CFR is a desirable group. But CFR could do better, in the interests of competition, particularly by explaining its considerations where relevant to public interests. The emergence of the minutes of RBA board meetings is a good example of evolving use of communication as a way of improving public confidence. As we have found in other chapters, equivalent institutions to our regulator group do offer more open public information on their intentions.

The CFR is a vehicle for improving regulators' ability to influence expectations in financial markets. It can build trust in the actions of regulators. But of greatest value is its capacity to be a forum that can test the proposition of a macroprudential intervention in terms of its impact on competition (both among suppliers and upon consumers). The balance of capability among the regulators to do this may need to some adjustment, but without the obligation to perform such an assurance role, it is very difficult to imagine policy-making succeeding in balancing stability with competition (consumer impact as well as supplier) over time.

The Commission sees merit in introducing a more formal, transparent review process into the CFR deliberations, which would enable the financial regulators to assess the market effects of regulations proposed by their peers *before* they are implemented.

A new process of review

Under existing arrangements, each regulator is responsible for developing its policies and assessing their possible implications across the economy. Given the specific objectives of each regulator, it is unsurprising that these reviews do not fully reflect alternative views on policy options.

The regulators often coordinate their actions through the CFR, but its deliberations are held far from the public eye. This lack of transparency does little to improve community understanding of regulators' motivations and objectives.

These concerns are particularly relevant to macroprudential policies developed by APRA. The RISs and other consultation papers published by APRA acknowledge that some of these policies would affect competition, but do not give substantial consideration to alternative interventions that may have had more limited effects on competition. The implementation of these policies was coordinated with the RBA (and to a much more limited extent, ASIC) and discussed at the CFR, but very little information is available on the way these policies — which have substantial effects on competition — have been developed (chapter 15).

The Commission considers that in future, the process of designing regulatory interventions (including those by APRA) should consider their effects on competition, using the frameworks developed by the Hilmer review (box 17.1). Regulators would advise the other members of the CFR of their planned interventions and the Chair would convene the CFR.

The entity to be tasked with leading on competition in the financial system (ACCC or ASIC) would, in turn, put before the Council a comprehensive review of the implications of the proposed interventions on competition in the market and consumer outcomes. The findings of the competition review would be discussed at the CFR (either at a scheduled meeting, or sooner if required). Any concerns about detrimental effects would be raised, and the regulator who had proposed the change would consider whether any amendments would be required prior to implementation. The CFR would publish the analysis conducted as well as the minutes of its decisions.

Policy interventions suggested by the other members of the CFR that have potentially material effects on the financial system would also be subject to a similar process. For example, large scale pro-competition policy initiatives would be reviewed by APRA, and their expected effects on financial stability would be discussed at the CFR.

Box 17.1 Addressing regulatory restrictions on competition

The Hilmer review, which laid the foundations of Australia's 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 et al. 1993, p. xxix). The review identified prudential policies as one example of regulation that may restrict competition.

The review suggested a framework for reviewing existing and new regulation to identify and minimise their effect 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 et al. 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.

The CFR is currently chaired by the RBA Governor and the Reserve bank provides secretariat services to the council (CFR 2017a). While the Australian Government could consider appointing an independent chair to the council at some future point (supported by a separate secretariat) to further community trust in the interactions between regulators, such a move is not considered necessary at this point in time.

A new approach to transparency

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 the proposed regulatory intervention is intended to occur — is valuable. As outlined above, in the existing regulatory architecture, transparency is limited.

Given the significance of economy-wide interventions setting revised prices for loans or conditions for related financial products, the cost 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 publishable.

As a further measure of transparency, the CFR should publish the minutes of its meetings, similar to the RBA board.

DRAFT RECOMMENDATION 17.2 TRANSPARENCY OF REGULATORY DECISION MAKING

The Council of Financial Regulators (CFR) should implement a process of review before its members put in place regulatory interventions that may have a material impact on competition in a product market.

There must be a member of the CFR designated to take up the role of assessing planned interventions, to establish possible consequences for competition in financial markets.

The assessment of competition impacts should be discussed at the CFR meeting, and the regulator planning the intervention should consider amending its policies to reduce the effects on competition.

Competition analyses, as well as the minutes of the CFR meetings, should be made public in a timely manner.

Conducting ex-ante assessments of expected effects 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.⁷⁹

Although evaluating the effects of macroprudential policies is a complex exercise, regulators and researchers have been developing frameworks for such evaluations (FSB 2017a).⁸⁰ APRA should evaluate the effects of the reforms it has been implementing, and make its findings public.

DRAFT RECOMMENDATION 17.3 ROBUST AND TRANSPARENT ANALYSIS OF MACROPRUDENTIAL POLICIES

The Australian Prudential Regulation Authority should conduct and publish annually quantitative post-implementation evaluations of its macroprudential policies, including costs and benefits to market participants and the effects on competition.

Is there a need for an external oversight body?

The Murray Financial System Inquiry 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).

⁷⁹ 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, no quality assurance framework, and a lack of internal compliance with deadlines and processes (ANAO 2016).

⁸⁰ 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).

Reflecting the principles of the regulatory architecture and ministerial oversight put in place by the Wallis FSI, the ASIC Capability Review (2015, p. 48) argued that such a board is unnecessary:

the 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.

A ‘regulator of regulators’ is not a desirable outcome for this inquiry.

APPENDIXES

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.

Terms of reference receipt

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 distributed to industry representatives and individuals. A consultation paper was released on 6 July 2017.

Consultations

The Commission held three public Roundtable Hearings on 29 June 2017 (table A.1) with representatives from the financial regulators, the regional banks, and consumer groups, and had a Roundtable discussion with representatives from non-bank financial institutions on 18 December 2017 (table A.2). Throughout the course of the inquiry to date, we have also had separate discussions with about 70 businesses, business groups, government agencies, academics and other individuals (table A.3).

The inquiry received 52 public submissions (table A.4) prior to the release of this report. All public submissions are 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.5). For data provided by ADIs, the response rate by institution and data category is reported in 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 this draft 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

What's next?

The Commission welcomes further contributions to the inquiry from interested individuals or groups. Public hearings will be held in Sydney on 28 February and 1 March 2018 and in Melbourne on 5 and 6 March 2018.

Submissions and comments on this draft report close on 20 March 2018. The final report for the inquiry will be provided to Government by 1 July 2018, and is required under the *Productivity Commission Act 1998* (Cth) to be tabled in parliament and released publicly within 25 parliamentary sitting days thereafter.

Further details on registering for public hearings and making submissions can be found on the inquiry website.

Table A.1 **Public roundtable hearings and participants** — Melbourne, 29 June 2017

Roundtable hearing 1: Financial system regulators

Australian Competition and Consumer Commission
Australian Prudential Regulation Authority
Australian Securities and Investments Commission

Roundtable hearing 2: Regional banks

Bendigo and Adelaide Bank
Bank of Queensland
Customer Owned Banking Association
ME Bank
Suncorp Group

Roundtable 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

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 Industry Group
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
Commercial & Asset Finance Brokers Association of Australia
Commonwealth Bank of Australia
Council of Small Business Australia
Credit and Investments Ombudsman
Cuscal

(Continued next page)

Table A.3 (continued)

David Murray
Deborah Ralston, Monash University
Department of the Treasury
eftpos
Equifax
Ernst and Young
Financial Ombudsman Service
Financial Planning Association
Financial Services Council
Fintech Australia
Genworth
Ian Ramsay, University of Melbourne
ING Direct
Insurance Council of Australia
Jonathan Mott and Rachel Bentvelzen
Kevin Davis, University of Melbourne
Liberty Financial
Maria Rigoni
Moody's
Mortgage & Finance Association of Australia
National Australia Bank
National Farmers' Federation
New Payments Platform Australia
Oliver Wyman
OnMarket Bookbuilds
Pepper Financial Services Group
Pin Payments
Promontory Financial Group
QBE
QBE Insurance Group
Rabobank Australia
Reserve Bank of Australia
Rodney Maddock, Victoria University
Roy Morgan
Underwriting Agencies Council
Unhappy Banking
Westpac Banking Corporation
Xero
Xinja

(Continued next page)

Table A.3 (continued)

New Zealand

Financial Markets Authority
Co-operative Bank
Kiwibank
Ministry of Business, Innovation and Employment

United Kingdom

Mutuo
Financial Conduct Authority
Amelia Fletcher, University of East Anglia

Table A.4 Public submissions received

<i>Participant</i>	<i>Submission no.</i>
Peter Mair	1, 4, 5
Australian Institute of Conveyancers WA Division	2
Winston Rodrigues	3
National Farmers' Federation	6
Credit and Investments Ombudsman	7
Dixon Advisory	8
Xinja	9
Eftpos Payments Australia	10
Australian Bankers' Association	11
Judo Capital	12
Federation of Ethnic Communities Councils of Australia	13
Australian Payments Network	14
Credit Union Australia	15
Commercial & Asset Finance Brokers Association of Australia	16
Australian Competition and Consumer Commission	17
Finance Sector Union	18
PayPal	19
ING Bank Australia	20
Customer Owned Banking Association	21
Australian Prudential Regulation Authority	22
Consumer Action Law Centre, Financial Counselling Australia and the Financial Rights Legal Centre	23
Financial Services Council	24
Commonwealth Bank of Australia	25

(Continued next page)

Table A.4 (continued)

<i>Participant</i>	<i>Submission no.</i>
Financial Planning Association of Australia	26
Business Council of Co-operatives and Mutuals	27
Westpac	28
Reserve Bank of Australia	29
Australian Small Business and Family Enterprise Ombudsman	30
National Australia Bank	31
Insurance Council of Australia	32, 33
QBE Insurance Group	34
Bank of Queensland	35
Hero Broker	36
Regional Banks (AMP/Bendigo Bank/Bank of Queensland/ME Bank/Suncorp)	37
Equifax	38
Lateral Economics	39
Australian Securities and Investments Commission	40
Caji DeSouza	41
CHOICE	42
John Dahlsen	43
Genworth	44
Australian Lawyers Alliance	45
Maria Rigoni	46
Australian Finance Industry Association	47
Mortgage & Finance Association of Australia	48
ANZ	49
AMP	50
Heritage Bank	51
MLC Life Insurance	52

Table A.5 Commission requests for data and other information from participants

Regulators

Reserve Bank of Australia
Australian Prudential Regulation Authority
Australian Securities and Investments Commission

Authorised deposit-taking institutions

AMP
ANZ Banking Group
Bank of China (Australia)
Bank of China, Sydney Branch
Bank of Queensland
Bendigo and Adelaide Bank
Citigroup
Commonwealth Bank of Australia
Credit Union Australia
Heritage Bank
HSBC Bank Australia
ING Bank (Australia)
Macquarie Bank
ME Bank
National Australia Bank
Regional Australia Bank
Suncorp Group
Westpac Banking Corporation

Table A.6 Response rate of ADIs on data request^{a,b}

Institution	Category of data collected						
	Residential mortgages	Financial advice	Payments system	Small business lending	Business integration	Other personal credit products	Insurance
AMP	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided little or no relevant data in this category	Provided data for most relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables
ANZ Banking Group	Provided data for most relevant variables	Provided data for all relevant variables in all years	Provided data for most relevant variables	Provided data for all relevant variables in all years	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for all relevant variables in all years
Bank of China (Australia)	Provided limited data for relevant variables	—	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided little or no relevant data in this category
Bank of China, Sydney Branch	—	—	—	Provided data for most relevant variables	Provided limited data for relevant variables	—	—
Bank of Queensland	Provided data for most relevant variables	—	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables
Bendigo and Adelaide Bank	Provided data for most relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided data for all relevant variables in all years	Provided limited data for relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables
Citigroup	Provided data for most relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	—	Provided limited data for relevant variables	Provided data for most relevant variables	Provided data for most relevant variables
Commonwealth Bank of Australia	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for all relevant variables in all years	Provided data for most relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables
Credit Union Australia	Provided limited data for relevant variables	—	—	—	Provided limited data for relevant variables	Provided little or no relevant data in this category	Provided limited data for relevant variables
Heritage Bank	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided data for all relevant variables in all years	Provided limited data for relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables
HSBC Bank Australia	Provided data for most relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables	—	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables
ING Bank (Australia)	Provided data for most relevant variables	Provided limited data for relevant variables	—	—	Provided limited data for relevant variables	—	Provided limited data for relevant variables
Macquarie Bank	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables
ME Bank	Provided data for most relevant variables	—	—	—	Provided little or no relevant data in this category	Provided limited data for relevant variables	Provided data for most relevant variables
National Australia Bank	Provided data for most relevant variables	Provided limited data for relevant variables	Provided data for all relevant variables in all years	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables
Suncorp Group	Provided limited data for relevant variables	Provided limited data for relevant variables	—	Provided data for all relevant variables in all years	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables
Westpac Banking Corporation	Provided data for most relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables
ALL	Provided data for most relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided data for most relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables	Provided limited data for relevant variables

^a Where an ADI does not provide all services in a given category, response rates were calculated using relevant questions only. Where an ADI does not have any services in a particular category, this is treated as 'not applicable' and represented by a dash line. Non-response due to 'not applicable' is not included in the category total for all ADIs. ^b To supplement the Commission's information on smaller ADIs, the Regional Australia Bank voluntarily provided data to the Commission in some categories.

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

	<i>APRA</i>	<i>ASIC</i>	<i>RBA</i>
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.

This appendix considers these regulators further with particular focus on boundaries, funding, enforcement, coordination, accountability, independence and changes over 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 2018b).

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.

Across industries, APRA is responsible for setting and enforcing prudential requirements on financial institutions as well as supervising performance and assessing system stability. APRA's high level objective is to promote stability in the Australian financial system by ensuring the prudent management of regulated institutions (such as by requiring regulated entities to hold capital against risks). 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 the extent of due diligence undertaken by the lender, and assign a risk weighting to the total value of the loan. A portion of the risk-weighted loan must have capital held against it as provision for default. Similarly, other risks, such as the risks of a firm's internal processes or employees, must also have capital provisions. Insurers have an additional risk category of product concentration. For example, if a home insurer has its policies concentrated in one area and a flood hits that area, the risk will be higher than if the policies had been spread across different locations.

As well as regulating the amount of capital which financial services businesses must hold, 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 securitisation (an important market for systemic stability as seen in the global financial crisis) and credit quality (the proportion of non-performing loans). For insurers, this additional regulation includes areas such as reinsurance management.

Table B.2 APRA regulation by institution type^a

	<i>ADIs</i>	<i>General insurers</i>	<i>Life insurers</i>	<i>Health insurers</i>	<i>Superannuation</i>
Capital adequacy	•	•	•	•	
Risk management	•	•	•	•	•
Credit/asset risk	•	•	•	•	
Insurance risk		•	•	•	•
Operational risk	•	•	•	•	•
Market and currency risk	•				
Interest rate risk	•				
Related entity risk	•	•	•		
Concentration risk		•	•		
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.

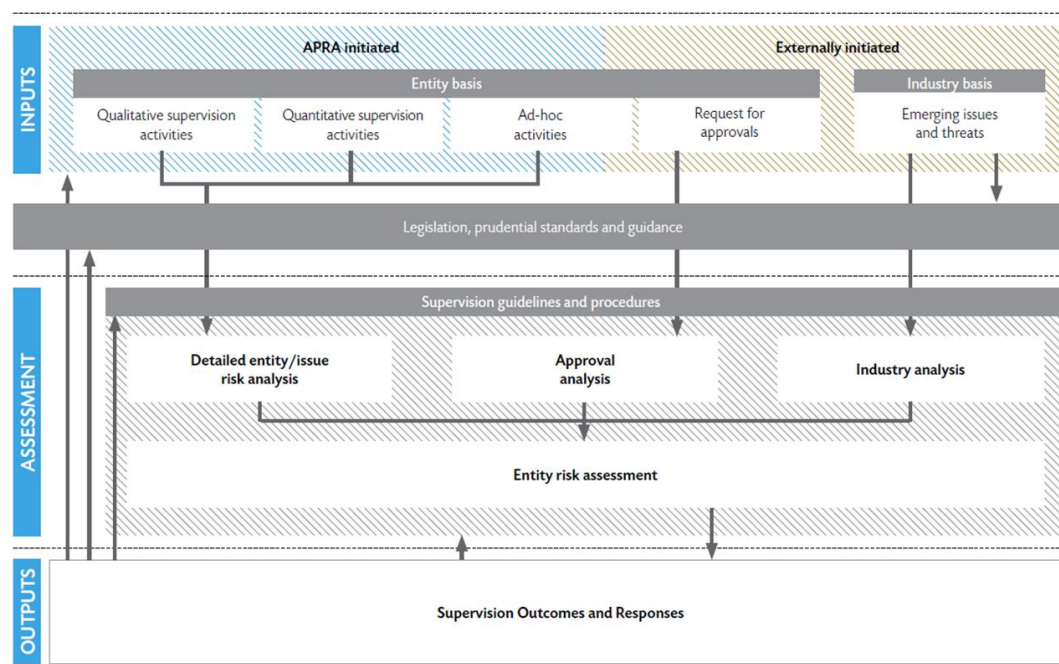
Source: APRA prudential regulations (various).

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 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.1 illustrates APRA's process of information collection and how it is applied back into the regulatory process.

Figure B.1 APRA's supervision process



Source: APRA (2015i)

Supervision requirements parallel the prudential requirements of 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 yet examined through regular statistical collections.

Enforcement

While APRA tends to take pre-emptive action rather than waiting for circumstances to reach the point at which hard enforcement action becomes necessary, APRA has multiple tools for 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 with only one reported enforceable undertaking in the last four years and no disqualifications (these are usually managed by ASIC using its licensing powers) (APRA 2018a, 2018c).

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).

Following the global financial crisis, there was a lot of debate, domestically and internationally, about whether the ‘regulatory pendulum’ had swung too far in favour of stability (Byres 2015). Intuitively, requirements that increase costs, such as the implementation of risk reporting systems, increase the fixed cost of operating a financial service institution, increasing the sunk cost barriers to entry.

An example of regulation potentially impacting on competition is provided by APRA’s requirements for advanced risk modelling accreditation. Advanced risk modelling allows a bank to calculate their own capital provisioning requirements, often less than the standard rate. However, the accreditation process required extensive data, labour and sunk costs — increasing the cost of banking and giving advantage to the already accredited incumbents (Bendigo and Adelaide Bank 2015; Suncorp Bank 2015). Since the Murray Financial System Inquiry (FSI), APRA has made efforts to break down the accreditation process to make it more accessible to new entrants or smaller banks (APRA 2015e). We have not received any evidence about progress with APRA’s initiative, though the Australian Bankers’ Association suggested that APRA should ‘proactively partner with standardised approach banks who are seeking internal model accreditation to ensure the process is as seamless as possible’ (ABA, sub. 11, p. 51).

The non-monetary effort required to establish a business in a complex regulatory framework may also act as deterrent — work commissioned by the Murray FSI found regulatory processes and short implementation schedules may prevent entry (Murray et al. 2014b).

Despite the findings of some international literature (OECD 2011), APRA agrees with the Murray FSI that there does not need to be a trade-off between stability and competition in financial regulation. As the Chairman of APRA said in 2015:

In the context of the debate on the positioning of the regulatory pendulum, however, the most interesting outcome from their analysis is that, at its core, the Inquiry is advocating a set of policy changes designed to produce a more competitive and a more stable (or in the words of the FSI, resilient) financial system. It is not advocating a trade-off – that is, it is not arguing that one objective must be sacrificed to achieve the other. I think this conclusion is absolutely correct. (Byres 2015).

ASIC

ASIC focusses on setting market level regulation for conduct and consumer protection. ASIC’s responsibilities include licensing of financial institutions, administration of the National Credit Code 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 the financial services licensing scheme, market regulation, consumer credit regulations and supervision functions.

ASIC’s legislation gives it the authority to regulate any financial market or financial advice providers and a range of criminal, civil and administrative remedies.

Licensing

ASIC’s Australian Financial Services licence applies to any entity providing financial advice, establishing a financial market or selling a financial product. These licences cover the employees of the entity. The licence may also be cover subsidiaries — who may operate as an authorised representative 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 2017ai). Additional to resourcing, the licence mandates requirements for product disclosure statements and conflict of interest management.

Market regulation

ASIC enforces specific regulations for particular markets or products. A full listing of product specific regulations can be found in the financial services regulatory index on the ASIC website (ASIC 2017s).

ASIC’s regulation is not limited to market participants. 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 the ASX. ASIC uses this information to inform its enforcement and market integrity reporting.

National Credit Code

ASIC also administers the National Credit Code.⁸¹ The National Credit Code regulates any medium to long term loans provided to consumers. The code applies to any entity providing credit — a definition which covers more of the market than targeted APRA regulation. It does not apply to loans of 62 days or under, provided that fees and interest charges do not exceed specified limits. The code covers disclosure requirements (including the requirement to present a ‘comparison rate’ combining the interest rate plus most fees and charges into a single percentage figure, and making it easier for consumers to compare different loan

⁸¹ The Code is set out in schedule 1 of the *National Consumer Credit Protection Act 2009* (Cth).

providers), adequate capital provisioning — if not already regulated by APRA — and the suitability of financial products. Under the code, lenders are required to establish the creditworthiness of an applicant and only lend according to the presented information on ability to repay. If a customer cannot repay for certain reasons, lenders are required to enter into a hardship agreement contract, enabling easier repayment terms. ASIC administers the National Credit Code requirements through a licensing regime (where only licensed entities may provide credit).

Monitoring and enforcement

To enforce obligations under the National Credit Code, Australian Financial Services licence and general corporate obligations ASIC regularly undertakes targeted monitoring programmes. These can range from analysis of high level market data⁸² to in-depth investigation with onsite visits. The ‘*Surveillance coverage of regulated populations*’ report offers information of status of surveillance by institution and market (ASIC 2016b).

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).

Figure B.2 provides summary statistics on ASIC’s enforcement actions in the first half of 2017.

⁸² Since August 2010, ASIC has been responsible for supervision of real-time trading on Australia’s domestic licensed markets, including the ASX.

Figure B.2 ASIC enforcement actions
January 2017 to June 2017



Source: ASIC (2017e)

ASIC has questioned the level of financial remedies available to it. In its submission to the Murray FSI, ASIC highlighted large differences between the maximum penalties allowed to it and those available to other international conduct regulators, as shown in table B.3.

Table B.3 International comparison of penalties for individuals^a
A\$

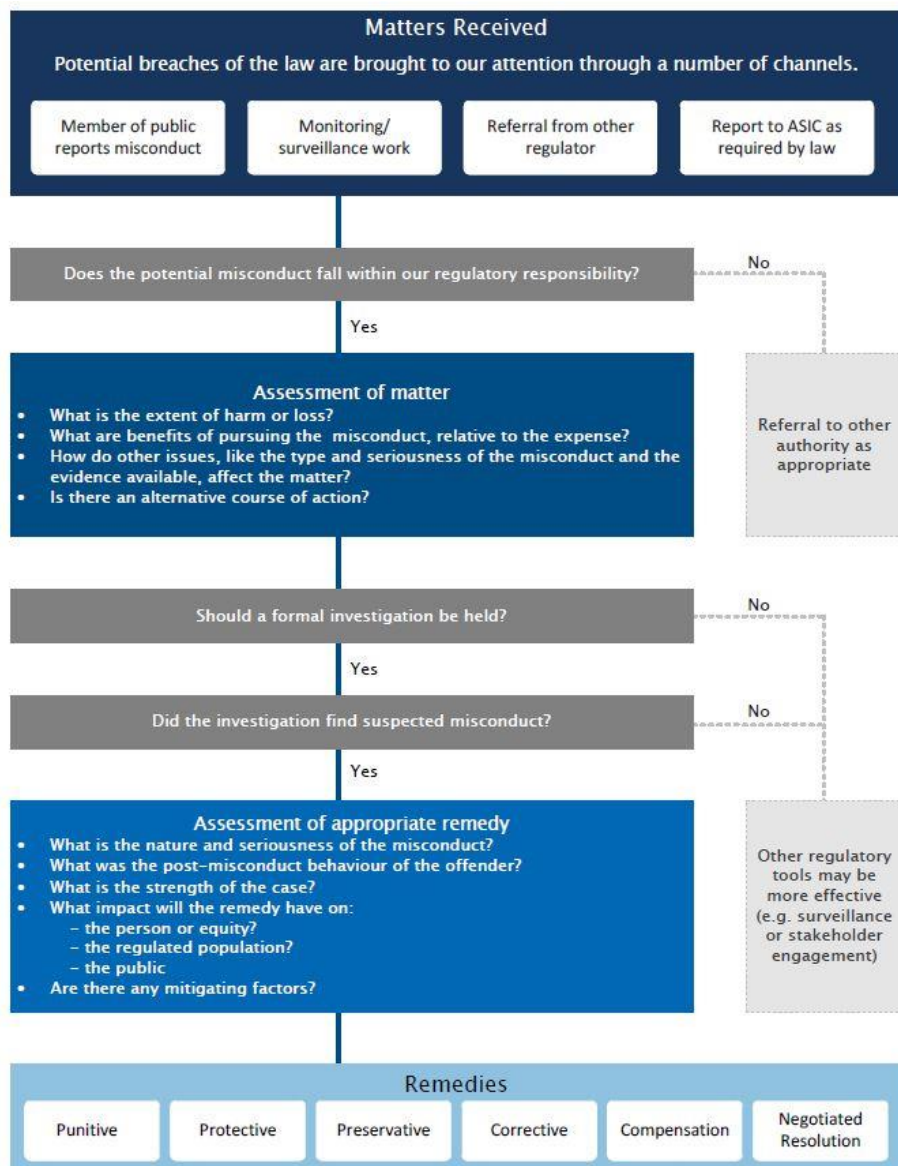
	<i>Insider trading</i>	<i>Market manipulation</i>	<i>Disclosure</i>	<i>False statements</i>	<i>Unlicensed conduct</i>	<i>Inappropriate advice</i>
Australia	Civil: \$200 000	Civil: \$200 000	Civil: \$200 000	–	–	Civil: \$200 000
Canada	Admin: \$1.05 million	Admin: \$1.05 million	Admin: \$1.05 million	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 Does not include criminal penalties.

Source: ASIC (2014d)

Because of ASIC’s broad role and finite resources, it is selective in its investigation and enforcement procedures (ASIC 2013b). Figure B.3 shows a flow chart of ASIC’s enforcement process.

Figure B.3 **ASIC’s approach to enforcement**



Source: ASIC (2017e)

Competition

ASIC does not have any formal responsibility to promote competition in the financial system. ASIC’s submission stated that the regulator 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).

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 Australian financial services or credit licence. (ASIC 2017ab) 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 2017b). 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 2017t).

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 is also involved with 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 to receive a product intervention power to enable it to take a more proactive approach to reducing the risk of significant detriment to a class of consumers. The Murray FSI suggested that the power would allow ASIC to intervene to require or impose amendments to marketing and disclosure materials; warnings to consumers, and labelling or terminology changes; distribution restrictions; or product banning.

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

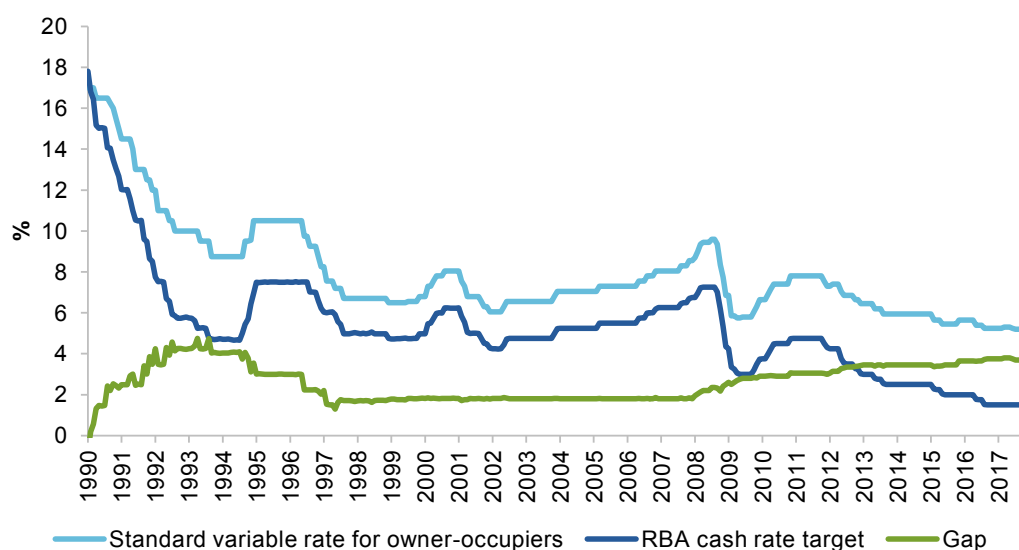
Historically, one of the main interventions of the RBA in the financial system has been through its role in setting the cash rate through injecting or withdrawing inter-bank exchange settlement funds in the overnight money market (Bech and Monnet 2013). The intention is that the demand for exchange settlement funds is satisfied at or close to the cash rate target, and the RBA manages to achieve this almost all of the time (RBA 2016e).

Unlike APRA or ASIC regulations which can target specific institutions, the RBA's monetary policy affects the financial system and economy as a whole. Setting the cash rate and money supply levels regulates investment, spending and the level of inflation in the Australian financial system. 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 manipulation 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 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.4). 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).

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 2017u) and a quarterly bulletin on developments in the financial sector and economy (RBA 2017l). 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 necessarily follow a regular publication schedule like the stability review or bulletin, instead the RBA conduct research into current market movements and policy options as needed. The main resources for other RBA research are the financial stability, payments system and market operation publications (RBA 2017r, 2017s, 2017z), and research discussion papers (RBA 2017ad).

Figure B.4 RBA cash rate and bank variable mortgage rate



Source: RBA (2018b)

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 agreement in exchange for liquid currency. The RBA and a bank will agree to a value of the liquidity commitment ahead of time and pay an annualised 15 basis point fee for the commitment to allow the repurchase agreement. This does not mean a bank will use the facility, instead it allows its use up to the agreed value — a valuable resource for unexpected liquidity stress. Accreditation for use of the CLF is managed by APRA. Currently, all banks which are regulated under APRA's Liquidity Coverage Ratio rules have access to the CLF (APRA 2016f). 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.

The RBA is statutorily required to have regard to efficiency, competition and stability in determining payments system policy and regulating the payments system⁸³ (RBA 2015b). 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.

Additionally, under s. 11 of the *Payment Systems (Regulation) Act 1998* (Cth) the RBA may designate anything as a payments system, if it considers it to be in the public interest to do so — this includes MasterCard, Visa, UnionPay, Diners Club, American Express, EFTPOS and ATMs. The RBA may regulate these forms of payment by, for example, setting standards that a designated system must comply with and imposing access regimes (RBA 2015g).

RBA policy and regulatory oversight

The RBA establishes standards for the safety and efficiency of the designated system. These may impose technical requirements, procedures, performance benchmarks or pricing (RBA 2015f). For example, in 2016, the RBA set standards to improve the competitiveness and efficiency of its designated four-party and companion card systems. These standards imposed caps on interchange fees and limited customer surcharges to a merchant's cost of acceptance (RBA 2016c).

The RBA's access regimes determine the rules for participation in that system, including rules on access for new participants. For example, the RBA imposed an access regime on both MasterCard and Visa credit card systems (RBA 2017ac). These access regimes mean that any ADI is eligible to apply to participate in the scheme, either as an issuer or acquirer. 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 RBA. For example, three-party system providers, 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 2017ac).

Table B.4 provides an overview of the retail payments system providers regulated by the RBA.

The RBA reviews and formulates payments system policy to meet its objectives. For example, in 2012 the RBA reviewed card payments regulation and produced a strategic review of innovation in the payments system (RBA 2012d). The RBA also works with

⁸³ Under s. 10B of the *Reserve Bank Act 1959* (Cth) and s. 8 of the *Payment Systems (Regulation) Act 1998* (Cth).

industry to develop strategic objectives for the Australian payments system. The Australian Payments Council was formed in 2014 to facilitate a relationship between the RBA and the payments industry (PSB and APC 2015).

Table B.4 RBA regulations for retail payments systems

<i>Payments system</i>	<i>Designated system</i>	<i>Standards^a</i>	<i>Access regime</i>	<i>Undertaking</i>
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 (2017ac)

Co-regulation in the payments system

The RBA 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 2015). However, if the RBA 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 RBA 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 Payments System Board and ACCC is set out in a Memorandum of Understanding signed in 1998 (RBA and ACCC 1998).

Some regulations also require the RBA 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 (ACCC 2016). The amendment states that a payment surcharge is excessive if it exceeds the permitted surcharge referred to in the RBA standard (the cost of acceptance). Therefore, the RBA is responsible for setting the level of excessive surcharging, and the ACCC is responsible for enforcing the ban.

Self-regulation

The RBA 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 RBA imposes regulation only where it considers it necessary in the public interest and where the industry is unable or unwilling to address the RBA's 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 Community⁸⁴
- 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.

⁸⁴ The Issuers and Acquirers Community rules cover the eftpos scheme, but do not apply to commercial card schemes (APCA 2015a).

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.

Competition

In pursuing competition in the payments system, the RBA states that it 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).

ACCC

The ACCC is the statutory authority responsible for the enforcement of competition and consumer law. 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, 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.

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 2017e).

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:

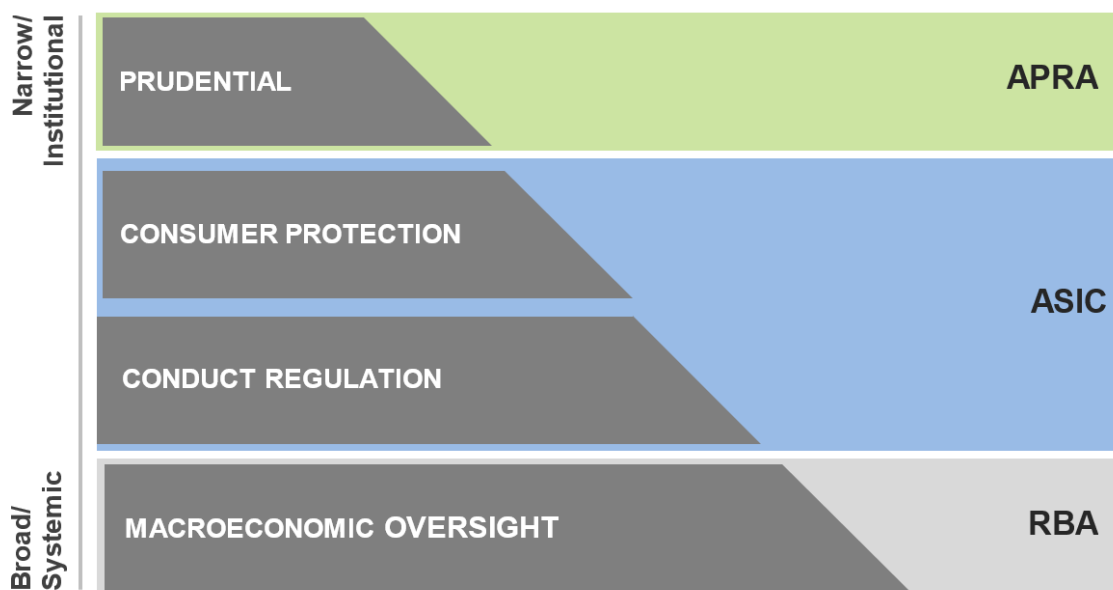
- help keep Australia safe from financial and other serious crime
- build and maintain trust in Australia's financial system as part of the global community. (AUSTRAC 2016)

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 Boundaries and coordination

The regulatory regime divides responsibilities by type of regulation. Figure B.5 shows the broad scope of the regulators and how this depends on the type of regulation.

Figure B.5 **Scope of regulators**

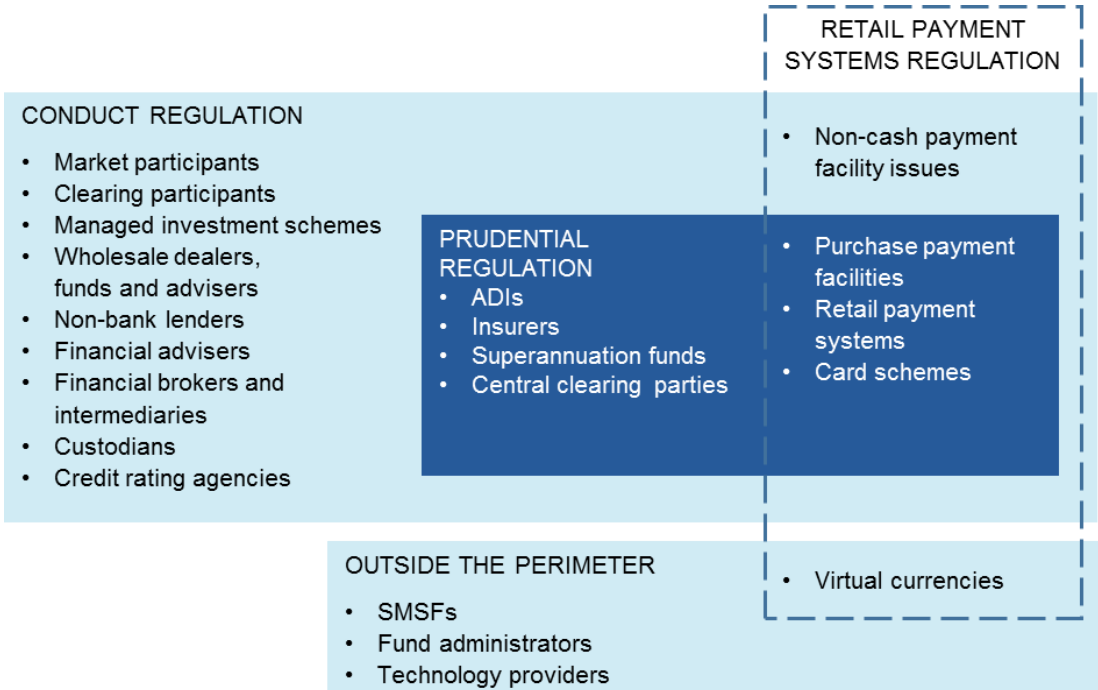


At one end of the spectrum, APRA enforces targeted regulations on specific entities. APRA tailor regulations to each entity which entail quantifiable constraints. In the middle of the spectrum, ASIC looks at whole market performance though taking enforcement action against individuals. ASIC regulations have more of a legal orientation than APRA, focused on duties of entities rather than quantified properties of the firm. At the broadest level, the RBA regulates systemic issues, with policies which affect the entire financial system. RBA

policies rarely target a specific institution or market (though they have regard to each market).

The Murray FSI defined the overlapping perimeters of different forms of regulation by type of regulation and by the different categories of regulated entity as shown in figure B.6.

Figure B.6 Perimeters of regulation by institution^a



^a ASIC regulates conduct, APRA regulates prudential requirements and the RBA regulates payments systems.

Source: Murray et al. (2014b)

In some circumstances, regulatory boundaries will overlap. This may occur where different regulators cover the same type of institution (figure B.6) or where different regulators cover the same type of regulation (figure B.5).

Institutional overlap is common as each regulator will cover a different aspect of a business’ functions. Payments systems provides an example of this. All three regulators cover payments systems — the RBA regulates payments systems generally, ASIC regulates all non-cash payment facilities and APRA regulates providers of purchased payment facilities (such as PayPal) as ADIs. Though each regulator covers a different aspect of regulation for a payments system, the multiple regulations and accreditations applying to a payments system may become onerous or complicated (Murray et al. 2014b).

Regulatory overlap is less common and where it does occur, there may need to be specific provisions to avoid duplication of regulation. There is no statutory requirement for cooperation between the regulators, but a network of memoranda of understanding and the regular meetings of the Council of Financial Regulators provide a means for collective policy direction. 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 (RBA and APRA 2012).

The Council of Financial Regulators (CFR) is a forum of the Treasury, the RBA, ASIC and APRA established in 1998. The CFR helps 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. Whilst the CFR is the main forum for coordination, members also use other cooperative vehicles such as staff sharing and the APRA/RBA coordination committee (which meets every six weeks) (RBA and APRA 2012).

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. The Expectations are intended to deliver outcomes consistent with those arising from a competitive environment (responsiveness to user input, fair and reasonable pricing, and transparent and non-discriminatory access to clearing and settlement services). The Expectations are not legally enforceable under the existing legislative framework, but the intention is that powers should be put in place for use if necessary (CFR 2017b). Should a committed competitor emerge for any aspect of the ASX's clearing and settlement services, the expectations will be reviewed.

B.3 Accountability

Australia's financial regulators are accountable to varying extents to the Australian Government, to Parliament and to the courts. Table B.5 sets out the various reporting and transparency measures in place to support this accountability. The IMF reviews the work and performance of the regulators as part of the regular Financial Sector Assessment Program.

The minister 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.⁸⁵ This is arguably a necessary accountability measure. The minister may also

⁸⁵ Australian Prudential Regulation Authority Act, s. 12; *Australian Securities and Investments Commission Act 2001* (Cth), s. 12.

direct ASIC to investigate certain matters if he considers it to be in the public interest⁸⁶. These powers have been used only once.⁸⁷

Table B.5 Reporting requirements and transparency measures for financial services regulators

	<i>RBA^a</i>	<i>APRA</i>	<i>ASIC</i>
Statement of Expectations <i>(provided by the Minister)</i>	✗	✓	✓
Corporate plan <i>(required under s. 35 of the Public Governance, Performance and Accountability Act 2013 (Cth))</i>	✓	✓	✓
Annual report <i>(required under s. 46 of the Public Governance, Performance and Accountability Act)</i>	✓ 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 <i>(to be published online in accordance with Senate Standing Order no. 12)</i>	✗	✓	✓
Annual self-assessment <i>(under the Regulator Performance Network)</i>	✓ (Payments System Board only)	✓	✓
Regulation impact statements <i>(to be published for major decisions)</i>	✓ (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 (DoF 2017).

⁸⁶ Australian Securities and Investments Commission Act, s. 14.

⁸⁷ The Attorney-General enforced cooperative arrangements between ASIC and the Director of Public Prosecutions in 1992.

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.

Following the Murray FSI, ASIC has been moving to an industry funding model since 1 July 2017 with the introduction of industry levies to recover the costs of ASIC's regulatory activities.

The RBA earns net interest income from its assets and fee income associated with the Committed Liquidity Facility (RBA 2017e).

C The Australian banking system

This appendix is a quantitative overview of the Australian banking system.

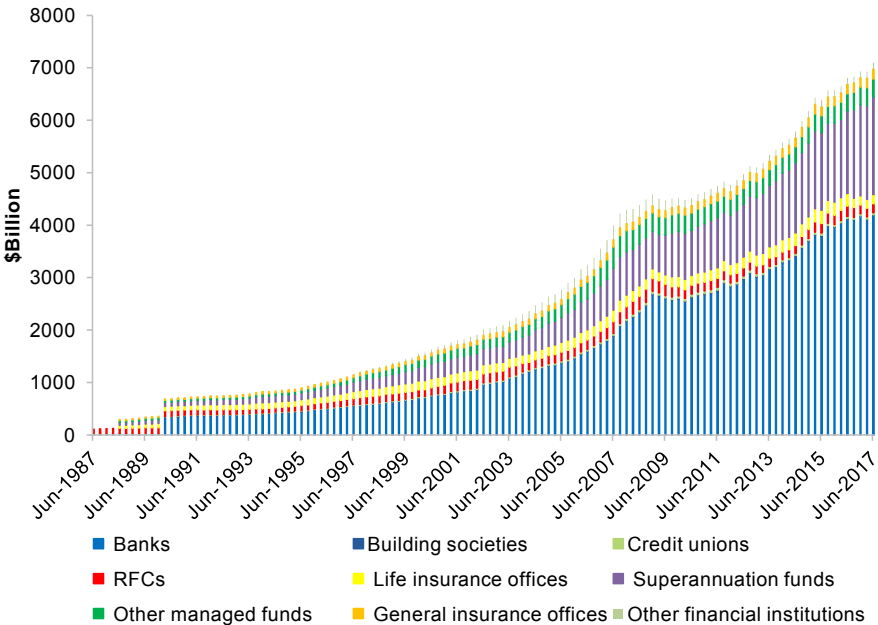
Australia's banking system is based on authorised deposit-taking institutions (ADIs), which include banks and non-bank financial institutions (such as building societies and credit unions), and other financial intermediaries that are not ADIs (such as money market corporations, finance companies and 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 data used in this appendix are drawn from a variety of public sources, including from the RBA, APRA and submissions to the 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
 June 1987 – June 2017



^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 (2017g)

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)).

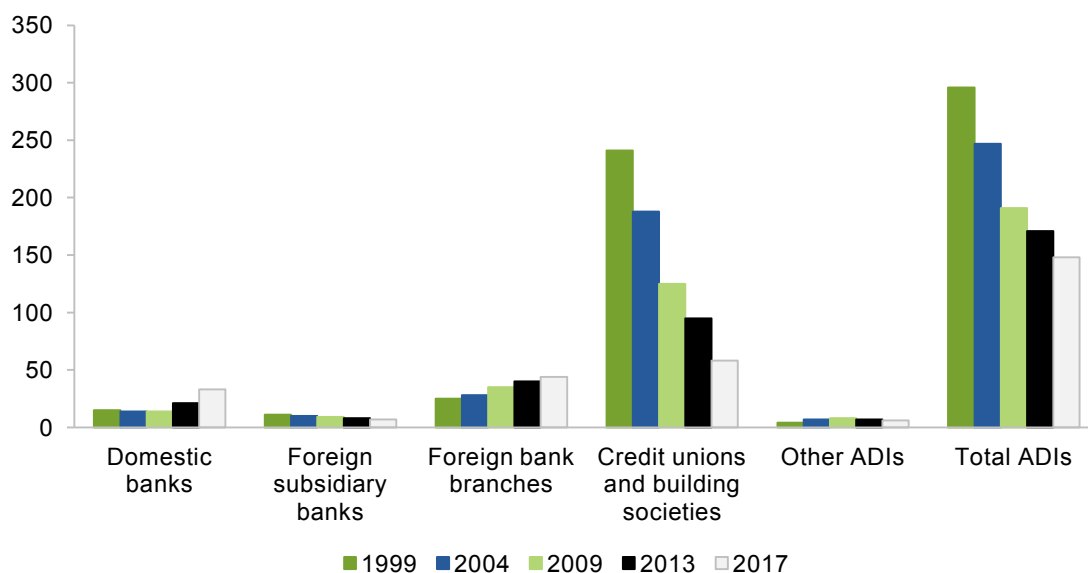
However, the term 'financial services' is not defined in the Act. APRA considers that this term includes:

- 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.

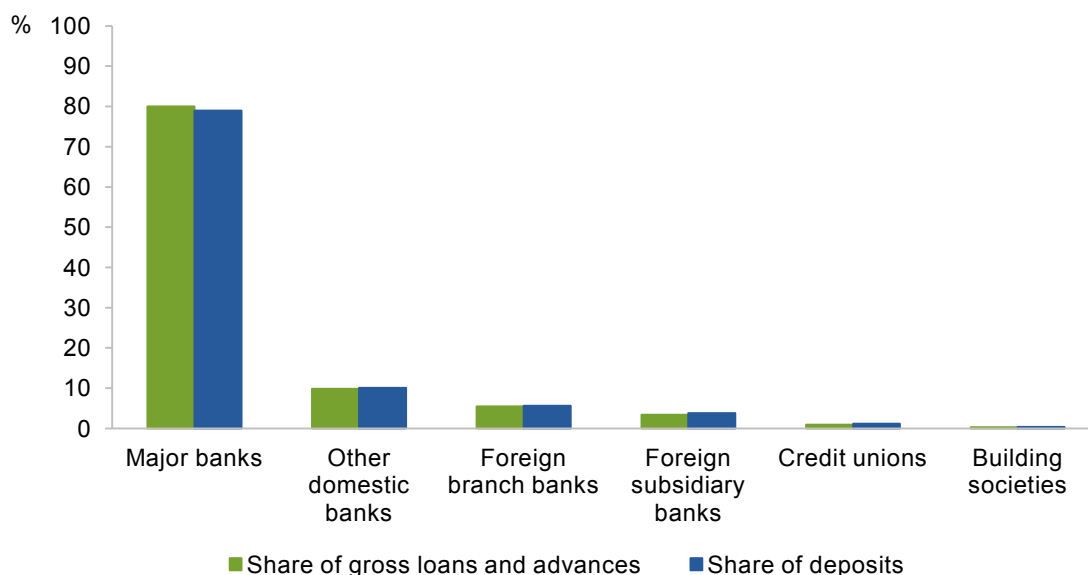
Source: APRA (2008a); *Banking Act 1959* (Cth)

Figure C.2 The total number of ADIs has been declining
1999 – 2017



Source: APRA (sub. 22)(RBA 2017d)

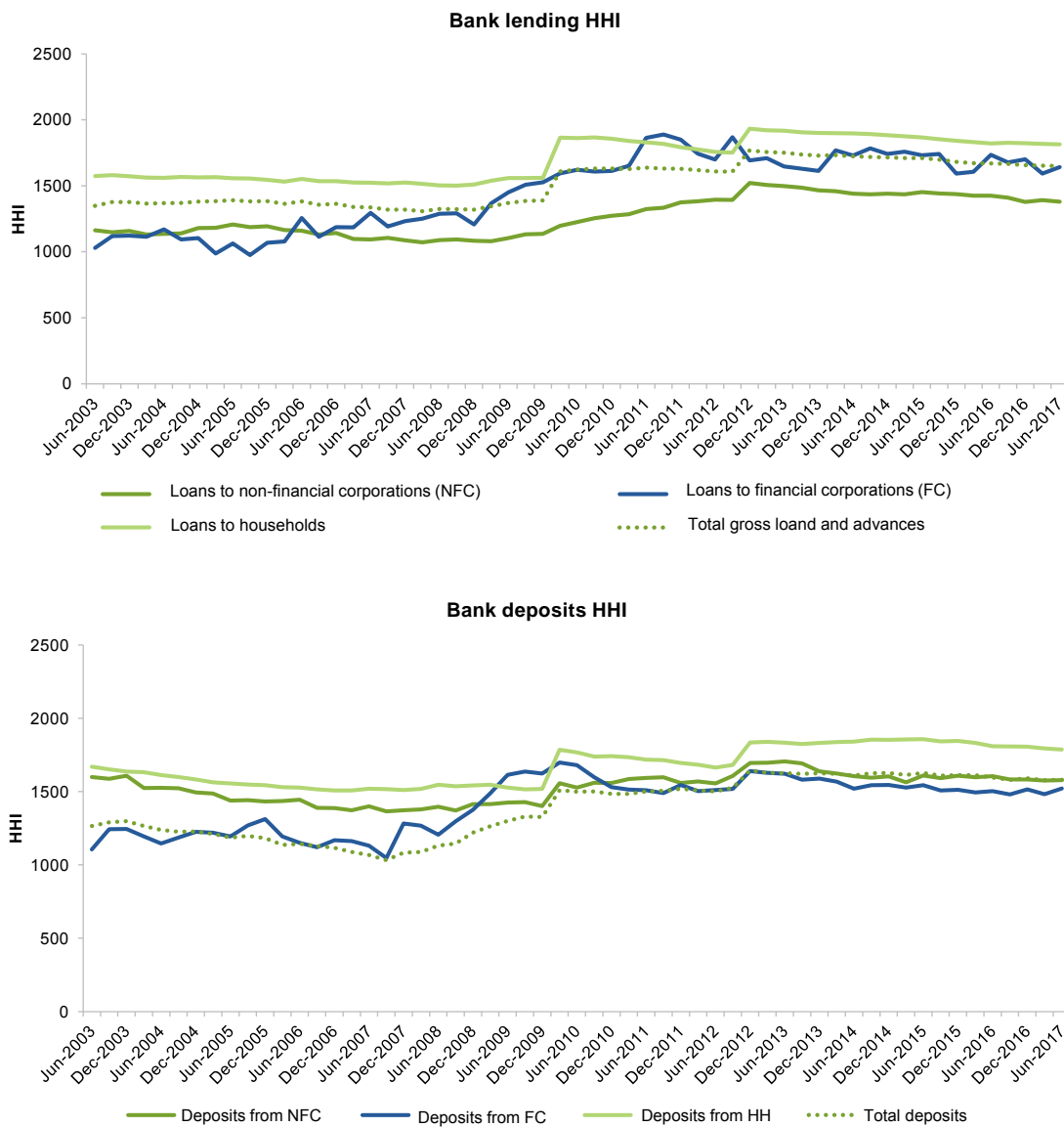
Figure C.3 Major banks dominate lending and deposits ^a
June 2017



^a Share of total gross value of loans and advances, and deposits of all ADIs (excluding 'other ADIs' or mutual ADIs). Major banks are the CBA, Westpac, NAB and the ANZ.

Source: APRA (2017s)

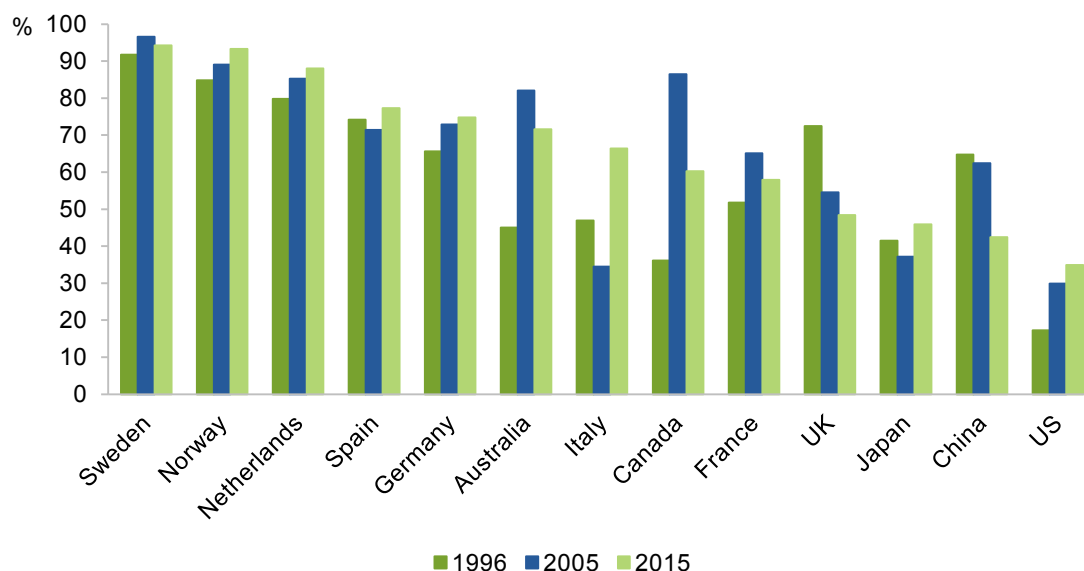
Figure C.4 Concentration in lending and deposit markets has increased^a
June 2003 – June 2017



^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. To this end, the HHI overstates the level of concentration in terms of gross loans and advances in the entire financial system. SMEs are included as non-financial corporations.

Source: Commission estimates based on APRA (2017m)

Figure C.5 Australia's banking system concentration compared to other countries^a
1996 – 2015

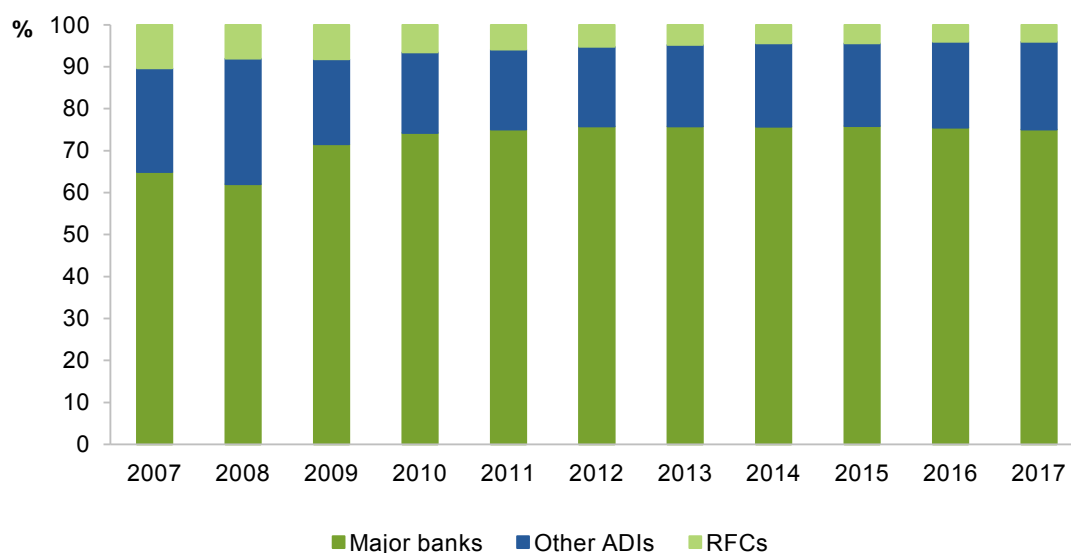


^a Top five banks' share of assets.

Source: World Bank (2017)

Figure C.6 And the smaller banks and registered financial corporations (RFCs) have been losing lending market share^{a,b}

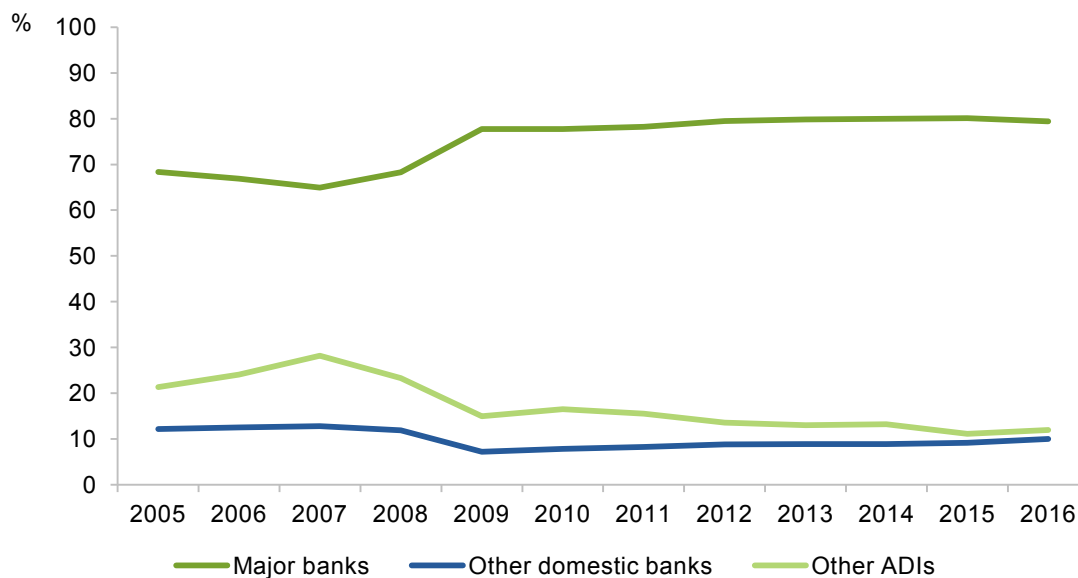
ADIs' and RFCs' share of total gross loans and advances, 2007-2017



^a Other ADIs include all non-major banks. RFCs include wholesale funders. ^b RFC data are provided by APRA, but are 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).

Source: APRA (2017p, 2017s, unpublished data)

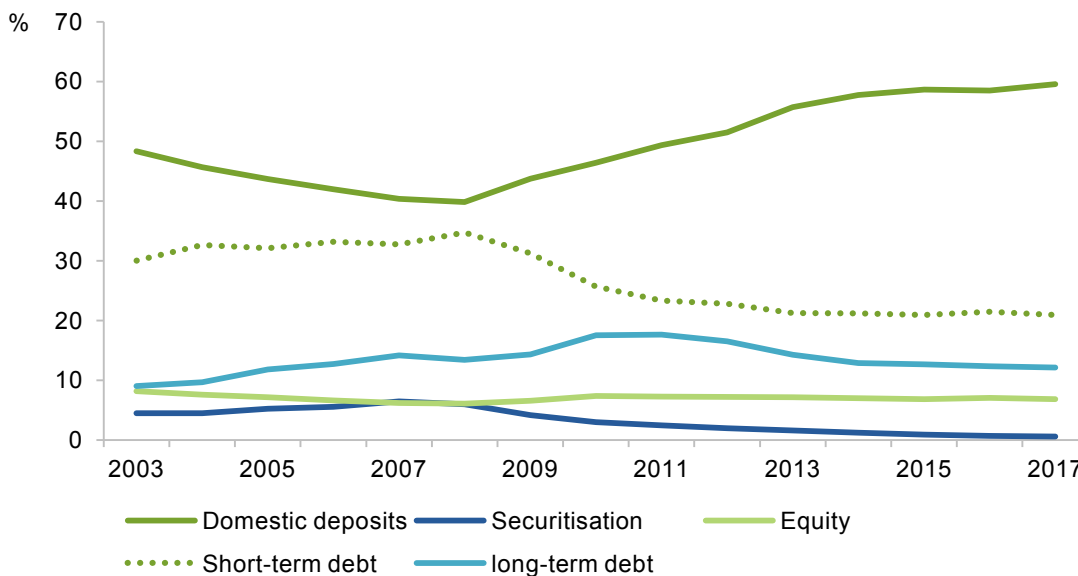
Figure C.7 The major banks have increased their deposit market share^a
Share of total deposits 2005 – 2016



^a Major banks are the CBA, Westpac, NAB and the ANZ.

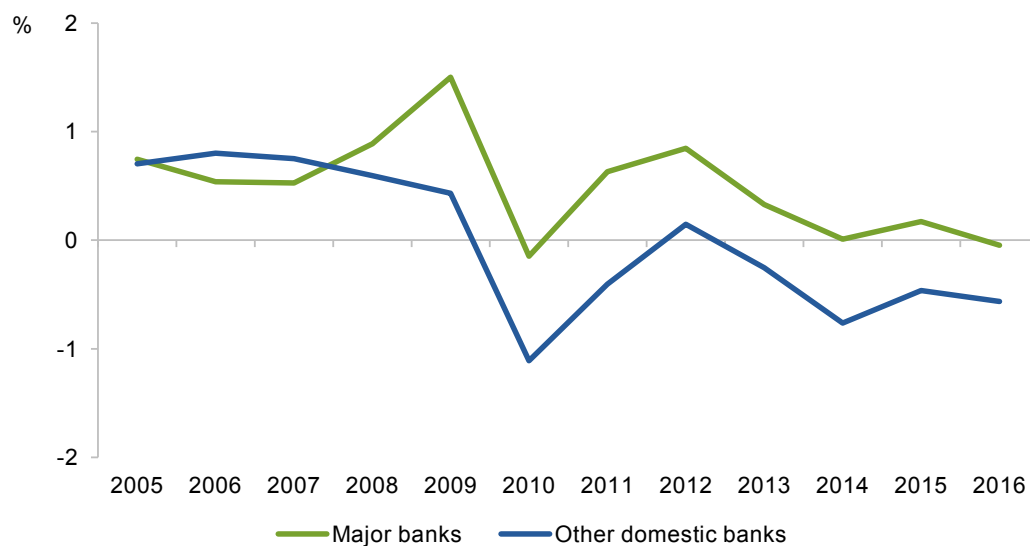
Source: APRA (2017s)

Figure C.8 Deposit share of funding has increased since the GFC
Share of total funding 2003 – 2017



Source: Unpublished RBA data

Figure C.9 Debt funding costs are currently lower for the major banks^a
2005 – 2016

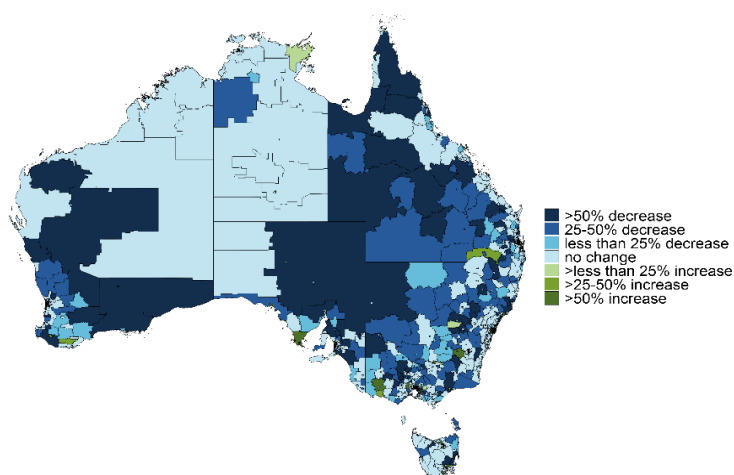


^a Spread to the cash rate. The larger the spread, the lower the funding cost. Average funding costs are measured as interest expense on deposits and borrowings as a proportion of deposit and borrowing liabilities. Major banks are the CBA, Westpac, NAB and the ANZ.

Source: APRA (2017s); RBA (2017w)

Consumer banking patterns

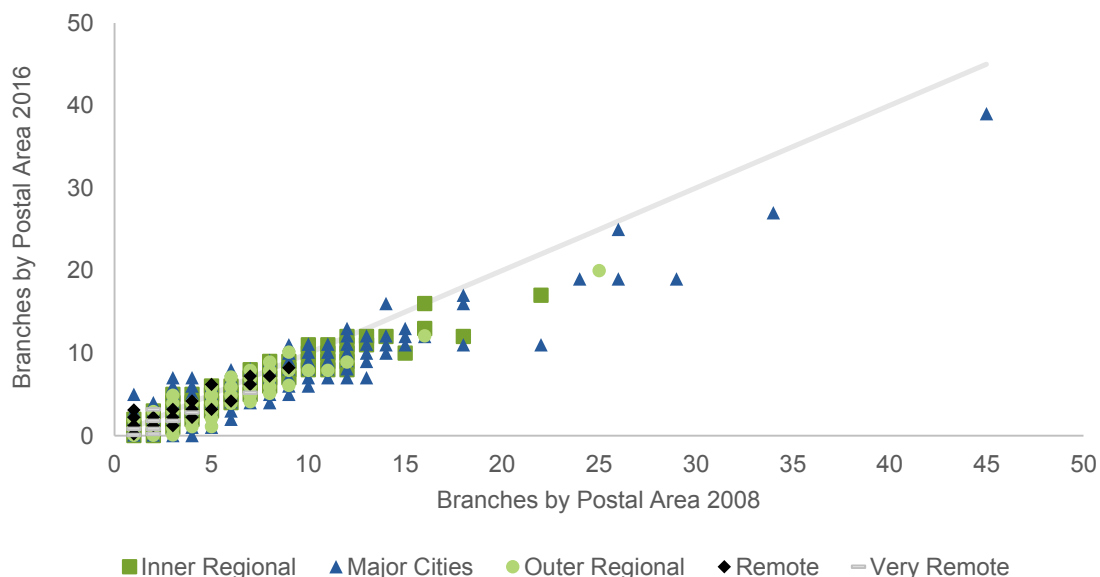
Figure C.10 The location of bank branches has changed^a
(Percentage change between 2008 and 2016)



^a Percentage change between 2008 and 2016.

Source: Unpublished APRA points of presence data

Figure C.11 Most locations have fewer branches^a
2008 and 2016



^a Change in number of bank branches by postal area. Postal areas are defined by the ABS and approximate postal codes.

Source: ABS (Cat. no. 1270.0.55.005, *Australian Statistical Geography Standard (ASGS): Volume 5 – Remoteness Structure, July 2011*, table 3, accessed 24 November 2017); unpublished APRA points of presence data

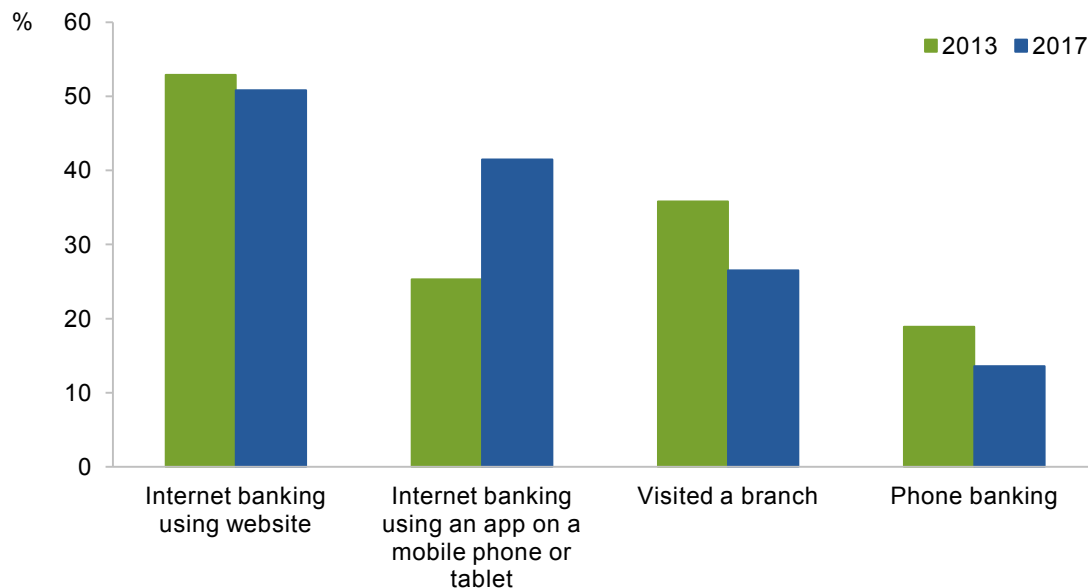
Table C.1 Electronic transactions are increasing^a
2002 – 2014

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 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: ANZ (2015)

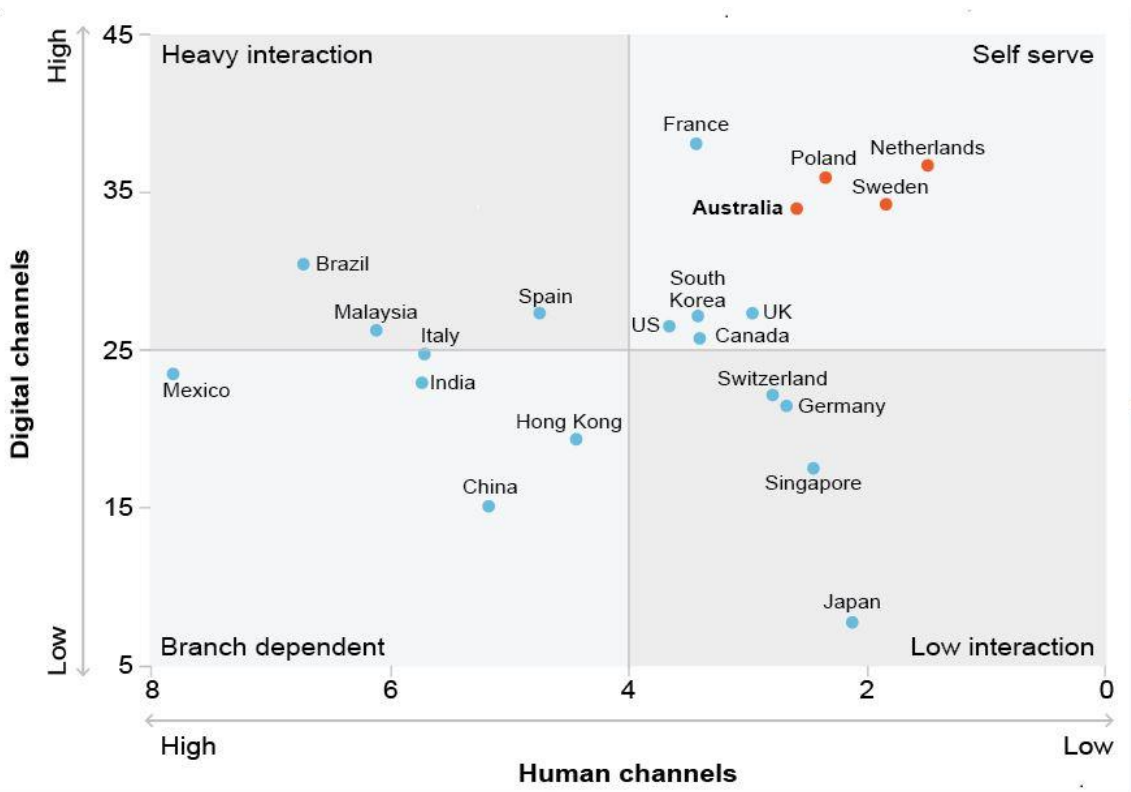
Figure C.12 Internet banking by phone and tablet has increased, while branch use and phone banking have fallen^a
2013 and 2017



^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)

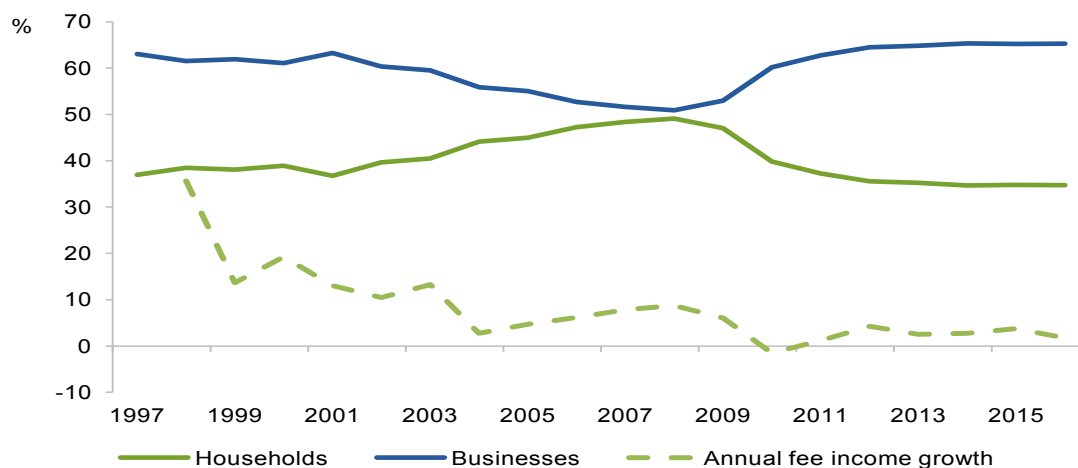
Figure C.13 **Australians are among world leaders in embracing digital and self-serve banking channels^a**
2016



^a Average interactions per respondent in the previous quarter, by channel. Digital channels exclude ATMs.
Source: du Toit and Burns (2016)

Bank fees

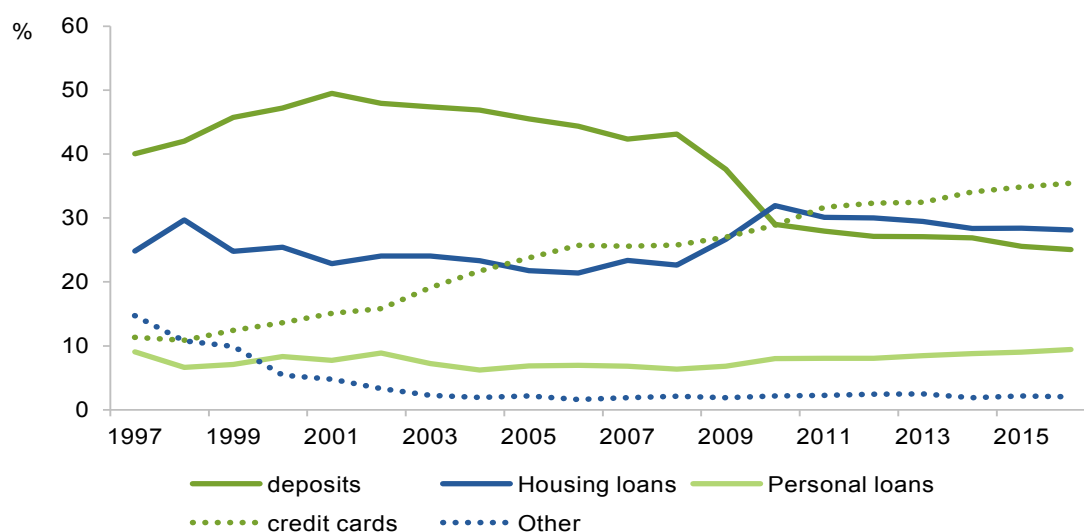
Figure C.14 **Most fee income is from businesses, but fee income growth has slowed^a**
1997–2017



^a Share of total domestic bank fee income. Fee data are collected from 16 ADIs operating in Australia covering almost 90% of total ADI assets.

Source: RBA (2017q)

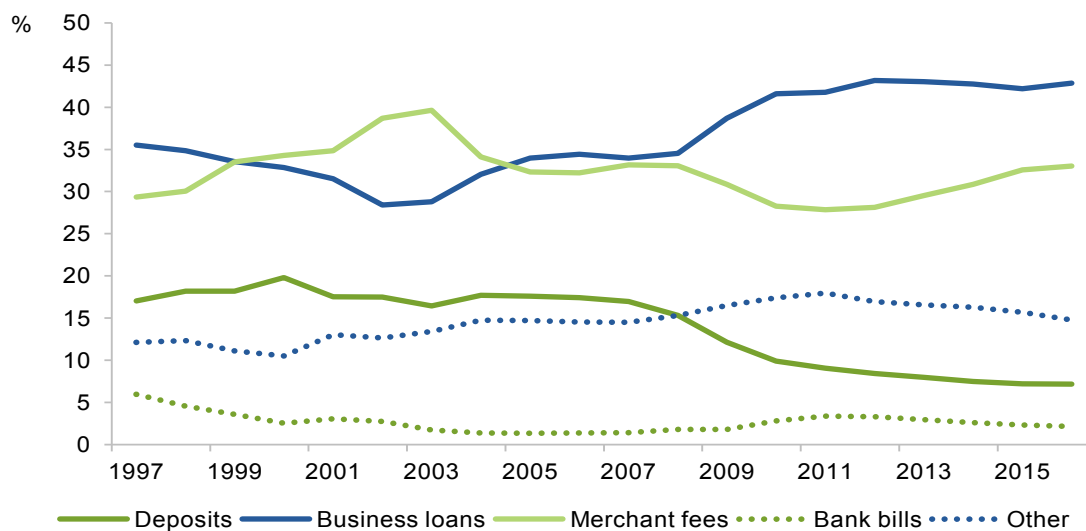
Figure C.15 **Credit card, housing loan and deposit fees account for most banking fees paid by households^a**
1997 – 2016



^a Share of domestic banks' fee income from households. Fee data are collected from 16 ADIs operating in Australia covering almost 90% of total ADI assets.

Source: RBA (2017q)

Figure C.16 Loan and merchant fees account for most bank fees paid by businesses^a
1997 – 2016

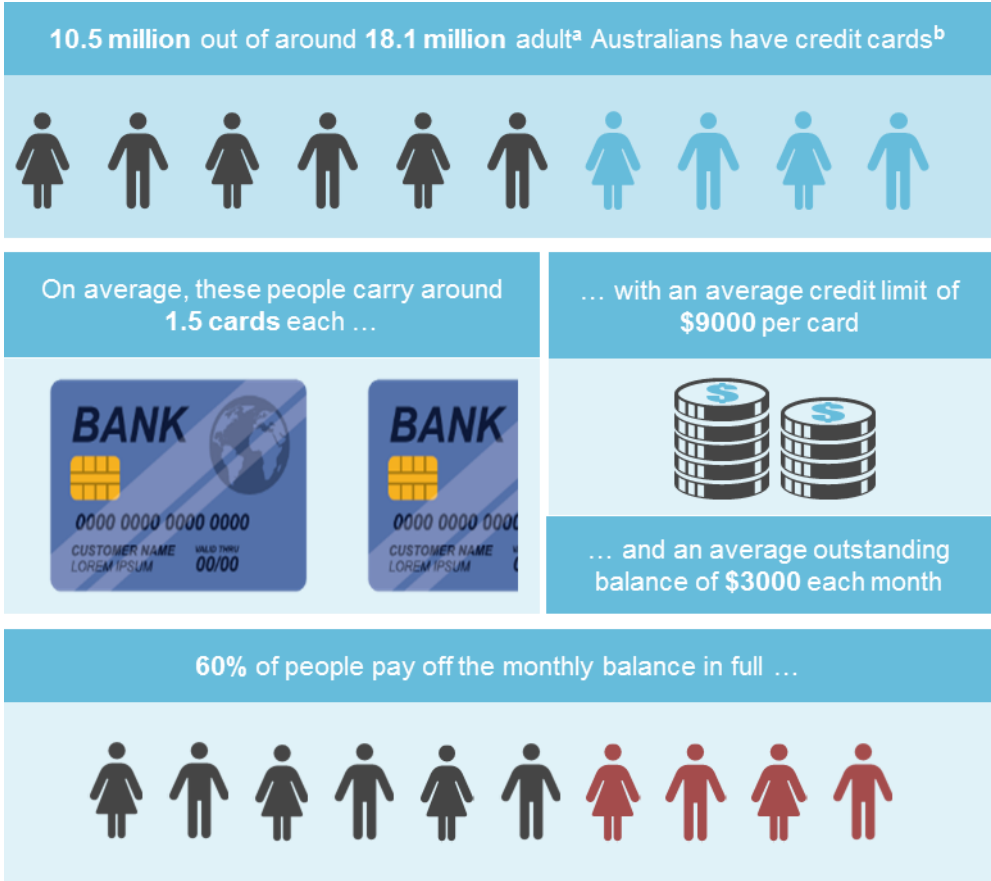


^a Share of domestic banks' fee income from businesses. Fee data are collected from 16 ADIs operating in Australia covering almost 90% of total ADI assets

Source: RBA (2017q)

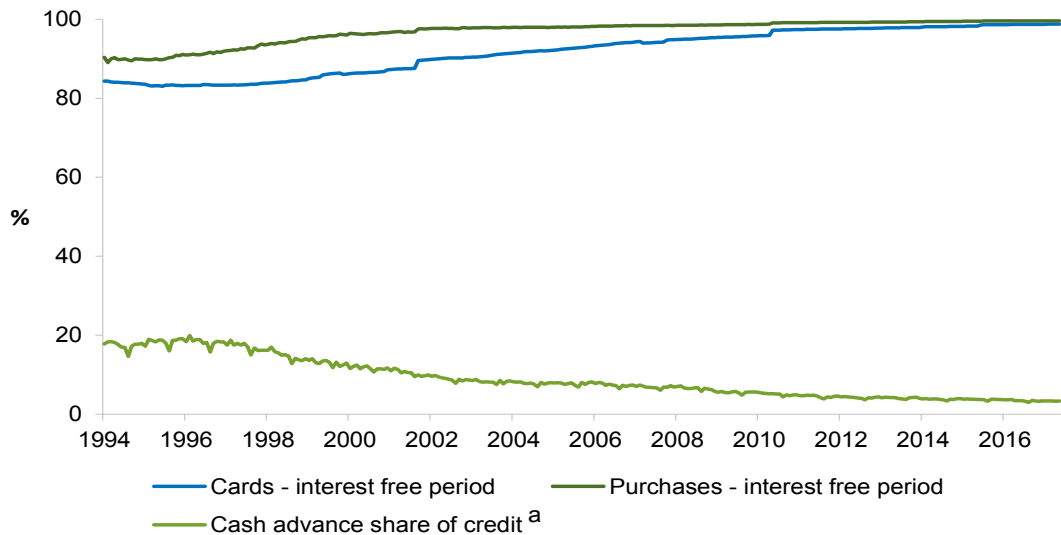
Credit cards and consumers

Figure C.17 Key statistics on credit card use in Australia



Source: RBA (2017n); ABS (2017a); CreditCard.com.au (2014)

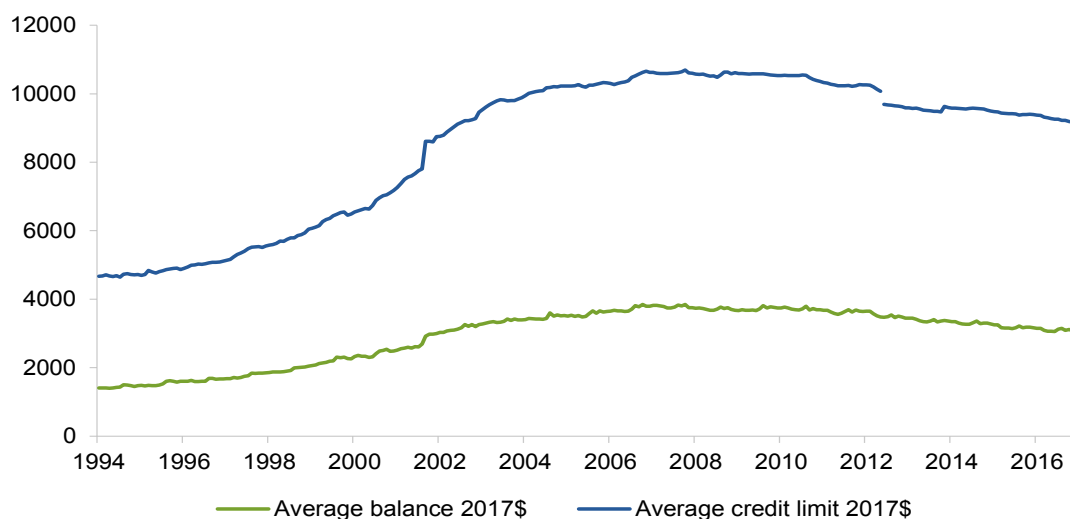
Figure C.18 Interest free periods are standard and cash advances are rare
1994 – 2016



^a Cash advances used in a month as a percentage of total additional charges for the month.

Source: RBA (2017n)

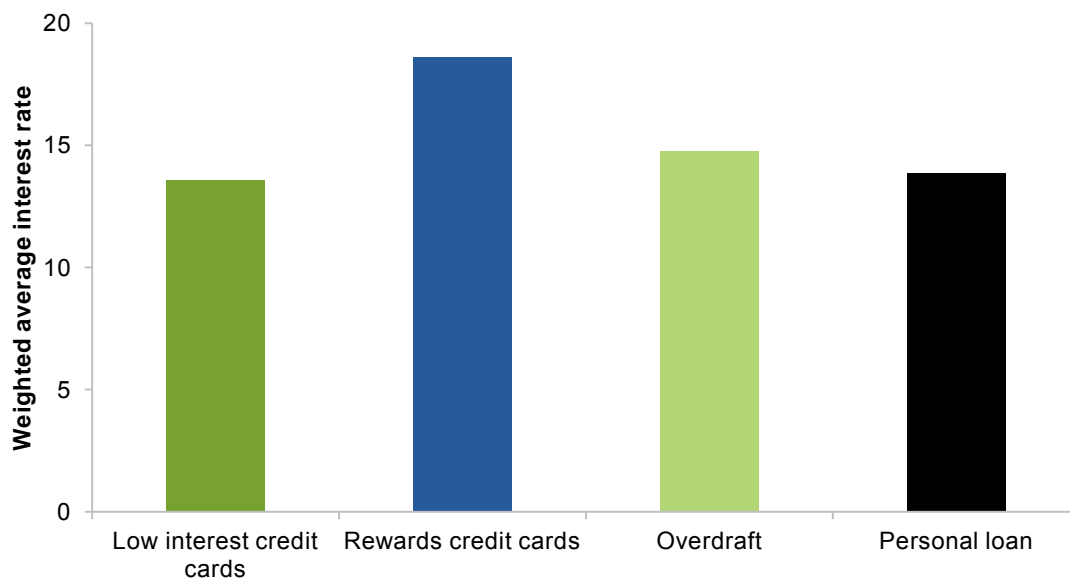
Figure C.19 Credit card balances have stabilised in real terms^a
2017 dollar terms, 1994 – 2016



^a Average outstanding monthly balance and credit card limit per credit card (2017 dollars). The All groups CPI index for Australia was used as the deflator (ABS 6401.0 Sept 2017).

Source: RBA (2017n)

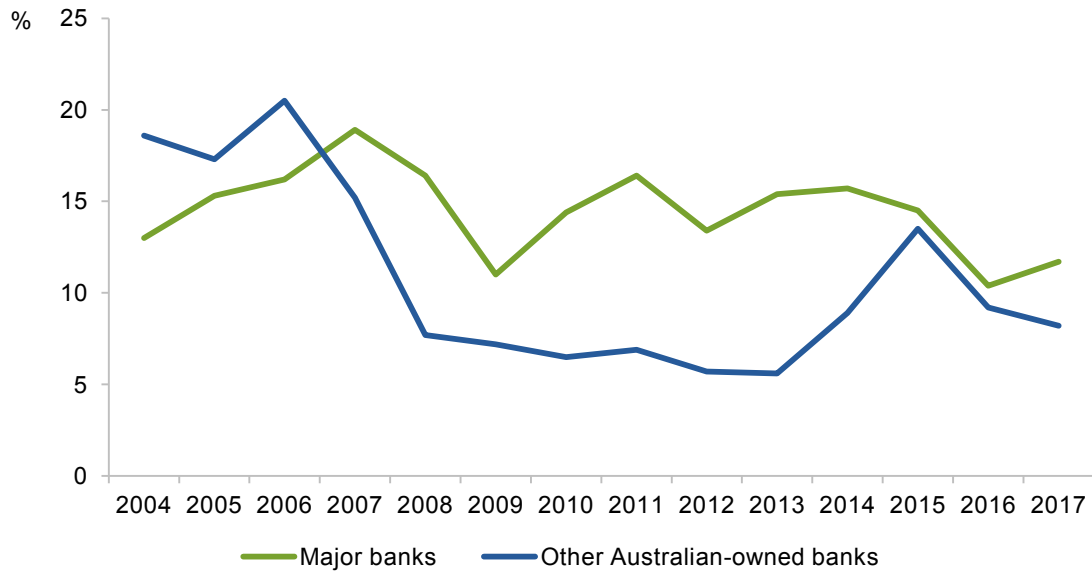
Figure C.20 **Average interest rates on credit cards can be higher than for other personal credit products^a**
2017



^a Weighted by number of customers. For credit cards, when interest charged on outstanding balances.
Source: Productivity Commission estimates based on unpublished ADI data

C.2 Performance of the banking system

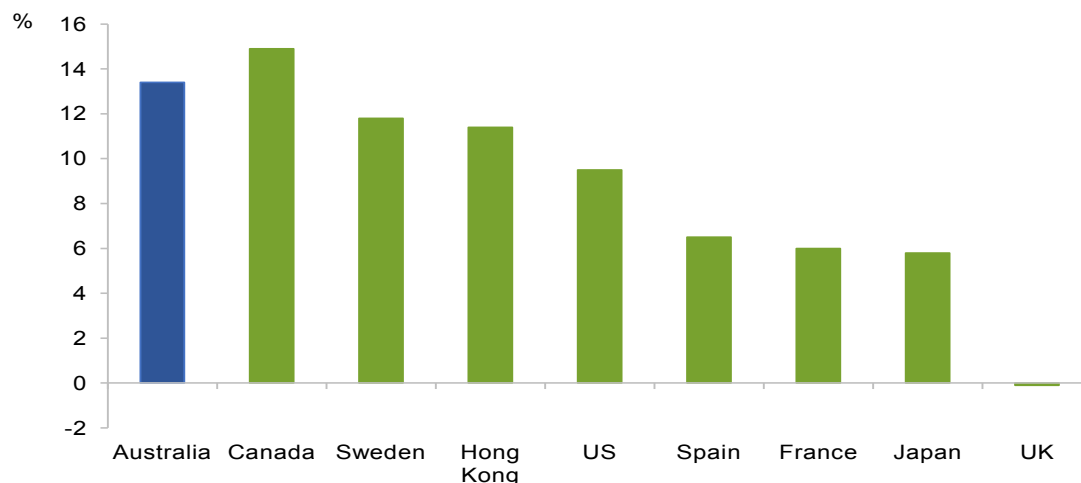
Figure C.21 **The major banks' return on equity (RoE) has been higher than other banks since the GFC, but the gap has narrowed^a**
2004 – 2017



^a Major banks are the CBA, Westpac, NAB and the ANZ. Others are the Australian owned ADIs.

Source: APRA Reporting Standards (ARF 320 Statement of Financial Position (Domestic Books); ARF 323 Statement of Financial Position (Licensed ADI); ARF 330 0 L. Statement of Financial Performance).

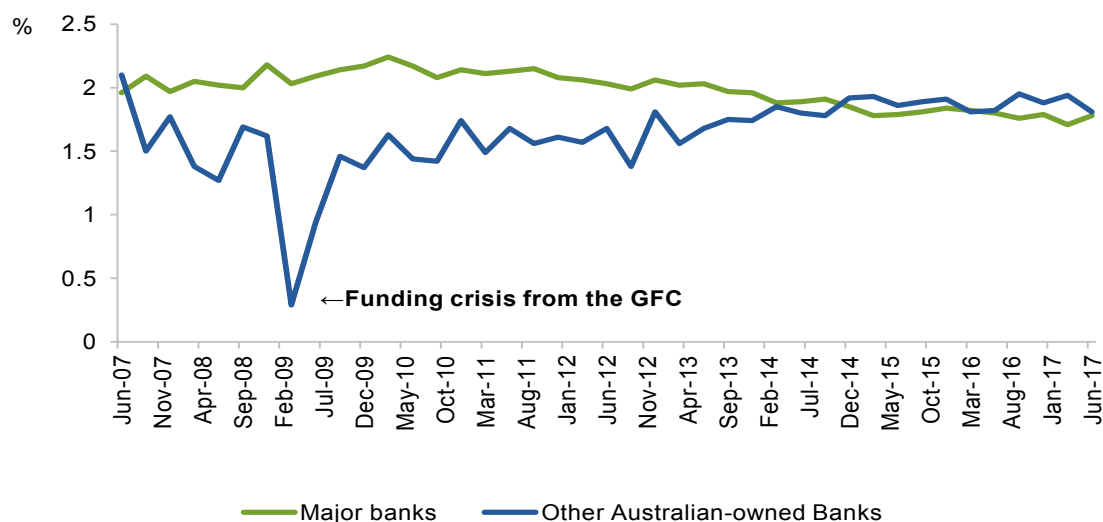
Figure C.22 Australian major banks' ROE is higher than banks in most countries^a
2016



^a The ROE for Australia's banks are the 4 major banks; Canada is based on 5 banks; Sweden on 4 banks; Hong Kong on 2 banks; the US on 6 banks; Spain on 3 banks; France on 4 banks; Japan on 4 banks and the UK on 5 banks.

Source: Thomson-Reuters in ABA (sub. 11)

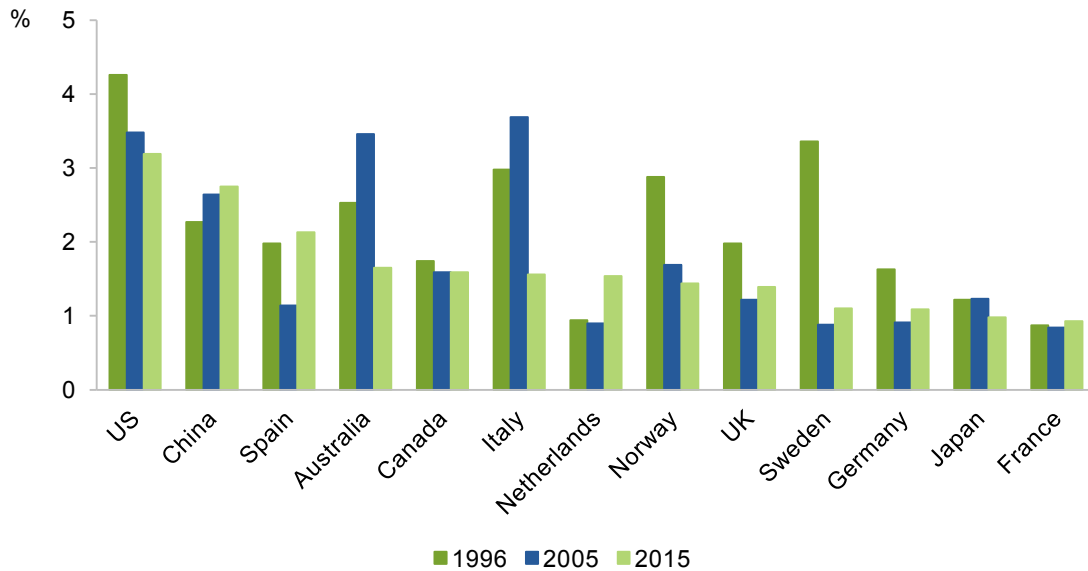
Figure C.23 Net interest margins (NIM) have declined for the major banks and increased for other Australian-owned banks^a
2007 – 2017



^a Net interest income (interest income less interest expenses) as a share of interest-earning assets. Major banks are the CBA, Westpac, NAB and the ANZ. Others are the Australian owned ADIs

Source: APRA Reporting Standards (ARF 330 1 L. Interest Income and Interest Expense, ARF 320 0 Statement of Financial Position (Domestic Books); ARF 323 Statement of Financial Position (Licensed ADI))

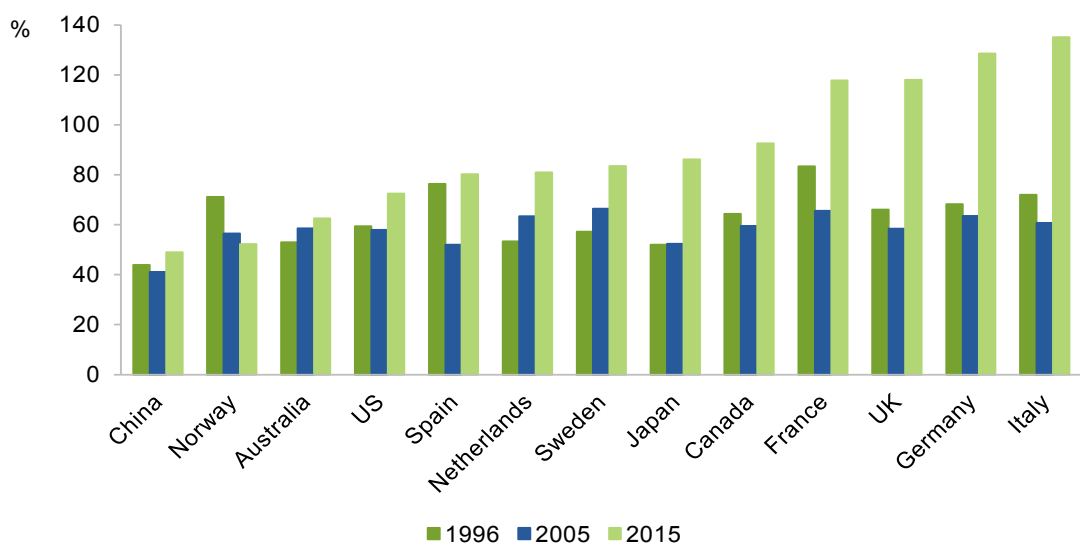
Figure C.24 But the NIM of Australia's banks are in the middle of those of other countries^a
1996 – 2015



^a Data for Australia is for all ADIs.

Source: World Bank (2017)

Figure C.25 Australian banks have a low cost to income ratio compared to overseas banks^a
1996 – 2015

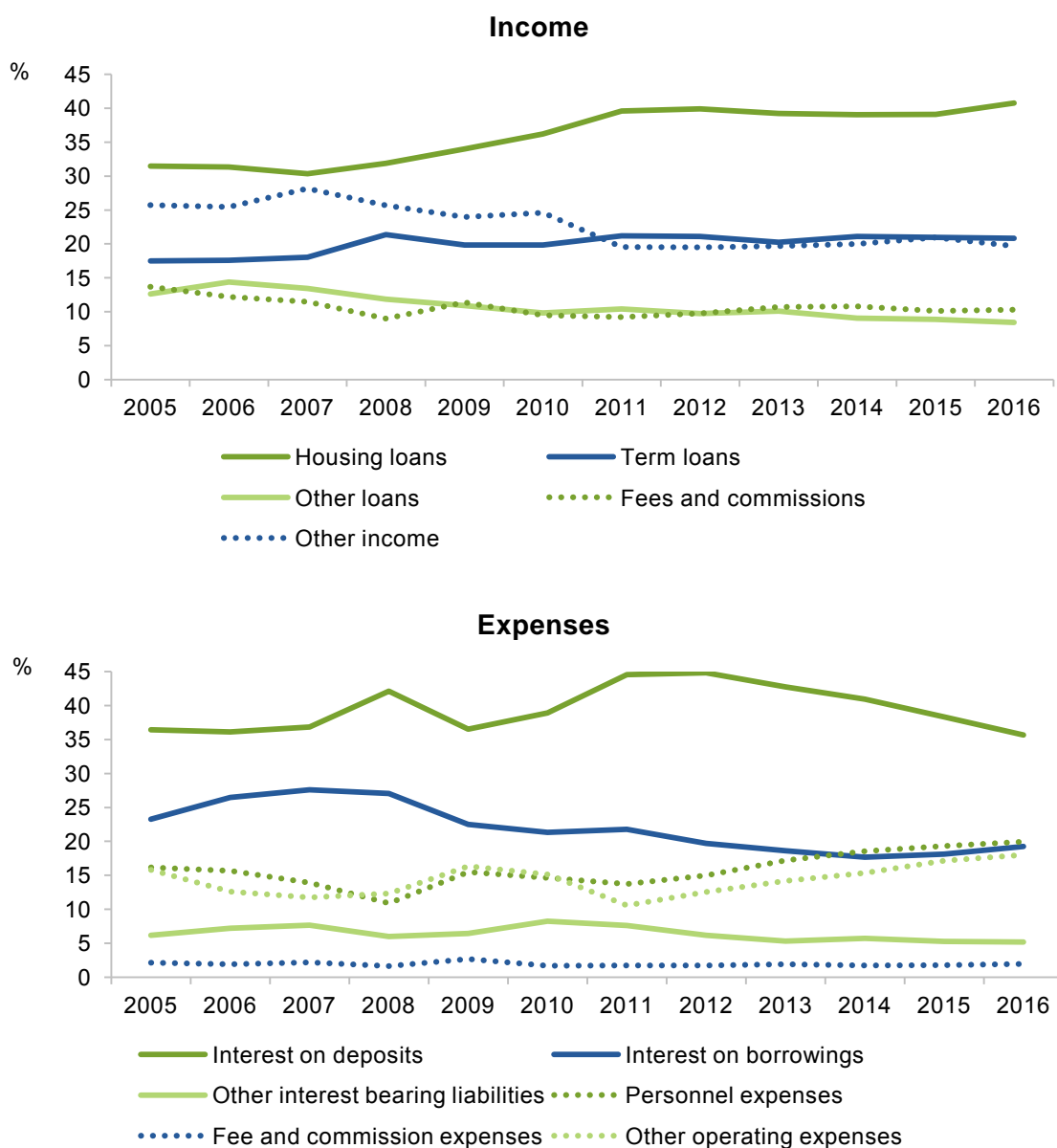


^a Banks' costs as a share of total income. Data for Australia is for all ADIs.

Source: World Bank (2017)

Figure C.26 Housing loans are the largest source of banks' income and deposits are their biggest expense^a

Share of total income and of total expenses 2005 – 2016



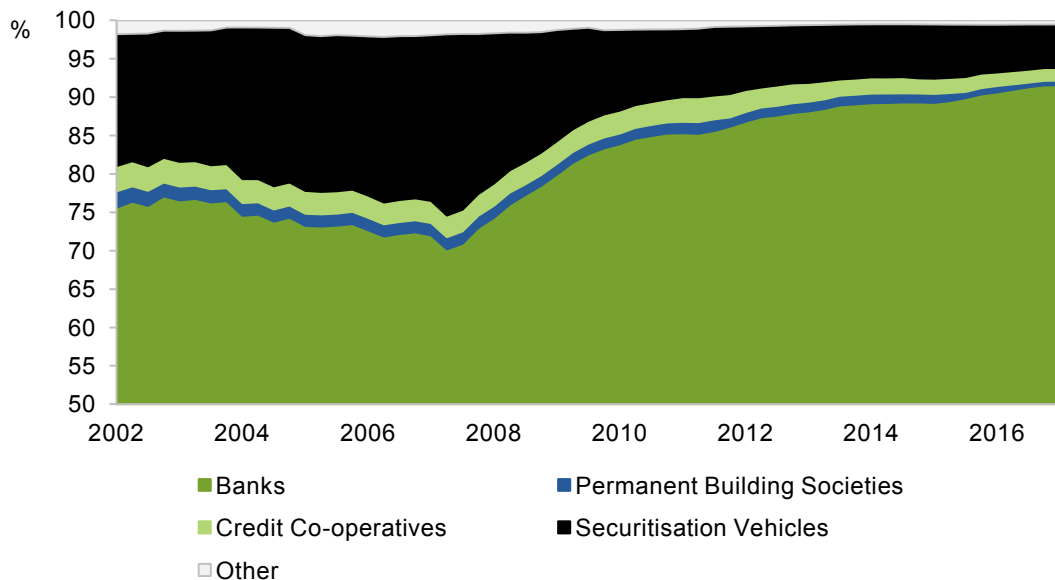
^a Annual average shares for all ADIs. Other income includes cash and liquid assets, other interest earning assets and other operating income.

Source: APRA (2017s, table 2a)

C.3 Residential mortgage lending

Figure C.27 **Banks provide the majority of home loans**

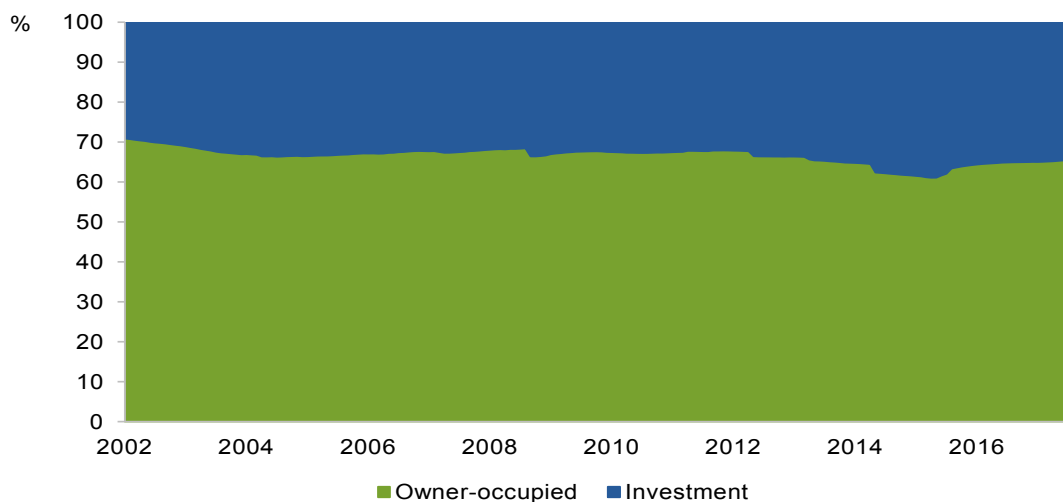
Lenders' shares of outstanding home loans by value of loan, 2002 – 2017



Source: ABS (Cat. no. 5609.0, *Housing Finance, Australia, September 2017*)

Figure C.28 **Most home loans are for owner-occupied housing^a**

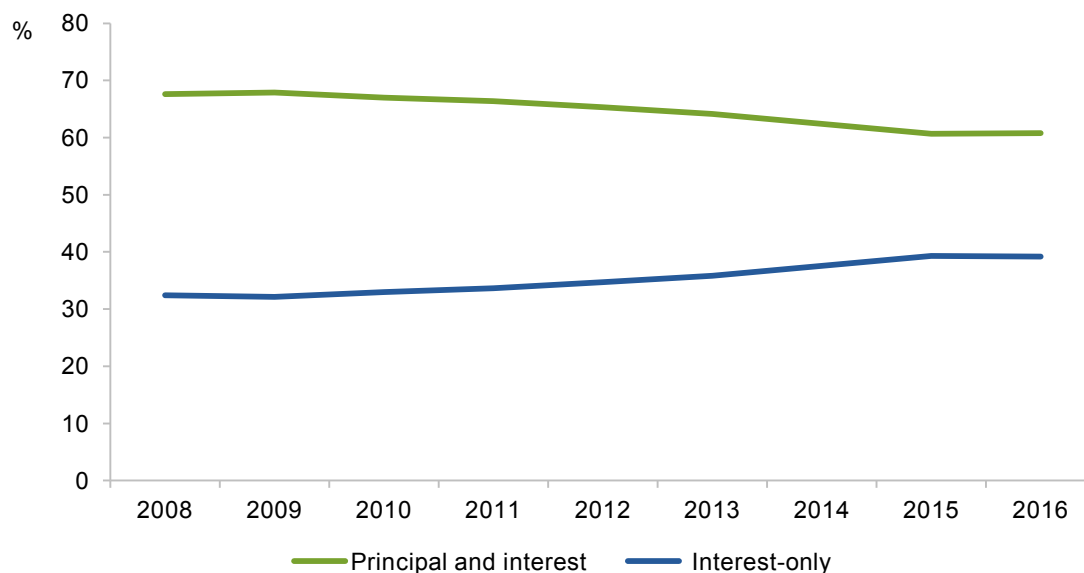
2002 – 2017



^a Share of total value of outstanding loans.

Source: ABS (Cat. no. 5609.0, *Housing Finance, Australia, September 2017*)

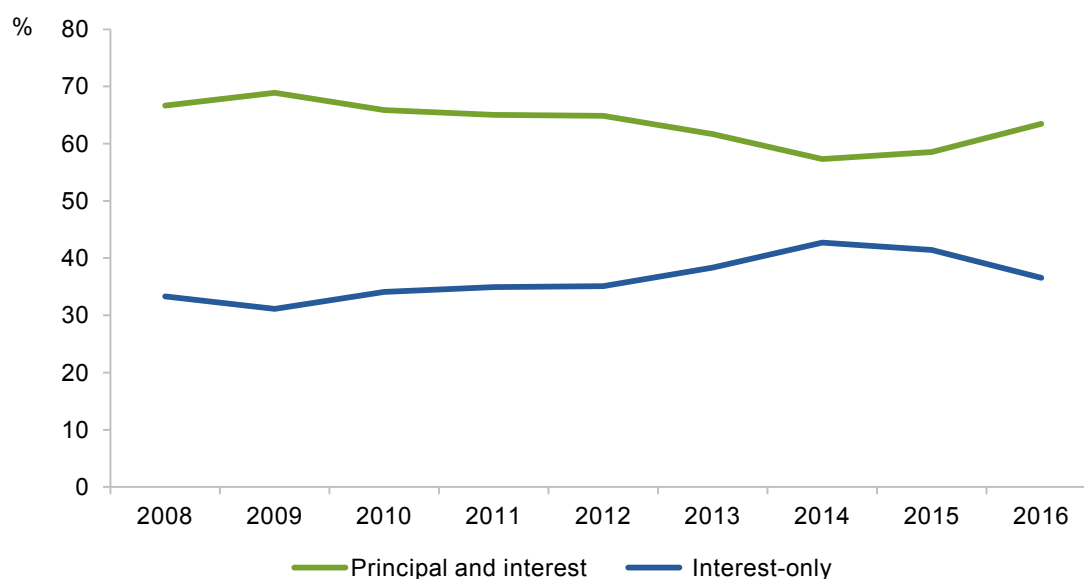
Figure C.29 Most housing loans are for principal and interest^a
2008 – 2016



^a Annual average share of total outstanding credit.

Source: RBA (2017u, graph B.1)

Figure C.30 Most home loan approvals are for principal and interest^a
2008 – 2016

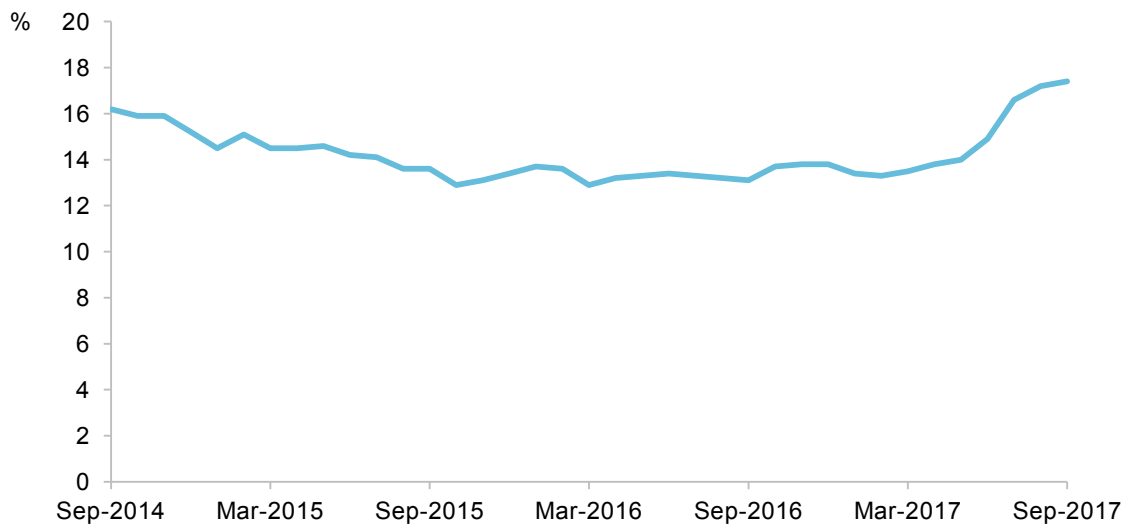


^a Annual average share of total loan approvals.

Source: RBA (2017u)

Figure C.31 First home buyers are in the minority^a

September 2014 – September 2017

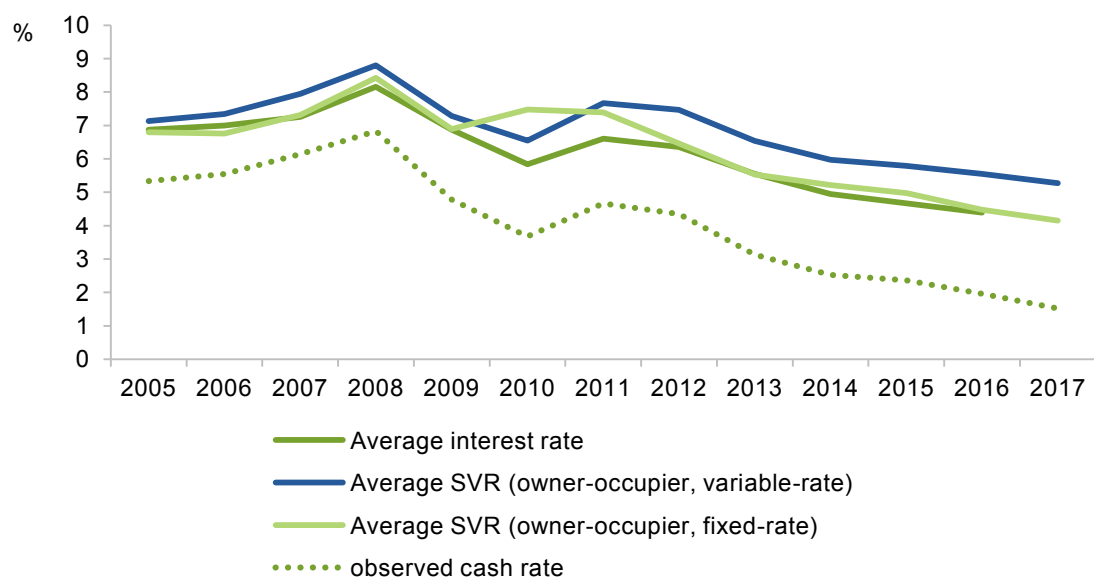


^a Share of new home loans.

Source: ABS (Cat. no. 5609.0, *Housing Finance, Australia, September 2017*)

Figure C.32 Housing interest rates have drifted lower^a

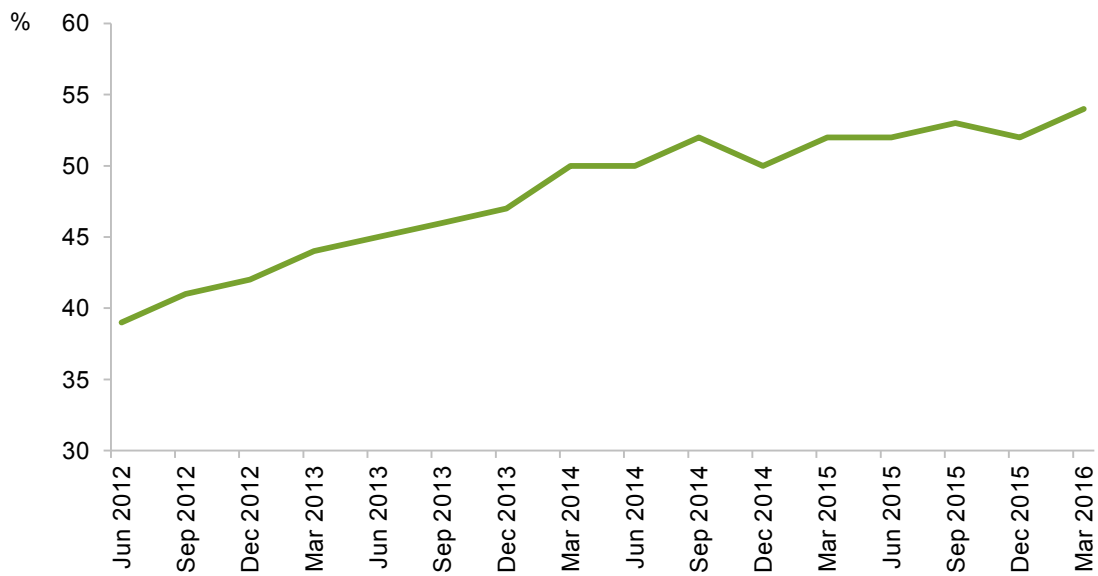
2005 to 2017



^a Weighted annual average rates. SVR refers to the standard variable rate. Observed cash rate is the interbank overnight cash rate.

Source: APRA (2017s); RBA (2017v, 2017w)

Figure C.33 Over half of home loans are originated by mortgage brokers^a
2012 – 2016



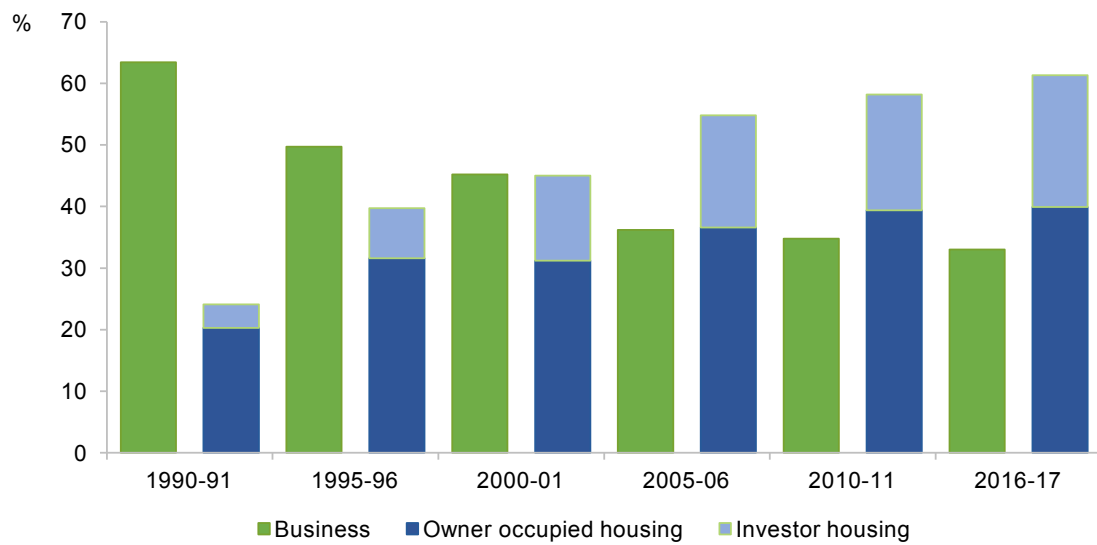
^a Share of total housing loan commitments.

Source: Macquarie Research in ABA (sub. 11)

C.4 Banking and the business sector

Business banking

Figure C.34 **Lending for business has declined while lending for housing has increased^a**
1990-91 to 2016-17

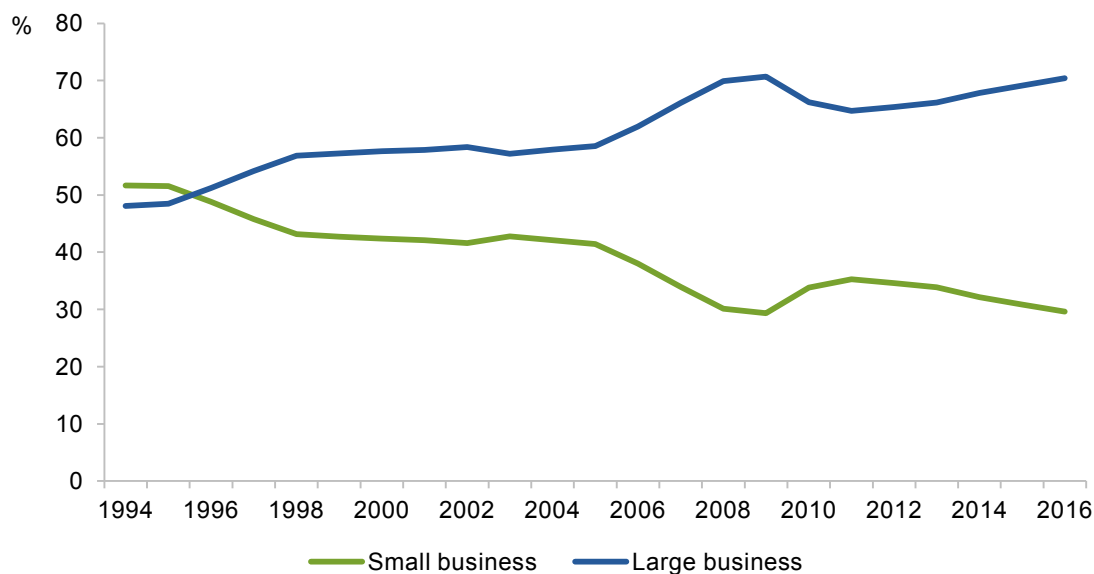


^a Share of total lending by banks and non-bank financial institutions (building societies, credit unions, specialist credit card institutions and registered financial corporations).

Source: RBA (2017x)

Figure C.35 Large businesses dominate business lending^a

1994 – 2016

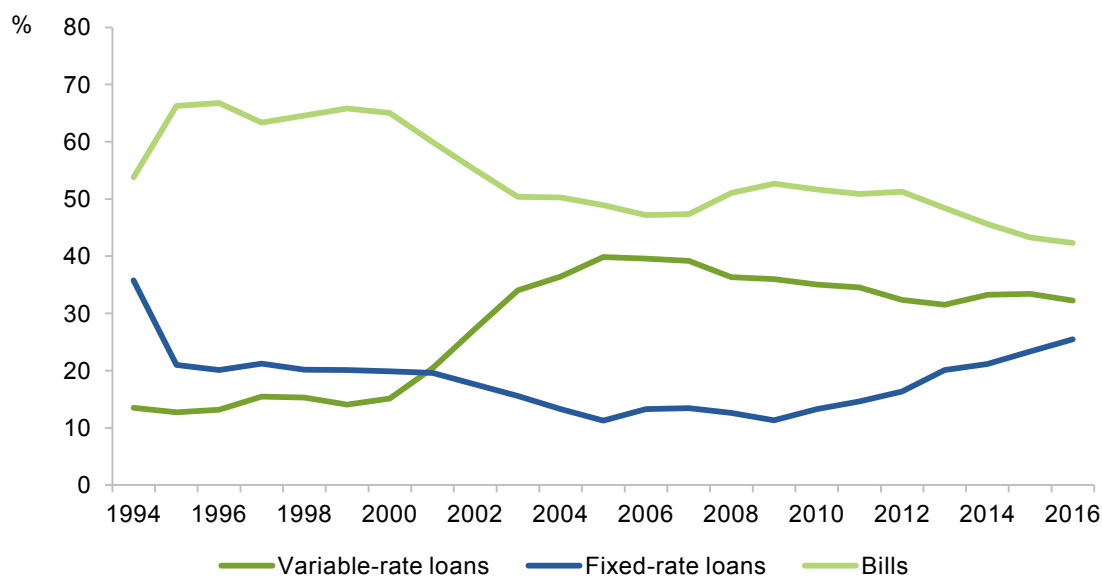


^a Annual average share of total outstanding credit. Small business refers to outstanding credit of less than \$2 million.

Source: RBA (2017j)

Figure C.36 Most large business bank lending is via bills^a

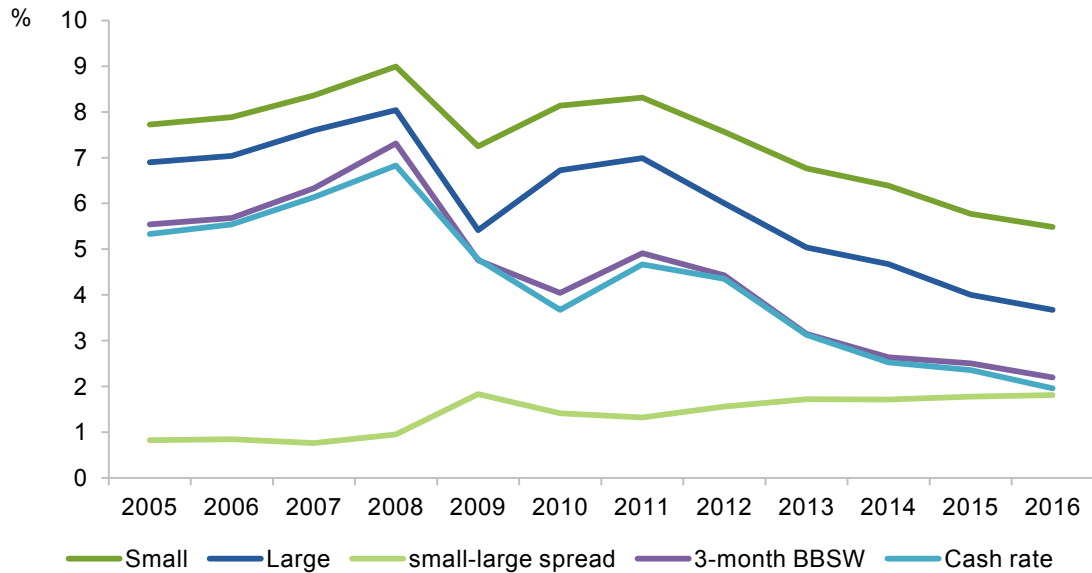
1994 – 2016



^a Annual average share of total outstanding credit. Large business is for credit of \$2 million and over.

Source: RBA (2017j)

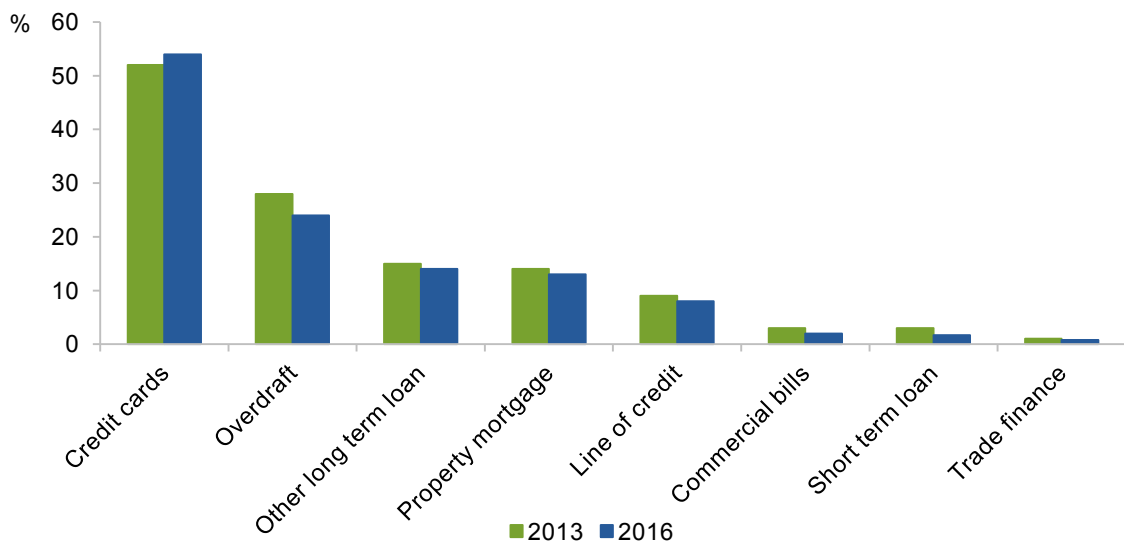
Figure C.37 Interest rates are lower for large business lending^a
2004-05 to 2015-16



^a Weighted annual average interest rates on total outstanding credit. Large business is for outstanding loans \$2 million and over, and includes bill lending. The BBSW is the Bank Bill Swap Rate.

Source: RBA (2017j)

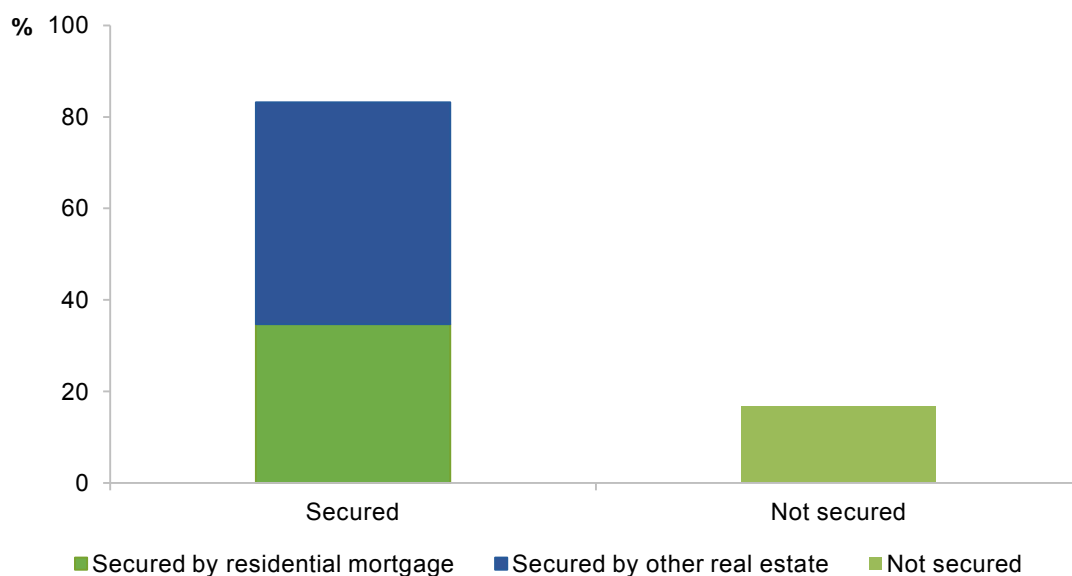
Figure C.38 Small businesses typically use some form of debt finance^a
2013 and 2016



^a Share of small businesses with these type of lending products.

Source: ABA (2016)

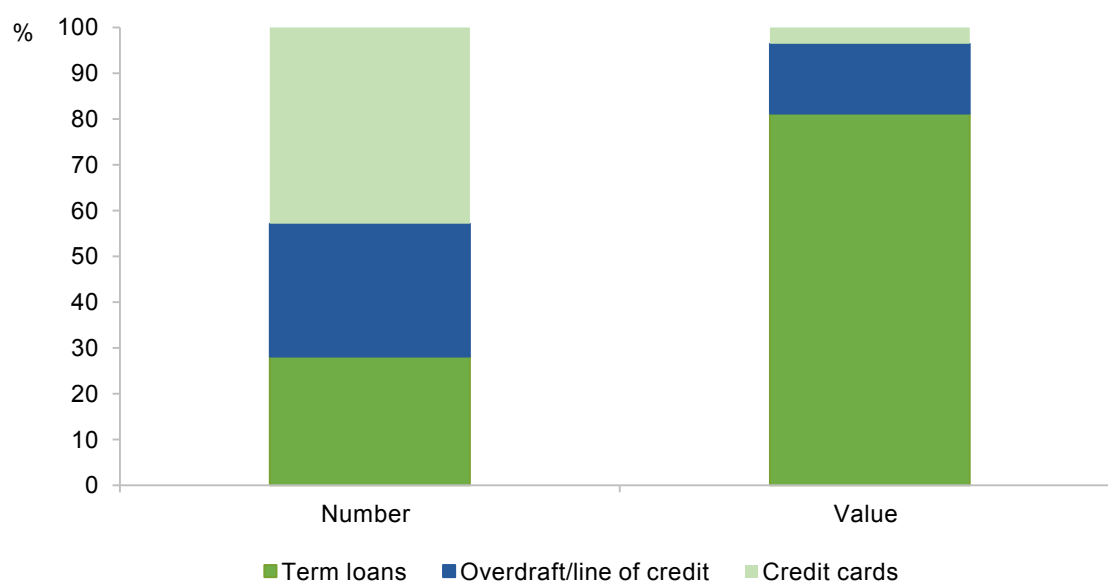
Figure C.39 Most small business term loans are secured by real estate^a
June 2017



^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.40 Term loans dominate small business lending by value^a



^a Share of small business lending by selected debt finance products provided by banks by number and value as of June 2017. One ADI's data is based on June 2016. The classification of a small business loan is determined by each bank.

Source: Unpublished ADI data, representing 84% of the market for SME lending

Institutional banking

Box C.2 What is institutional banking?

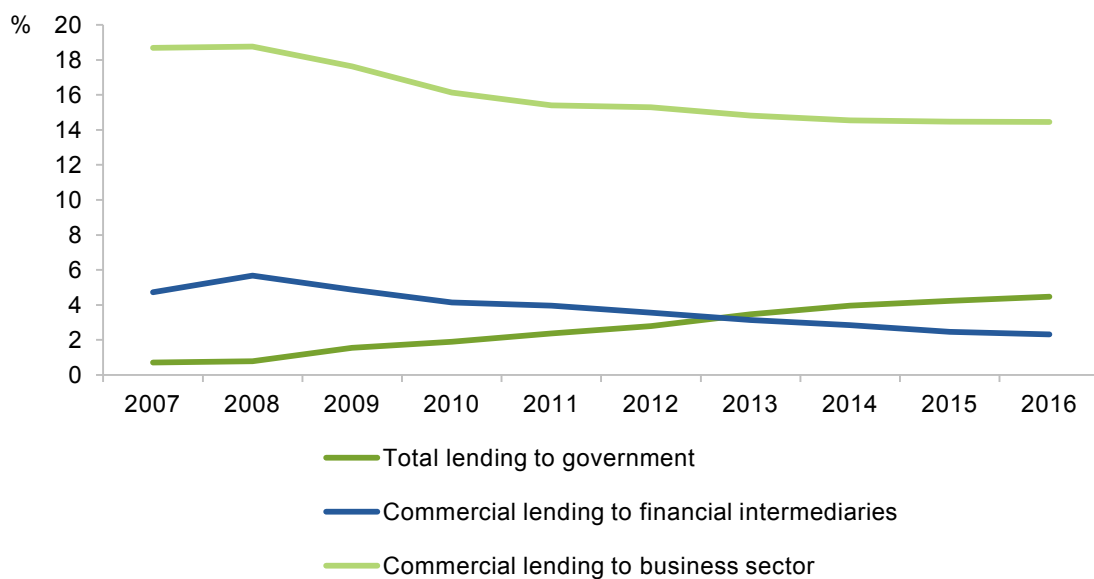
Institutional banking is typically a separate division within a bank. It provides financing and advisory functions for large corporations, governments, very high-net-worth households and investment managers with wholesale banking products and services. This includes financing and advisory functions relating 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: Citigroup (2017); Yeates (2016); CBA (2017a); NAB (2017a); WBC (2017); ANZ (2017c)

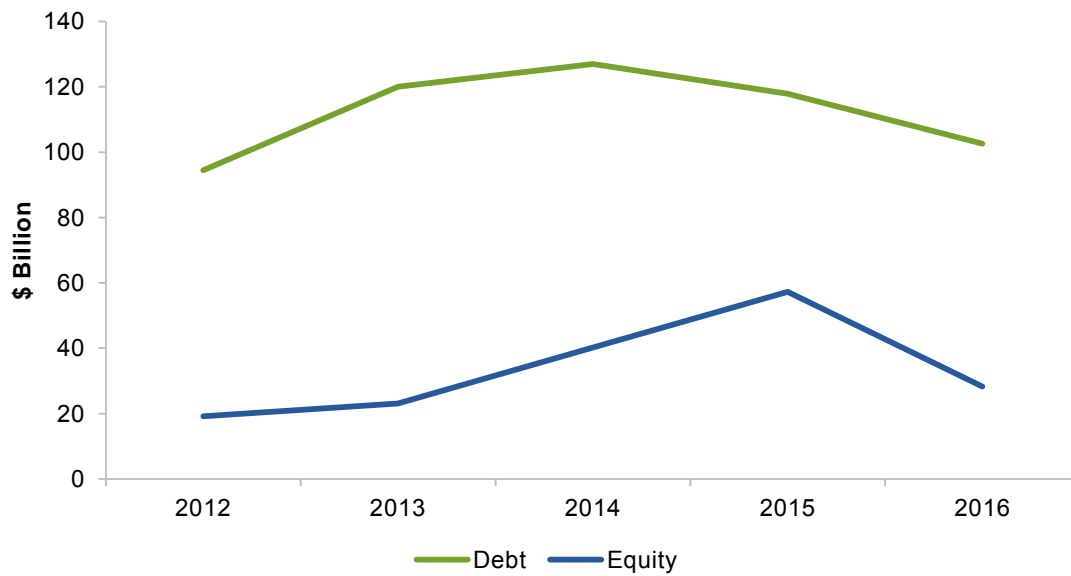
Figure C.41 **Bank lending to governments is increasing and lending to business is declining**

Share of total lending 2007 – 2017



Source: RBA (2017i)

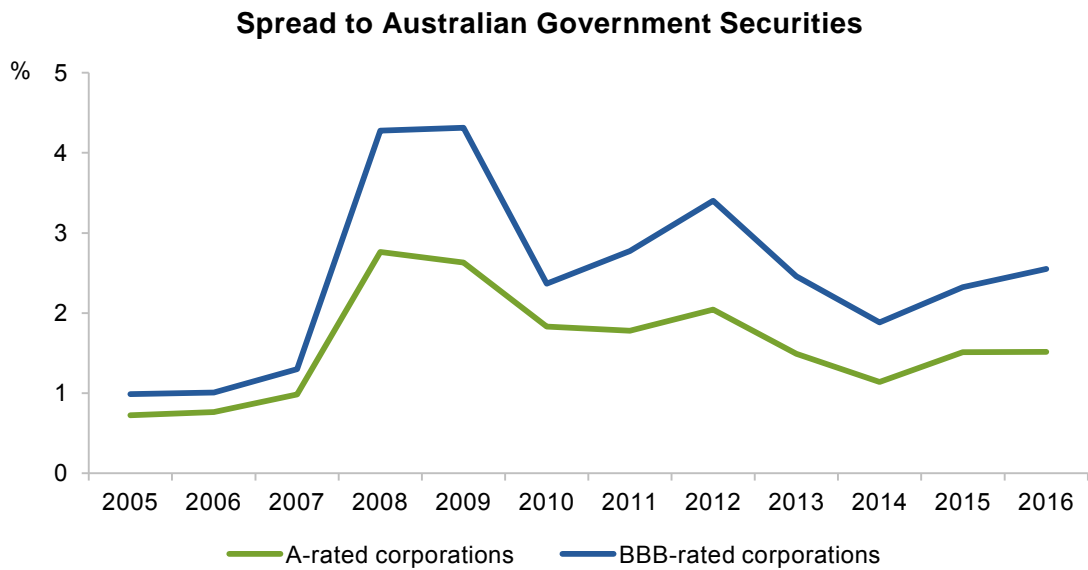
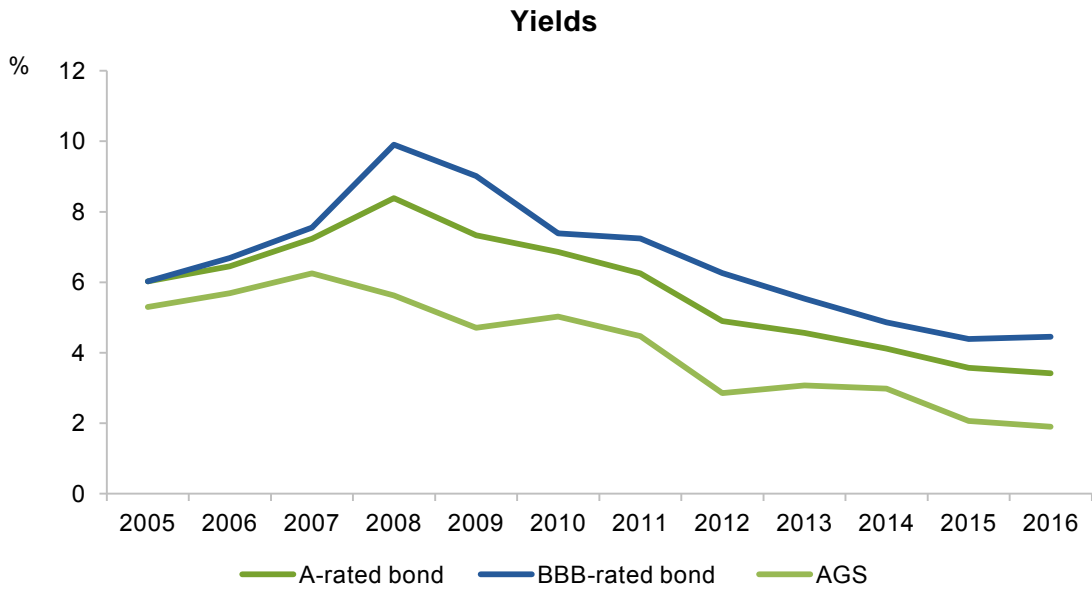
Figure C.42 **Debt is the main source of capital^a**
2012 – 2016



^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.43 Australian corporate bond yields have fallen and spreads have narrowed recently^a
2005 – 2016



^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)

D Asset management and financial advice

D.1 What is wealth management?

Although there is no clear definition of wealth management (Murray et al. 2014b), it is generally taken to mean a range of investment services (insurance, superannuation, asset management) and financial advice (Golat 2016).

This appendix focuses on asset management and financial advice, and should be read in conjunction with chapter 7. Insurance is discussed in chapters 11 and 14. Superannuation is out of scope of this inquiry as the Commission is conducting a parallel inquiry (chapter 1).

D.2 Asset management

What is asset management?

Asset management involves the provision of professional management services of various securities (such as shares and bonds) and other assets (such as infrastructure funds, real estate, hedge funds and private equity) in order to meet the investor's specified investment goals (Australian Trade and Investment Commission 2017). There is widespread household exposure to asset management services due to Australia's superannuation system. Consequently, asset management plays an important role in the wider economy (box D.1).

Box D.1 The role of asset management in the economy

The aggregation approach of asset management — where investors' savings are pooled for the purpose of investment — has potential benefits for investors:

- access to a wider range of asset classes, which may not be otherwise accessible to investors directly investing in capital markets
- diversification of risk
- economies of scale (cost savings from netting of transactions or pooling of funds to acquire investments).

Asset management also contributes to funding the broader national economy and the efficient functioning of capital markets through:

- capital allocation (channelling funds to businesses), often facilitated by long-term holding periods
- providing alternative sources of finance — asset managers can provide debt finance (as an alternative to bank lending) and diverse financing channels (such as alternative forms of debt finance and infrastructure projects)
- reducing information asymmetry between investors and companies.

Source: Oxera (2016)

Fund managers can invest funds on behalf of clients, and provide other investment services to clients for a fee (Price and Schwartz 2015; box D.2). These are known as managed funds. In general, these funds can either be invested through:

- *investment funds (collective investment vehicles)*: allowing investors to pool their money and use it for investment, rather than buying the securities directly as individuals (Board of Taxation 2010). These are either public or private funds, with public funds available to both retail and institutional investors. Private funds, however, are only accessed by institutional investors (Price and Schwartz 2015)
- *separate accounts*: only accessible by institutional investors and used to manage the cash of single institutional investors (Price and Schwartz 2015).

Market structure

Funds management is a global industry

Australia's funds management industry is part of the wider global capital market and is significant by global standards, in part because of Australia's compulsory superannuation system. According to the Investment Company Institute (2017), in the second quarter of 2017, Australia had the world's sixth largest managed fund assets under management (AUM), and was the largest in the Asia and Pacific region (excluding funds of funds). About 58% of these funds were invested in 'other funds', with the balance in equity (37%) and bond funds (5%) (ICI 2017). Approximately 21% of AUM is invested in overseas assets,

although the proportion of overseas investors remains relatively small (3.5% of the managed funds industry) (ABS 2017h).

Box D.2 Types of funds management

Funds management generally fall within the following categories:

- funds under management (FUM) — value of funds held in the name of a fund manager on behalf of the client that are actively managed by the manager on a discretionary basis. Generally, investors purchase units in a fund while the fund manager owns the underlying assets. Clients will typically receive continuous and regular supervisory or management services, and give control to the investment manager so they can buy and sell securities on their behalf
- funds under administration (FUA) — typically, clients retain ownership of the funds (they are not transferred to the fund manager) and actively make investment decisions, but may receive assistance or other services from the fund manager
- funds under supervision — this may include funds that are supervised by fund managers in the capacity of a trustee (for example, as a trustee of a superannuation fund)
- funds under advice — the value of funds placed for investment purposes through a financial adviser.

What is the difference between AUM and FUM?

Assets under management (AUM) refers to the market value of assets that a firm manages on behalf of investors, and includes the amount of funds available to a fund manager to make transactions. It typically excludes purely advisory assets and other banking activities. As noted above, FUM only covers funds held by the manager on behalf of investors. As a result, the value of AUM will exceed that for FUM.

However, the distinction between the two are somewhat blurred in practice. Sometimes financial institutions use AUM interchangeably with FUM. And there are a number of different ways to calculate AUM. Some financial institutions include relatively liquid assets (such as bank deposits, mutual funds and cash) in their calculations; others limit AUM to funds under discretionary management. FUM may also exclude a firm's group assets and assets managed by managers located outside of Australia (but may be included in the AUM). In this report, the Commission has treated AUM and FUM as largely interchangeable. Even if there is any difference between the two measures, FUM can be regarded as a subset of AUM, and a proxy for AUM where data are unavailable.

Most of the major banks and specialised fund managers report on FUM or FUA; only the Commonwealth Bank of Australia reports its AUM.

Why does AUM or FUM matter?

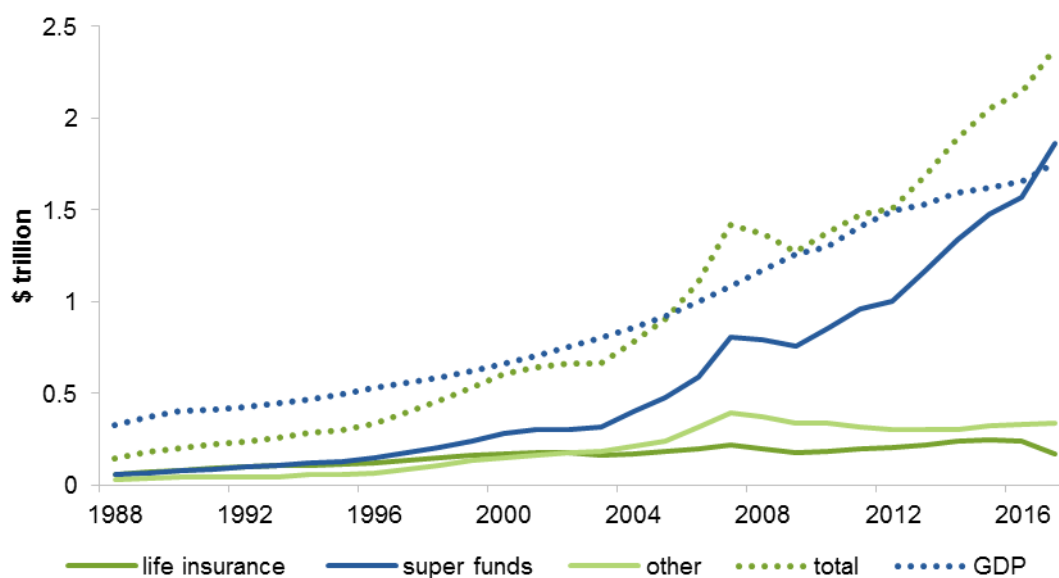
For fund managers, FUM is often regarded as an indicator of their financial performance. This is because fees (such as management, administration, entry and exit fees) are also often charged as a percentage of the AUM or FUM.

Source: Investment Association (2017); FCA (2015a); Nasdaq (2011)

Domestic market size

Funds management services are a major part of the Australian financial system. For the June 2017 quarter, the AUM of managed funds institutions was close to \$2.4 trillion (more than the value of GDP in that quarter) (figure D.1, ABS (2017c)). The AUM has rapidly increased over the past three decades, growing at an average rate about 10% per year, mainly due to superannuation. Growth in the managed funds industry (or more precisely, investment demand for managed funds) is affected by the superannuation and insurance sectors (Australian Trade and Investment Commission 2017).

Figure D.1 **Value of AUM relative to GDP^a**
1988 — 2017



^a Consolidated assets of managed funds institutions, as at 30 June each year. Excludes cross-investment that takes place between the various types of 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)

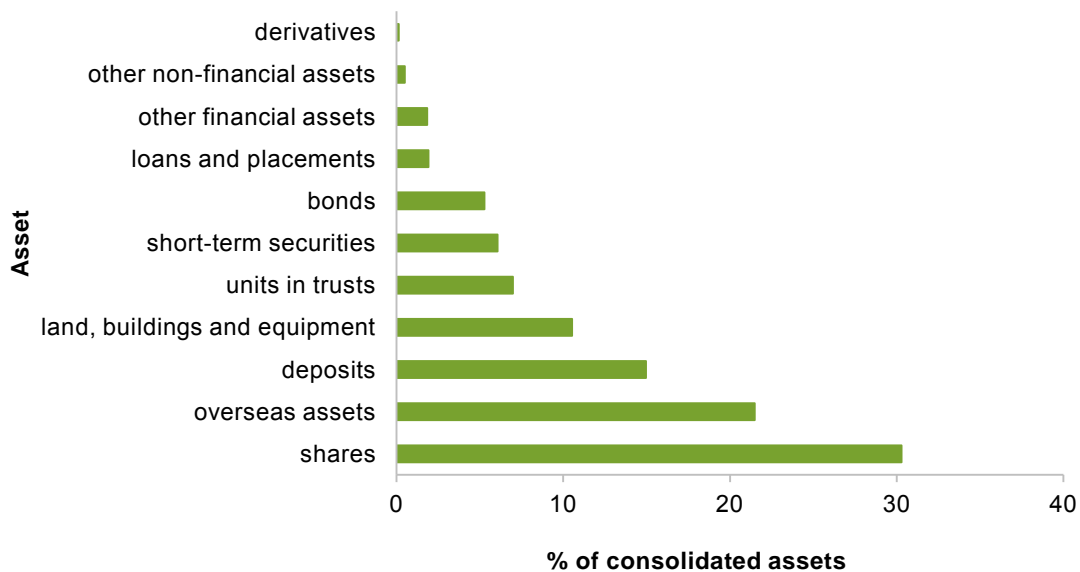
The nominal value of AUM is also influenced by valuation effects, such as movements in the price of assets and the exchange rate (ABS 2017h), as well as net capital flows and the asset composition. At 30 June 2017, just over half of assets were invested in shares (30%) and overseas assets (21%) (figure D.2).

Providers

Broadly speaking, there are two types of institutions that provide funds management services — managed funds institutions (direct) and investment or fund managers (intermediaries).

Managed funds institutions directly buy assets (and incur liabilities) on their own account for their members (typically by pooling funds of investors). These include life insurance corporations, superannuation funds, public offer (retail) unit trusts, friendly societies, common funds and cash management trusts. Managed funds institutions are the main source of funds management measured by value of AUM.

Figure D.2 Asset allocation of managed funds
June 2017



Source: ABS (*Managed Funds, Australia, Jun 2017*; Cat. no. 5655.0; table 2)

Investment (also known as fund managers) provide, on a fee-for-service basis, professional investment services for the managed funds institutions, as well as to other clients with substantial funds to invest (ABS 2017h). Investment managers:

- specialise in the investment of a portfolio of assets on behalf of, and subject to the directions by clients. Clients retain ownership of the funds and ultimate responsibility for the investment remains with the client. Investors buy units in a fund rather than the individual shares or underlying assets. Fund managers act as intermediaries for clients
- offer pooled investment products, individual portfolios and/or separately managed accounts for individuals
- mainly rely on management fees as the main source of their income
- can be directly approached by consumers or be referred by financial advisers.

Investment managers are generally subsidiaries of financial institutions such as life insurance offices, banks, investment banks or organisations related to these types of institutions (ABS 2017h). They can be either separately legal entities or form a segment of a particular

financial institution. This appendix will focus mainly on the funds management activities of ADIs, and on traditional ‘long-only’ asset management (long-term investment).

At 30 June 2017, the proportion of total assets of managed funds invested through investment managers compared to assets invested directly were roughly the same (valued at approximately \$1.4–1.5 trillion under each stream) (ABS 2017h).

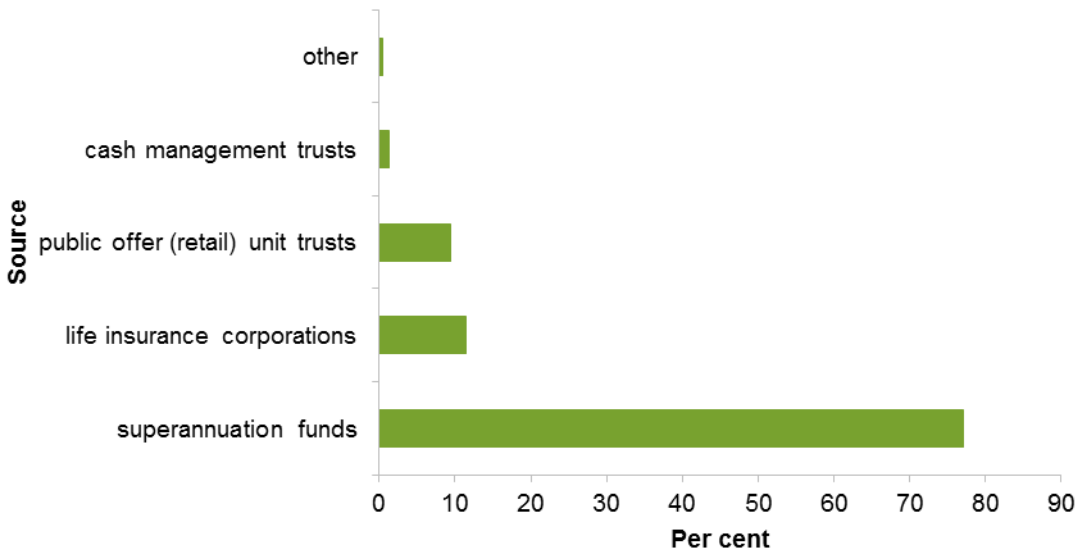
Consumers

Depending on the type of service, funds management services can be offered at both a retail and institutional level. Consumers include:

- retail investors and high-net-worth individuals with substantial funds to invest
- institutional investors such as pension/superannuation funds (however, the ultimate investors are individuals through the fund vehicle), insurance companies, corporations, mutual funds, governments and hedge funds.

While the data are incomplete, institutional investors appear to be the main clients of funds management services (figure D.3). Funds sourced from these investors were estimated to account for about two-thirds of AUM in 2009, but this proportion is likely to have increased due to recent increases in the superannuation guarantee (Price and Schwartz 2015). That said, it must be noted that the ultimate investors of superannuation funds are households.

Figure D.3 Source of assets invested through investment managers^a
30 June 2017



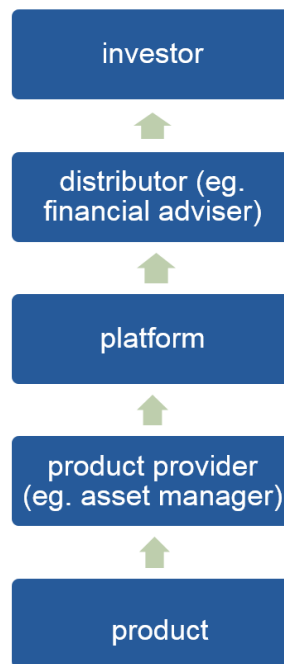
^a Per cent of unconsolidated assets of managed funds. Data on friendly societies and common funds not available.

Source: ABS (*Managed Funds, Australia, Jun 2017*; Cat. no. 5655.0; table 9)

D.3 The wealth management industry's supply chain

The wealth management industry manufactures and distributes investment products and services through a number of channels, which can be highly intermediated (figure D.4, chapter 7).

Figure D.4 **Stylised representation of the vertical value chain**



Source: FCA (2015a); FCS and UBS Asset Management (2017); Oxera (2016)

Investment products and services

There are a variety of investment products and services offered by manufacturers, including:

- pooled investment funds (box D.3) — such as wholesale funds,⁸⁸ exchange-traded funds and hedge funds. Retail investors may not be able to access a wide range of wholesale funds individually (ASIC 2017y)
- segregated mandates ('separate accounts') — investment portfolios managed specifically for a single investor
- insurance-based investment products — investment bonds, which are offered by insurance companies

⁸⁸ Wholesale funds include: Significant Investor Visa funds, property trusts, infrastructure trusts, mortgage funds, fixed interest (cash, bonds) and equity funds, and special purpose investment vehicle funds.

-
- private equity funds and venture capital funds
 - administrative or ancillary services and third party products and services — these include custody banking, fund administration, securities lending and risk management, which are provided in addition to investment management services, and part of the total asset management product offering (FCA 2015a).

Box D.3 Main types of investment funds

There are many varieties of funds, each with different investment objectives and strategies and a different investment portfolio. Investment funds can be generally divided into three categories:

- open-ended funds — also known as a ‘mutual fund’. These allow investors to purchase and redeem their shares directly from the fund, or through a broker for the fund. Investors cannot purchase the shares from other investors on a secondary market, such as the stock exchange. The number of a fund’s shares varies over time on a continuous basis (although some funds will stop selling shares when, for example, they reach a certain level of AUM) and the share price is generally determined by the fund’s net asset value and any fees.
- closed-ended funds — these have a fixed number of shares that are offered for sale at one time (in an Initial Product Offering (IPO)), after which shares typically trade on a secondary market such as the stock exchanges. The share price (after their IPO) is determined by the market.
- exchange-traded funds (ETF) — they have characteristics of both open-ended and closed-ended funds. The number of the fund’s shares can vary over time, with shares traded between the fund and authorised participants (usually broker-dealers) in the primary market. Authorised participants can trade these shares with investors in the secondary market, and these shares can then be traded among investors on stock exchanges. The share price is generally close to the fund’s net asset value. As at November 2016, there were 150 exchange-traded products (ETFs, exchange traded managed funds and exchange traded structured products) listed on the Australian Stock Exchange, with a total market capitalisation of \$24.6 billion.

Investment platforms (custodial, transaction and consolidated reporting services that allow investors, or their adviser to manage and control their entire investment portfolio through one service provider) can also provide access to ETFs and other wholesale managed funds.

Source: ASIC (sub. 40, att. 1); FSC and UBS (2017); Price and Schwarz (2015); SEC (2010, 2013)

Asset managers can specialise in certain asset classes (such as shares or property), investment strategies (active or passive) or the types of clients (such as retail or institutional clients) (FCA 2015a).

Distribution

As many wealth management products and services are often only directly available to wholesale investors (such as wholesale funds), distribution plays a crucial role in providing access to retail investors. Distribution can occur through a variety of means, including:

- fund managers

-
- financial advisers
 - platforms (accounts which allow investors to hold and manage a portfolio of investments)
 - off-platform.

This appendix will focus on the distributor roles of financial advisers and platforms, as they are the key channels by which retail investors can access wealth management products and services.

Financial advice

Financial advisers are an important distribution channel for financial products (chapter 7). Licensed financial advisers can recommend particular investment products and services, including asset management, to retail consumers. Financial advisers can also use platforms on behalf of clients to access these products and services.

What is financial advice?

Financial advice is regulated by Chapter 7 of the *Corporations Act 2001* (Cth) (Corporations Act). Under the Act, financial advice is called ‘financial product advice’, and means a recommendation or a statement of opinion, or a report of either of those things, that:

- (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
- (b) could reasonably be regarded as being intended to have such an influence. (s. 766B(1))

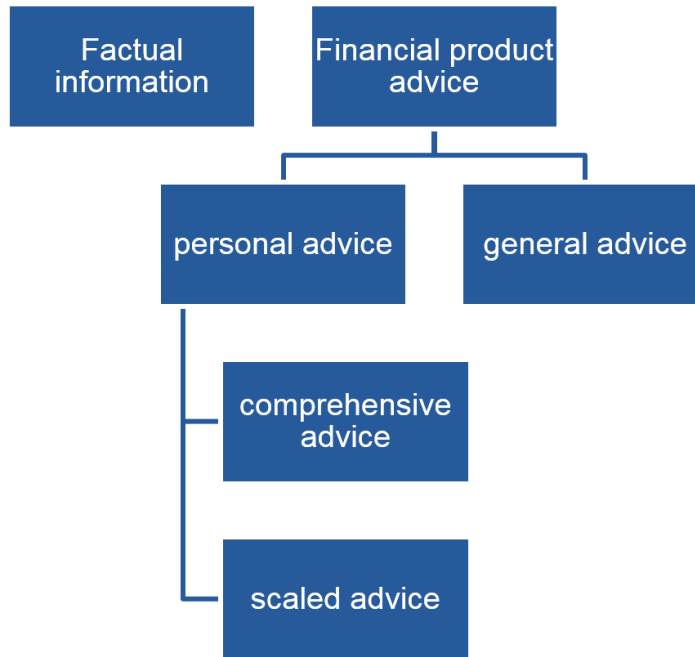
Financial advice generally involves a qualitative judgment about the features of a financial product (ASIC 2012). There are two forms of financial product advice (s. 766B(2); figure D.5):

- *personal advice* — where the provider of the advice has considered one or more of the person’s objectives, financial situation and needs, or a reasonable person might expect the provider to have considered one or more of those matters (s. 766B(3)). Personal advice can be further sub-divided into comprehensive advice (which looks holistically at a client’s financial circumstances) or scaled advice (which is limited in scope to a single topic or multiple topics and is often a lower cost option) (ASIC, sub. 40, att. 1).
- *general advice* — financial product advice that is not personal advice (s. 766B(4)). This includes guidance, advertising, and promotional and sales material highlighting the potential benefits of financial products. It comes with a disclaimer stating that it does not take a consumer’s personal circumstances into account (ASIC, sub. 40, att. 1).

Factual information about financial products is not considered to be financial product advice (ASIC 2012).

This appendix will focus on personal advice, as the majority of financial advisers (72%) are licensed to provide personal advice (ASIC, sub. 40, att. 1).

Figure D.5 **Financial product advice under the Corporations Act**



Source: ASIC (2012); *Corporations Act 2001* (Cth)

Licensed financial advisers

The Australian Government in 2012 began implementing the Future of Financial Advice (FOFA) reforms, which were designed to lift the standard of financial advice provided to consumers (boxes D.5 and D.6). This included the introduction of ASIC licensing requirements.

Financial advisers are required to hold a Australian Financial Service (AFS) licence issued by ASIC or become an authorised representative of a licensee, unless an exemption applies (ASIC 2014a). (The ‘accountant’s exemption’ was repealed on 1 July 2016. This exemption previously allowed recognised accountants to give financial product advice about Self-managed Superannuation funds (SMSFs) without an AFS licence (ASIC 2014g).)

An AFS licence includes authorisations to provide one or more of the following financial services:

- provide financial product advice to clients
- deal in a financial product
- make a market for a financial product

-
- operate a registered scheme
 - provide a custodial or depository service, or
 - provide traditional trustee company services (ASIC 2014a).

Recently, ASIC clarified its position on automated financial advice, and advised that digital financial advice providers are subject to FOFA requirements (box D.4).

Box D.4 Robo-advice

Robo-advice (also known as digital 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. The customer enters his or her personal details (such as age, gender, income, expenses, assets, financial goals and risk tolerance) into a computer program, which then generates financial advice based on these details and financial market information. Robo-advice is usually limited to one particular area (such as investment advice). Examples of computer-generated advice include advice on superannuation, investment and self-managed super funds. Fees for robo-advice may be charged on a fee-for-service basis, and/or a percentage fee of assets under management.

Individuals or entities who provide robo-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 license or be an authorised representative of an AFS licensee, unless an exemption applies. Robo-advisers are subject to the 'best interests obligations' as outlined below.

ASIC noted that the provision of digital advice has grown rapidly in Australia since 2014, with a number of start-up and existing AFS licensees developing digital advice models. In a survey by Investment Trends, 27% of the Australian online investor population had heard of robo-advice in 2016. The survey also estimated that about 12% of the Australian adult population are open to using automated investment services (in line with the UK, France and Germany), although customer uptake in Australia remains low compared to the US.

Source: ASIC (2016k, 2017ad; sub. 40, att. 1); Commonwealth of Australia (2012); Griffith (2017); Investment Trends (2016)

Box D.5 Key elements of FOFA reforms

FOFA is a major reform in financial advisory services. The objective is to increase the quality of personal financial advice, the transparency of fees, and to improve trust and confidence of retail investors in the financial planning sector. The reforms have been implemented in two stages — the original reforms in 2012, and later amendments.

Original FOFA reforms

The original FOFA package of legislation is mainly contained in amendments to the *Corporations Act 2001* (Cth) through the insertion of Part 7.7A of the Act. The reforms represent the Australian Government's response to the 2009 *Inquiry into Financial Products and Services in Australia*, which considered issues associated with major corporate collapses, including Storm Financial and Opes Prime. The main changes introduced were:

- best interests obligations (box D.6) — 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 interests, the provider must give priority to the client's interests when giving advice (ss. 960-961Q)
- ban on conflicted remuneration and other remuneration — remuneration that could be reasonably expected to influence the choice by, or advice of financial products to, retail clients. Volume-based benefits are presumed to be conflicted remuneration, unless it is dependent on the total value or number of financial products of a particular class or classes (s. 963L), while volume-based shelf-space fees (s. 964A) and asset-based fees on borrowed amounts (s. 964E) are banned remuneration (ss. 963-964H)
- 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 (ss. 962-962S)
- enhanced powers for ASIC.

Although the FOFA provisions became law on 1 July 2012, compliance became mandatory from 1 July 2013, with a facilitative period ending on 1 July 2014.

Later FOFA amendments

The *Corporations Amendment (Financial Advice Measures) Act 2016* (Cth) made a number of further amendments to the obligations of financial advisers, including extending the time period from which renewal notices and fee disclosure statements must be given, from 30 to 60 days from the relevant date. Also, the best interests obligation (s. 961B) and duty to give priority to client's interests (s. 961J) now expressly refer to insurance products.

Furthermore, from 1 January 2018, financial advisers of life insurance products will no longer be exempt from the ban on conflicted remuneration. ASIC will have powers (by legislative instrument) to set benefit ratios (maximum commission levels) and clawback requirements. The Australian Government has asked ASIC to conduct a review of these life insurance reforms in 2021.

Source: ASIC (2014f; sub. 40); Commonwealth of Australia (2012); *Corporations Act 2001* (Cth); *Corporations Amendment (Future of Financial Advice) Act 2012* (Cth); *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth); *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017* (Cth); *Corporations Amendment (Life Insurance Remuneration Arrangements) Regulations 2017* (Cth)

Box D.6 Best interests obligations of financial advisers

The best interests obligations cannot be contracted out and apply to all providers of financial advice, including licensees (ss. 960A, 961K-961L). These obligations include the:

- duty to act in the best interests of the client (s. 961B)
- duty to give resulting advice that is appropriate to the client (s. 961G)
- duty to warn clients of advice that is based on incomplete or inaccurate information (s. 961H)
- duty to give priority to the client's interests when there is a conflict of interest (s. 961J).

Prior obligations and legal context

Prior to 2013, there was no statutory obligation for financial advisers to act in the best interests of clients. However, there were statutory obligations to give advice that is appropriate to clients' needs (then s. 945A) and to disclose conflicts of interest in a Statement of Advice (then s. 947B).

There was (and still is) a best interests obligation on advisers in equity if a fiduciary relationship is found to exist in the circumstances, which is a question of fact. Fiduciary relationships are relationships of trust and confidence, arising from either agency or a relationship of ascendancy or influence by one party over another, or dependence or trust on the part of that other. The key feature of these relationships is that the fiduciary undertakes or agrees to act for, on behalf of, or in the interests of, another person in the exercise of a power or discretion which will affect the interests of that person. A fiduciary has a duty not to profit from the position, nor place himself or herself in a position where his interest and duty conflict, without the informed consent of the person to whom he or she owes the duty. Accepted fiduciary relationships include: trustee and beneficiary, agent and principal, solicitor and client, employee and employer, director and company, solicitor and client, wards and guardians, and partners.

Rationale — protection for retail clients against poor quality financial advice

In 2009, the Parliamentary Joint Committee on Corporations and Financial Services inquired into issues associated with financial product and services provider collapses, such as Storm Financial and Opes Prime, with particular reference to the role of financial advisers and other matters.

The Committee found that financial advisers had a conflict of interest. The role of financial advisers as a sales force for financial product manufacturers was viewed as potentially inconsistent with the contemporary expectation that financial advisers provide quality unbiased professional advice that meets their clients' best interests (particularly with a view to maximise their retirement income). Poor conflicted advice could lead to significant losses for consumers from poor investment performance or excessive fees.

Existing arrangements were regarded as unsatisfactory. Disclosure documents were inaccessible, and of limited use when the client trusted the adviser. The threshold for inappropriate advice was seen as low enough to allow advisers to prefer their own interests over the client's interests when giving advice. ASIC's enforcement of section 945A was also regarded as 'too slow'.

The Committee recommended that the Corporations Act be amended to explicitly include a fiduciary duty for financial advisers operating under an Australian Financial Service Licence, requiring them to place their clients' interests ahead of their own.

Source: ASIC, in the matter of NSG Services Pty Ltd v NSG Services Pty Ltd [2017] FCA 345; Breen v Williams (1996) 186 CLR 71; Commonwealth of Australia (2012); Corporations Act 2001 (Cth); Hospital Products Ltd v United States Surgical Corporation (1984) 156 CLR 41; PJCCFS (2009)

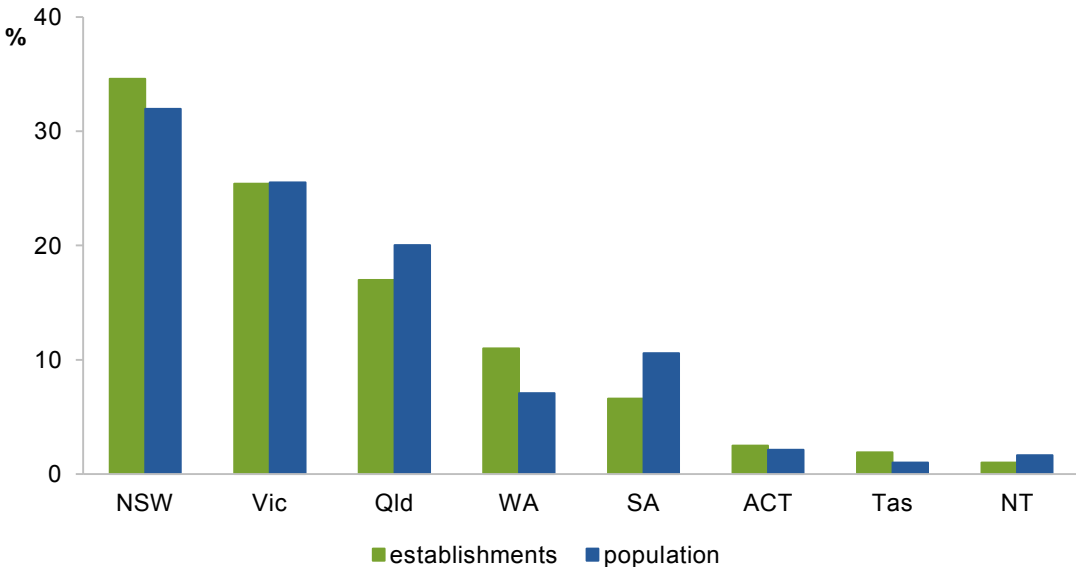
ASIC maintains the national register of licensed financial advisers, which was established on 31 March 2015. It contains details of persons who can provide personal advice on ‘relevant financial products’ to retail clients, as well as details such as relevant qualifications, training courses that the adviser has completed, work history, qualifications and products they can advise on. In 2016-17, the Register was searched more than 818 000 times (ASIC 2017a).

At 1 June 2017, there were 5822 AFS licensees who offered financial advice services to consumers, with the majority (4168 or 72%) authorised to provide personal advice (ASIC, sub. 40, att. 1).

Financial advice can either be directly provided by licensees, or by their authorised representatives (box D.7). At 3 October 2017, there were 25 459 financial advisers on the Financial Advisers Register — more than four times the total number of financial advice licensees (ASIC 2017f).

The majority of financial advisers are located in the eastern states — particularly New South Wales and Victoria — close to areas with business and financial centres, high population density and high proportion of high-income individuals (figure D.6).

Figure D.6 Distribution of financial advice establishments and population^a
June 2016



^a Per cent of establishments and per cent of estimated resident population, as at June 2016.
Source: ABS (Cat. no. 3101.0, *Australian Demographic Statistics, Mar 2017*); IBISWorld (2017)

Box D.7 Financial service licensees and authorised representatives

Who can provide financial advice?

Under the *Corporations Act 2001* (Cth), financial advice can be provided by:

- a financial services licensee. For example, an employee or director of the licensee are 'representatives' and do not need to be appointed as 'authorised representatives' (ss. 910A, 911B(1))
- a person or entity authorised by the licensee to provide particular financial services on behalf of the licensee ('authorised representative') (s 916A(1)). An authorised representative is exempt from the requirement to be licensed themselves (s. 911A(2))
- a person or entity authorised by an authorised representative (body corporate only) to provide specific financial services on behalf of the licensee (eg. an employee or director of a subsidiary company) (This is known as 'sub-authorisation' under s. 916B(3)). The licensee must give written consent to this appointment. This person is an authorised representative of the licensee (s 916B(6)).

Who can be an authorised representative?

Authorised representatives can be:

- individuals — such as employees and directors
- bodies corporate
- partnerships
- trustees of a trust.

In general, a financial services licensee cannot be the authorised representative of another licensee (s 916D), except when the other licensee is an insurer, and the authorised licensee acts under a binder given by the insurer (s 916E(1)).

What is the difference between a financial adviser and authorised representative?

ASIC maintains the Financial Advisers Register, which records individuals who are authorised to provide personal advice in relation to relevant financial products to retail clients.

Authorised representatives are natural or corporate persons who are authorised by a licensee to provide particular financial services on their behalf. This may include providing personal advice to retail clients in relation to relevant financial products or services. Authorised representatives are recorded on ASIC's Authorised Representatives Register, and also on the Financial Advisers Register (if they meet the definition of financial adviser).

Therefore in practice, an individual can be both a financial adviser and authorised representative. In both cases, the individual must operate within the terms of the licence.

Source: ASIC (2014b, 2014j, 2017q); *Corporations Act 2001* (Cth)

Consumers

The Act distinguishes between three types of consumers:

- retail clients (s. 761G Corporations Act, rr. 7.1.18-7.1.28 *Corporations Regulations 2001* (Cth)) — 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
- sophisticated clients (s. 761GA) — a person who is not a retail client generally because the client has previous experience in using financial service and investing in financial products
- wholesale clients (s. 761G(4)) — a person who is not a retail client is taken to be a wholesale client.

Additional statutory requirements on licensees mainly apply to personal advice provided to retail clients. For example, there are requirements imposed on licensees:

- to give a Statement of Advice (Part 7.7, Div 3) — which includes the advice given, and about any remuneration (including commissioning) the financial adviser will receive
- to act in the best interests of clients (‘best interests obligations’) (Part 7.7A, Div 2)
- in relation to charging ongoing fees to clients (Part 7.7A, Div 3)
- to avoid receiving conflicted remuneration (Part 7.7A, Div 4).

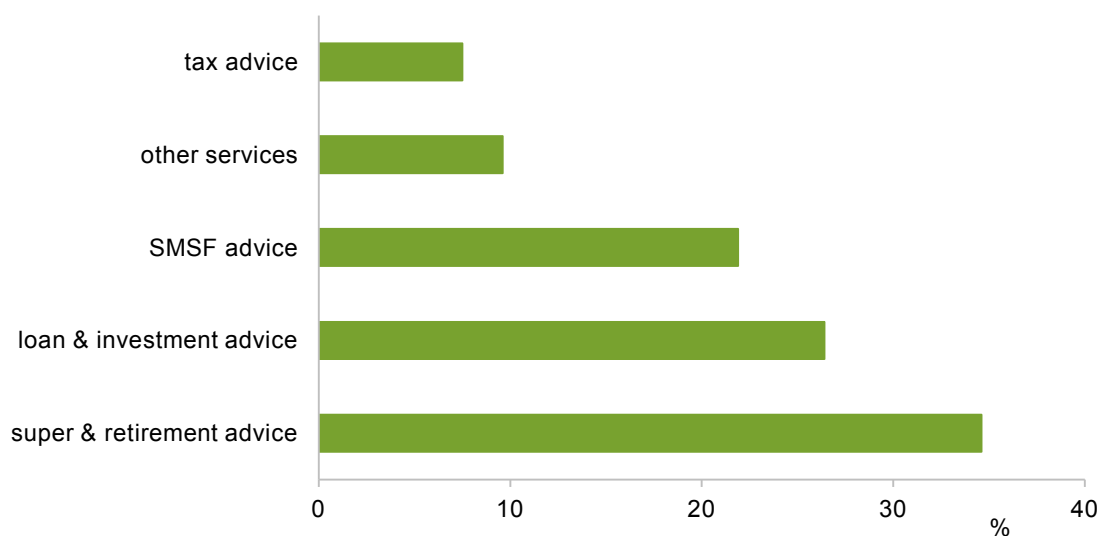
This appendix focuses on retail clients, as most licensees are authorised to provide services to retail clients and personal advice (St. John 2011; ASIC, sub. 40, att. 1). The FOFA reforms also focused on advice to retail clients as the Government saw a greater need for consumer protection for retail clients (Commonwealth of Australia 2012).

Data on retail consumers of financial planning and advice are limited, but the following observations can be made.

- ASIC (2010) estimated that between 20% and 40% of Australians use or had used a financial adviser in 2010.
- Investment Trends (2017a) estimated that the 2.6 million Australians sought advice from financial planners in 2016. Although this is double the number observed in 2013, the number of clients has fallen from 2007 (3 million) (Investment Trends 2017a; ASIC, sub. 40, att. 1).
- In 2016, Investment Trends (2016) also found that about half of the Australian adult population (48%) had unmet advice needs, most often relating to investment, tax and retirement planning. The two largest barriers to seeking advice are the perception of insufficient funds (27%) and the high cost of advice (20%) (ASIC, sub. 40, att. 1). That said, about 3 million Australia intend to seek financial advice in the next two years (Investment Trends 2017a).

- The Financial Planning Association of Australia (sub. 26) submitted that 30% of consumers have not sought financial advice and do not intend to seek advice in future. The high cost of advice is a key barrier to accessing financial advice.
- Most clients (about 83% of industry revenue) seek financial advice relating to superannuation (including self-managed super funds) and loan and investment advice (figure D.7)
- In general, people who accessed the most commonly used sources of financial advice:
 - are older (typically aged 50 to 64 years)
 - have a university education
 - work in an ‘upper white collar’ occupation or ‘blue collar’ occupation
 - have higher levels of savings and investments (\$100 000 or more)
 - have higher household incomes (greater than \$150 000) (ANZ 2015, figure D.8, box D.8).

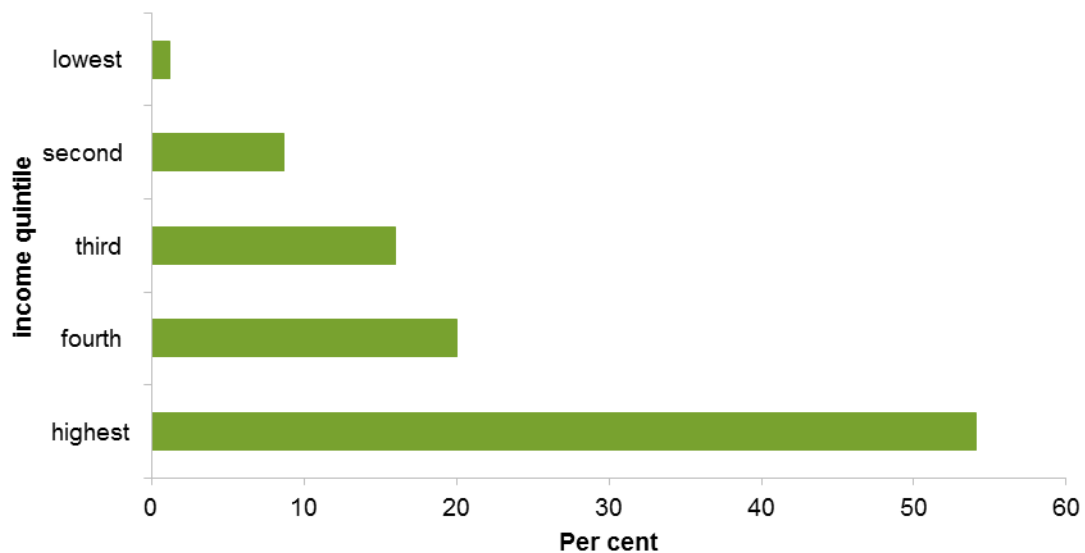
Figure D.7 **Type of financial advice sought by consumers^a**
2016-17



^a Per cent of industry revenue.

Source: IBISWorld (2017)

Figure D.8 **Financial advice clients by income level^a**
2016-17



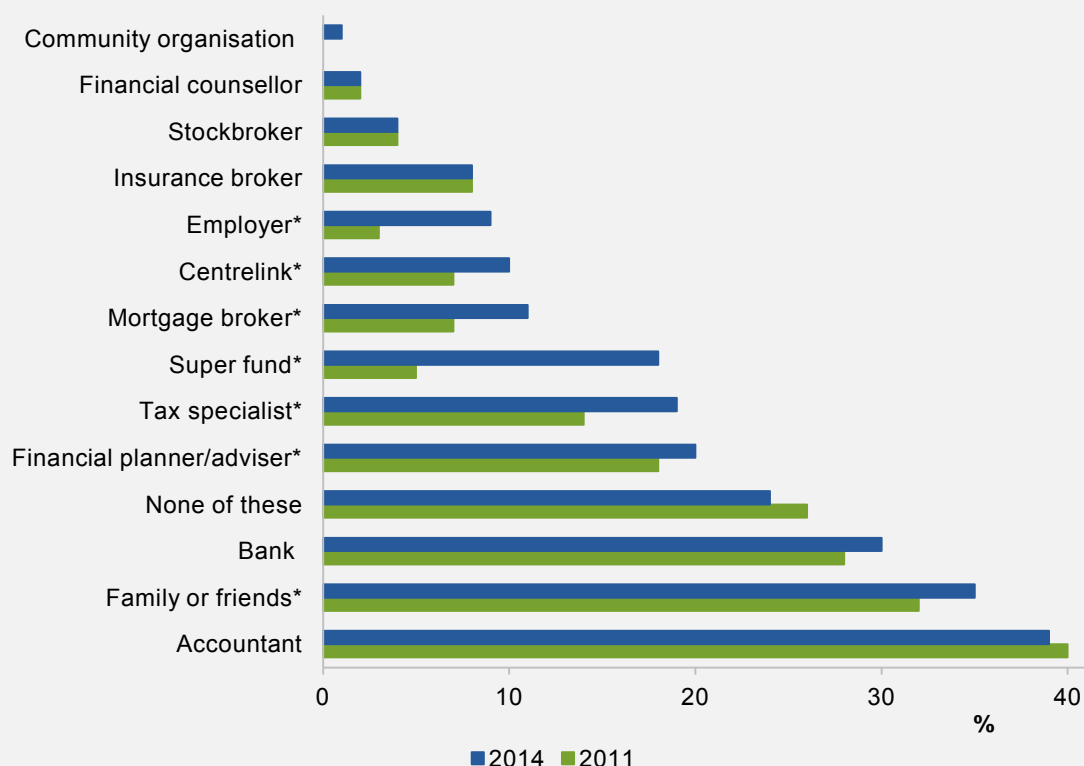
^a Per cent of industry revenue. Income quintiles based on mean equivalised income per week. Lowest income quintile = \$375 per week, second income quintile = \$615 per week, third income quintile = \$843 per week, fourth income quintile = \$1119 per week, and highest income quintile = \$2037 per week.

Source: IBISWorld (2017)

Box D.8 Access to financial advice and planning

In 2014, ANZ conducted a survey of 3400 people and found that about three-quarters of respondents had received financial information in the last 12 months from a variety of formal and informal sources (figure D.9).

Figure D.9 Sources of financial information^a
2011 and 2014



^a In 2011, n = 3502. In 2014, n = 3400, * = statistically significant at 5%.

While the overall use of professional financial management/planning specialists was unchanged at just over 50%, there were significant increases in the use of:

- taxation specialists (19%) — there was a notable increase in use among people with higher household incomes (incomes greater than \$65 000).
- financial advisers (20%) — usage among males aged 50 to 64 years increased from 26 to 33%.
- mortgage brokers (11%) — usage increased particularly among people with mortgages of \$300 000 or more
- superannuation funds (18%) — the largest increase occurred among those aged 50 to 64 years.

Source: ANZ (2015)

Cost of financial advice

Financial advisers charge on a fee-for-service basis for services they have provided. The cost of financial advice can be broadly divided into three categories:

- upfront fees — such as 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 — such as for regular reviews with financial advisers, regular reports on a client's investment portfolio, platform administration fees and investment management fees
- commissions and volume-based payments for recommending financial products — these are banned on *new* investments and superannuation products from 1 July 2013, but still exist for investment products purchased prior to this date (ASIC 2016e, 2017p).

In 2016, ASIC investigated the major banks, AMP and Macquarie, and found several instances of fees for no service. This related to cases where customers were subject to automatic periodic payments (including commissions), even though there was no clear agreement between advisers and customers about what specific services would be provided in return for these automatic payments (ASIC 2016e).

There are no comprehensive publicly available data on the average cost of financial advice to both consumers and financial advisers. The cost of advice will depend on factors such as its scope and the client's circumstances, and can range from \$200 to \$700 for simple advice, and between \$2000 and \$4000 for more comprehensive advice (ASIC 2017p).

However, there appears to be a significant gap between what consumers are willing to pay and the actual cost of supplying financial advice.

According to licensees, the cost of providing advice is on average \$2,500 to \$3,500 ... This is considerably more than the average \$301 that consumers are prepared to pay to receive advice. (ASIC 2010, p. 47)

Licensees reported that the significant gap was due to high fixed costs (ASIC 2010).

The gap appears to have narrowed slightly in recent years, with an increase in the amount consumers are willing to pay for financial advice. Investment Trends (2017a) surveyed 9552 Australian adults and found that Australians are willing to pay \$750 on average for advice, but the financial planners' estimated average cost of delivering advice was \$2500 (although the estimated cost may differ from the actual price charged).

Platforms

Consumers can also access investment products by using platforms, which are typically online services that allow investors to manage their investment portfolios (box D.9, chapter 7). In 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). (Box D.9 provides a comparison of master trusts and wraps). In

addition, the majority of platform assets (80%) were invested for superannuation and retirement purposes, whereas only 20% of platform funds were for investments outside of superannuation and retirement (FSC and UBS 2017).

The size of the platform market has expanded over time. Platform funds under management⁸⁹ has grown steadily from about \$8 billion in June 2012 to \$21 billion in June 2017 (Plan For Life 2015; Strategic Insight 2017). While annual net fund flows are significant, they remain about half of their pre-GFC level (figure D.10).

Figure D.10 Annual net fund flows to platforms
2005-06 to 2016-17



Source: Plan For Life (2015); Strategic Insight (2017)

⁸⁹ Strategic Insight (2017) uses the term ‘masterfunds’, which includes master trusts, platforms and wraps. The Commission considers these as all forms of platforms.

Box D.9 Retail investment platforms

Platforms (which ASIC calls ‘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). In general, there are two main types of platforms:

- master trusts (sometimes known as ‘fund supermarkets’)
- wraps.

Table highlights the main differences between the two platforms.

Key differences between master trusts and wraps

	<i>Master Trust</i>	<i>Wrap</i>
<i>Trustee operator</i>	Yes	Yes
<i>Value of member’s investment determined by value of ...</i>	Investment	Asset
<i>Type of investments</i>	Managed funds only	For example, managed funds and direct shares
<i>Fees and taxes bundled into unit price</i>	Yes	No
<i>Income distributed by</i>	Master trust, then distributed to members	Member’s cash account
<i>Franking credits distributed by</i>	Unit price	Member’s cash account
<i>Assets portable?</i>	No — funds are specific to the master trust. Need to sell current investment.	Yes

Platform fees may include administration fees (usually a percentage of FUM), entry and exit fees, management fees for investment options, and service fees from a financial adviser.

Retail investment platforms are also often aimed at different consumers, which can be directly accessed by retail investors (known as ‘direct-to-customer’ platforms), or intermediated by financial advisers and planners (known as ‘business-to-business’ platforms), who can use them on behalf of investors. The latter are most common in Australia, and is the focus of this appendix.

Source: ASIC (2017y, 2017z); FCA (2015a); Stevens (2015)

D.4 Competition in the wealth management sector

The state of competition in the wealth management market (asset management and financial advice) can be assessed in terms of its concentration levels, profitability and distribution.

Asset management

Concentration

The funds management market is dominated by Macquarie, AMP, CBA and Westpac (table D.1, chapter 7). Currently, the major banks hold a sizeable value of AUM, which reached almost \$492 billion at the end of June 2016. This is equivalent to a market share of about 16% of total FUM (figure D.11).⁹⁰ Macquarie holds the largest market share of close to 18%, while AMP's market share is about 9%. These six financial institutions together control about 43% of the market by AUM. Despite this, foreign fund managers and specialised fund managers have a relatively significant presence in the wealth management market (Golat 2016, table D.1).

Table D.1 Australia's top 10 asset managers are mostly big banks

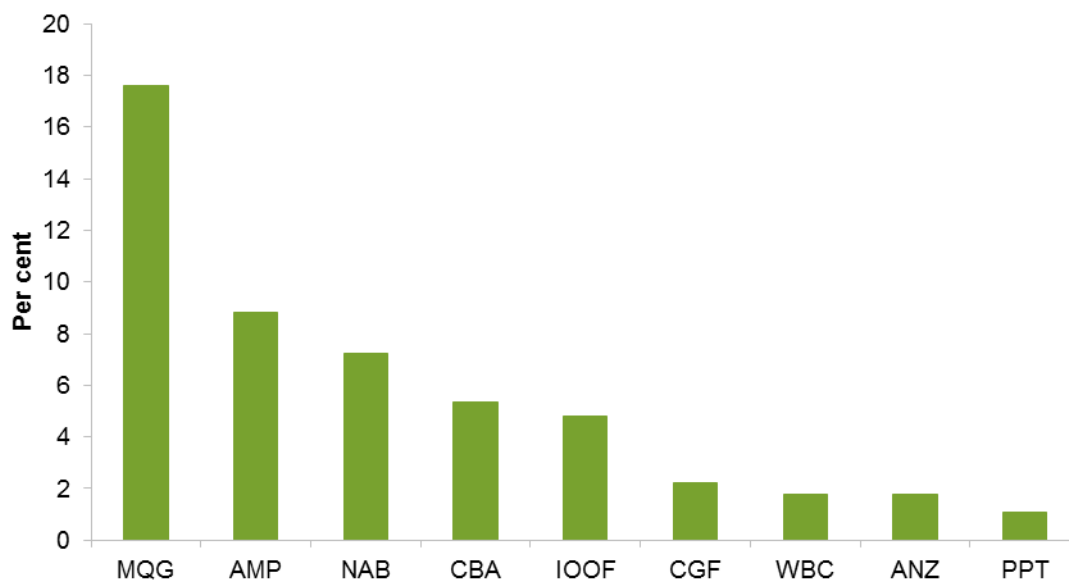
31 December 2016

<i>Manager</i>	<i>Australian rank</i>	<i>Global rank</i>	<i>AUM (\$US mil)</i>
Macquarie Group	1	52	362 511
Colonial First State (CBA)	2	102	147 154
AMP Capital	3	120	119 976
BT Investment Management (WBC)	4	182	60 699
QIC	5	193	57 453
IFM Investors	6	203	54 486
Challenger	7	227	47 230
Westpac Banking	8	269	34 974
Magellan Asset Management	9	275	33 612
Goodman Group	10	318	25 147

Source: Willis Towers Watson (2017)

⁹⁰ By way of comparison, the RBA estimated that the major banks' share of AUM (Australian total) increased from 13% in the late 1990s to around 20% in 2016 (Golat 2016). ASIC (sub. 40) estimated that the major banks hold about 21% of superannuation and fund manager AUM.

Figure D.11 Major asset managers' market share by FUM^{a,b,c,d}
30 June 2016



^a MQG = Macquarie Group, CGF = Challenger Group, WBC = Westpac, PPT = Perpetual. CBA figure is the average funds under administration (FUA). ^b NAB figure includes FUA. At 30 June 2016, FUA for Westpac and CBA were \$130.8 and \$134.2 billion respectively. ^c Westpac data for BT Financial Group only. ^d Market share is the value of funds under management as a proportion of the consolidated assets of managed funds institutions.

Source: ABS (*Managed Funds, Australia, Jun 2017*; Cat. no. 5655.0; table 1; accessed 24 October 2017)

Performance

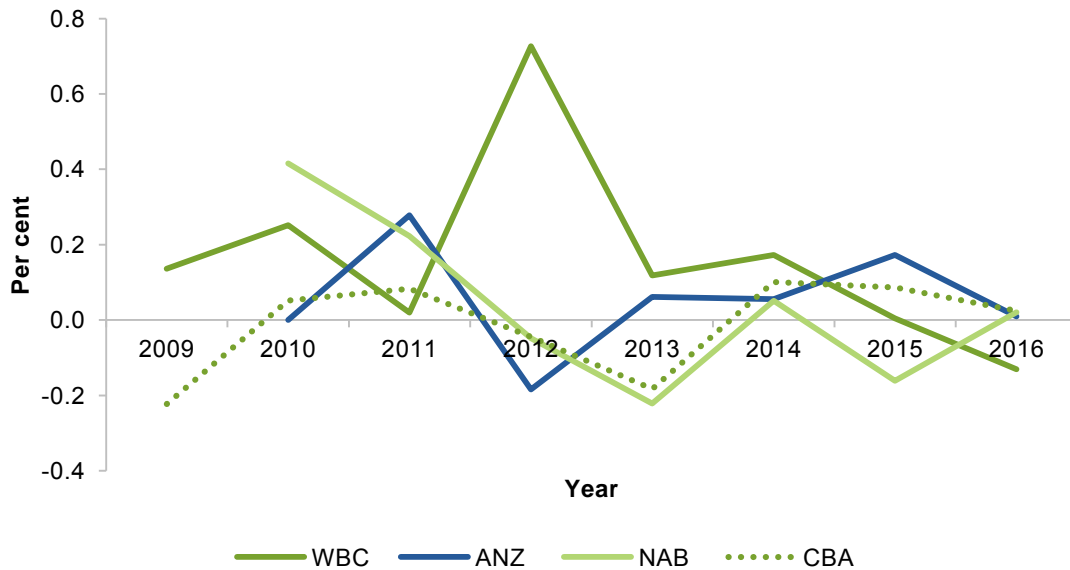
For the major banks, wealth management revenue has been relatively stagnant for some time (figure D.12). On average, funds management continues to be the largest source of wealth management revenue (figure D.13), but the data indicate that this share (together with financial advice and planning) has fallen in recent years, while insurance and superannuation have grown.

The 'asset turnover ratio' (measured by revenue 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. There appears to be significant variation in this ratio among the major banks in providing wealth management services (figure D.14).

Performance can also be measured by the expense ratio, which indicates what it costs to run an investment fund. Calculated by dividing the fund manager's operating expenses by the value of AUM, the ratio represents the percentage of a fund's assets that is spent on operating expenses. In 2015-16, the major banks had higher expense ratios than some of the focused fund managers (figure D.15). Similarly, most of the major banks had a higher ratio of

expenses to revenue from funds management, compared to that for specialist fund managers (figure D.16).

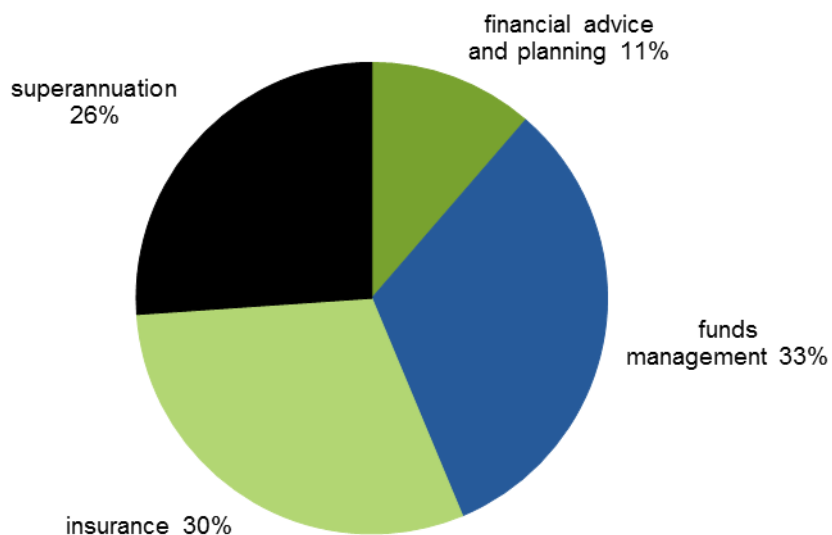
Figure D.12 Major banks' wealth management revenue growth^a
2008-09 to 2015-16



^a Funds 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 funds management business (BT Investment Management) from 59% to 31% in 2015, NAB's acquisitions of Aviva Australia and JBWere in 2009 and 2016, 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: Annual reports; NAB (2016)

Figure D.13 **Banks' income from wealth management^a**
2016



^a Average share of total wealth management income.

Source: Unpublished ADI data

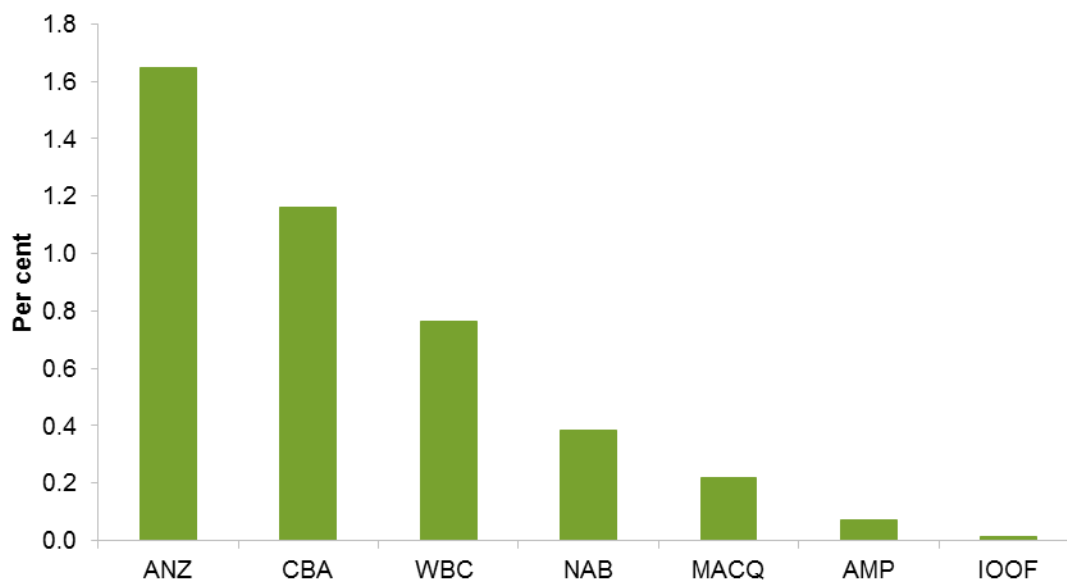
Figure D.14 **Major banks' funds management asset turnover ratio^a**
2016



^a Funds management income divided by FUM.

Source: Annual reports

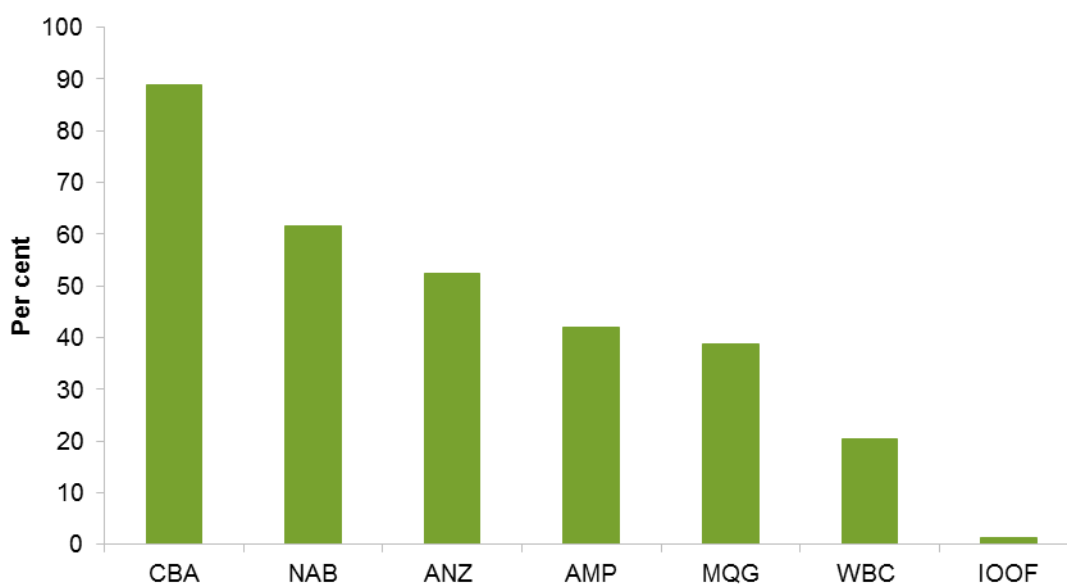
Figure D.15 **Operating expense to FUM ratio^a**
2015-16



^a Westpac data for BT Financial Group only.

Source: Annual reports

Figure D.16 **Operating expense to FUM income ratio^a**
2015-16



^a Westpac data for BT Financial Group only.

Source: Annual reports

Financial advice

Concentration

The top five operators, the major banks and AMP, collectively hold a market share of about 48% by industry revenue (figure D.19). Since 2011, the number of financial advice establishments, enterprises and employees has fallen (figure D.17). The Murray Financial System Inquiry (2014b) noted that since the 1997 Wallis Financial System Inquiry, a number of financial planners had consolidated or moved in-house to work directly for wealth management institutions.

Based on ASIC's Financial Advisers Register as at 3 October 2017, the following observations can be made:

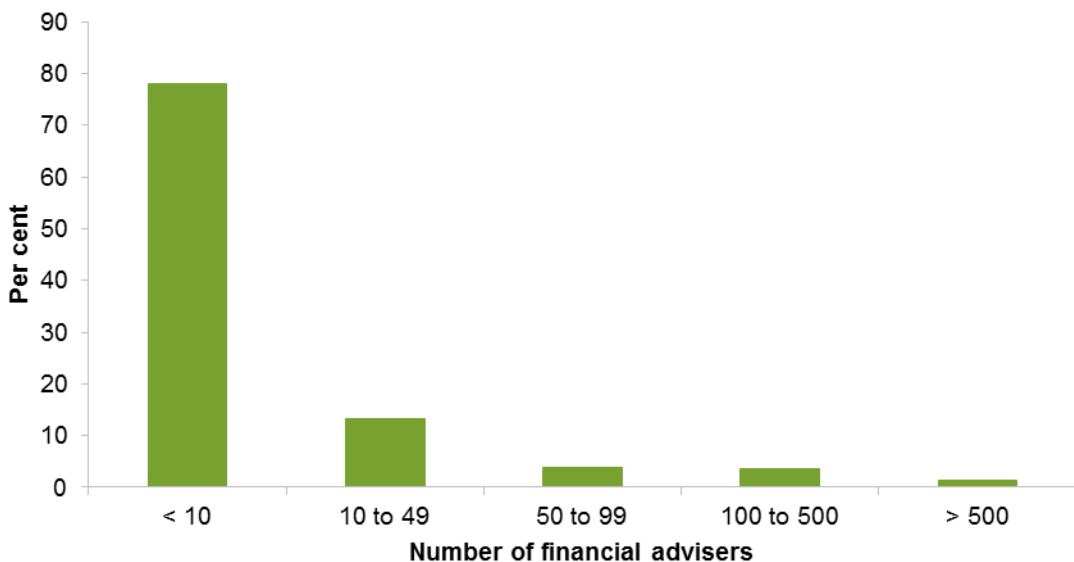
- 44% of advisers (including aligned and non-aligned) operate under a licence controlled by the largest 10 entities
- the largest 6 entities — the major banks, AMP and IOOF Holdings — have over 35% of total (including aligned and non-aligned) advisers operating under a licence they control (figure D.20)
- about 30% of the total number of financial advisers on the Register work for one of the major banks
- the majority of financial advisory firms are small (figure D.18). About 78% of advice licensees operate a firm with less than 10 financial advisers, about 90% with less than 50 advisers, and 95% with less than 100 financial advisers. The average number of financial advisers operating under a licence is 34 individuals (ASIC 2017f; ASIC, sub. 40, att. 1)

Figure D.17 Annual change in number of establishments, enterprises and employment^a
2007-08 to 2016-17



Source: IBISWorld (2017)

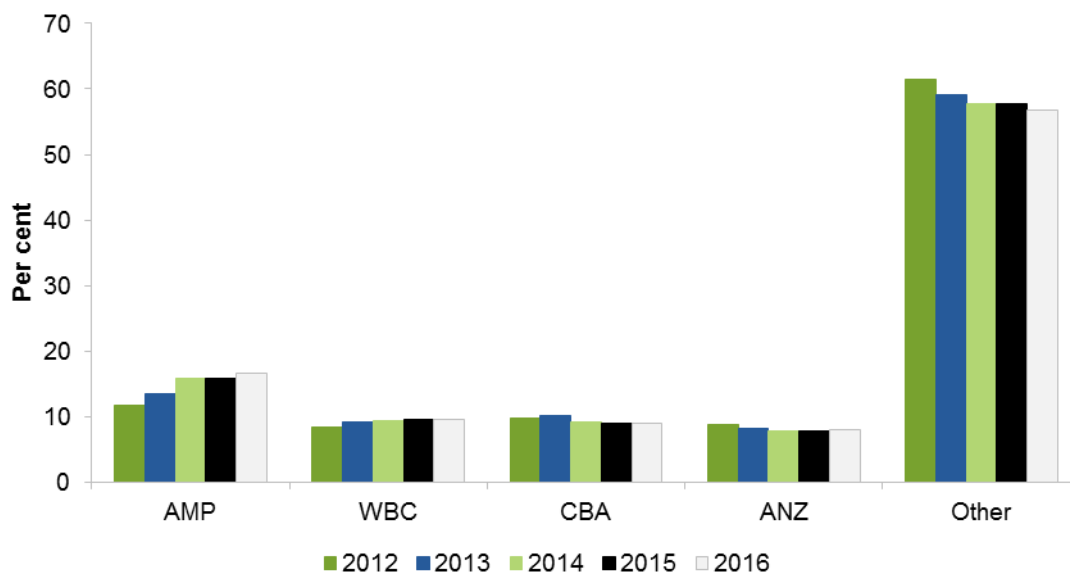
Figure D.18 Firm size by number of financial advisers^a
As at 3 October 2017



^a Those operating under a licence controlled by an entity. About 1% had more than 1000 advisers.

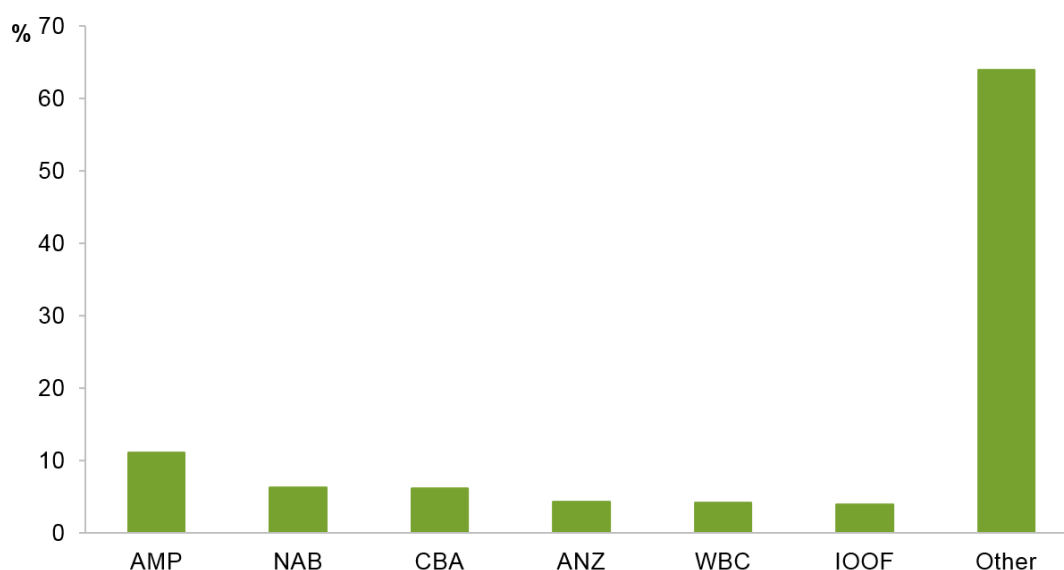
Source: ASIC (2017f)

Figure D.19 Financial advice market share by industry revenue^a
2012-13 to 2016-17



^a Per cent of industry revenue. NAB not reported because data only available for 2016-17 (4.8%).
Source: IBISWorld (2017)

Figure D.20 Financial advice market share by number of financial advisers^a
As at 3 October 2017



^a Includes financial advisers operating under a licence controlled by the entity and non-aligned financial advisers.
Source: ASIC (2017f)

Performance

In 2015-16, Australia's financial planning sector was estimated to be worth \$4.6 billion in revenue (IBISWorld 2017). However, industry revenue growth has declined, particularly in the past few years (figures D.21 and D.22).

Growth in financial advice and planning revenue of the top 5 entities — Commonwealth Bank, ANZ, Westpac and AMP — has slowed since 2014 (figure D.22). In 2016, their combined revenue was about \$2 billion from providing financial advice and planning services, equivalent to over 40% of industry revenue (IBISWorld 2017).

Distribution — alignment of financial advisers

The industry is dominated by dealer groups or financial advisory networks, which operate under their own separate brand name and AFS licence (IBISWorld 2017). Generally, financial advisers fall into two categories:

- non-institutional operators (known as independent or non-aligned financial advisers)
- those that are backed by a financial institution (often referred to as aligned or tied advisers).

Alignment (affiliation with other financial institutions) can occur via vertical ownership structures, contractual relationships, commissions and other forms of remuneration (chapter 7). The data may underestimate the actual number of aligned financial advisers as it does not incorporate ASIC's new guidance on restrictions on the use of the word 'non-aligned' (box D.10).

The number of financial advisers aligned to the banks has slightly decreased in recent years (figure D.24). On average, the data indicate that about half of the major banks' financial planners are part of their distribution channels.

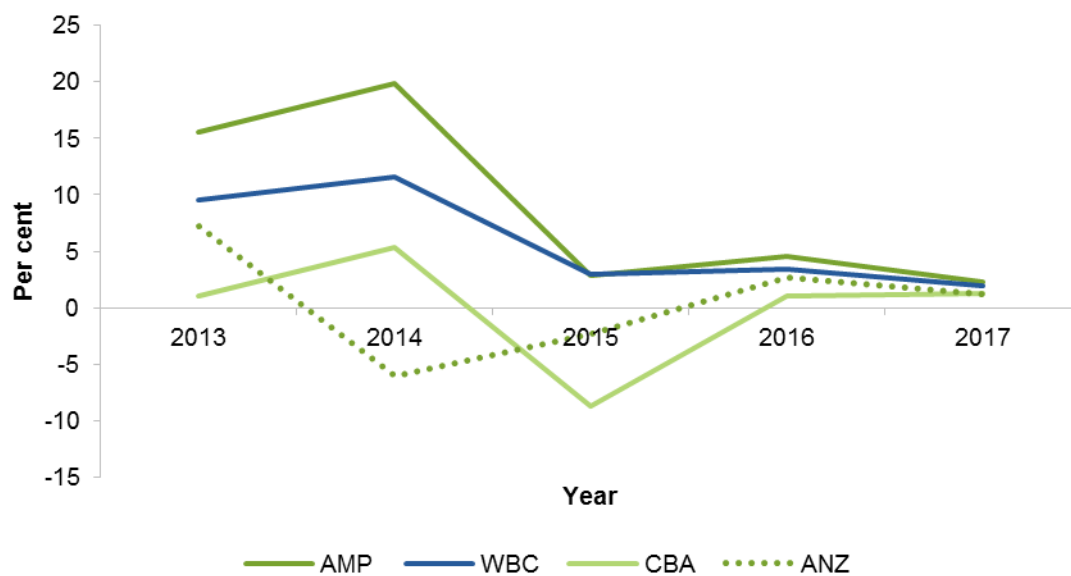
Alignment is also partly affected by the number of licences controlled by a financial institution. The major banks, which have the largest number of financial advisers working for them, control multiple licences held by their controlled entities (figure D.23). For example, NAB controls five licences, with close to 70% of its advisers in related entities operating under licences controlled by NAB.

Figure D.21 Financial advice and planning industry revenue growth
2004-05 to 2016-17



Source: IBISWorld (2017).

Figure D.22 Top 5 entities' annual change in financial advice and planning revenue
2012-13 to 2016-17

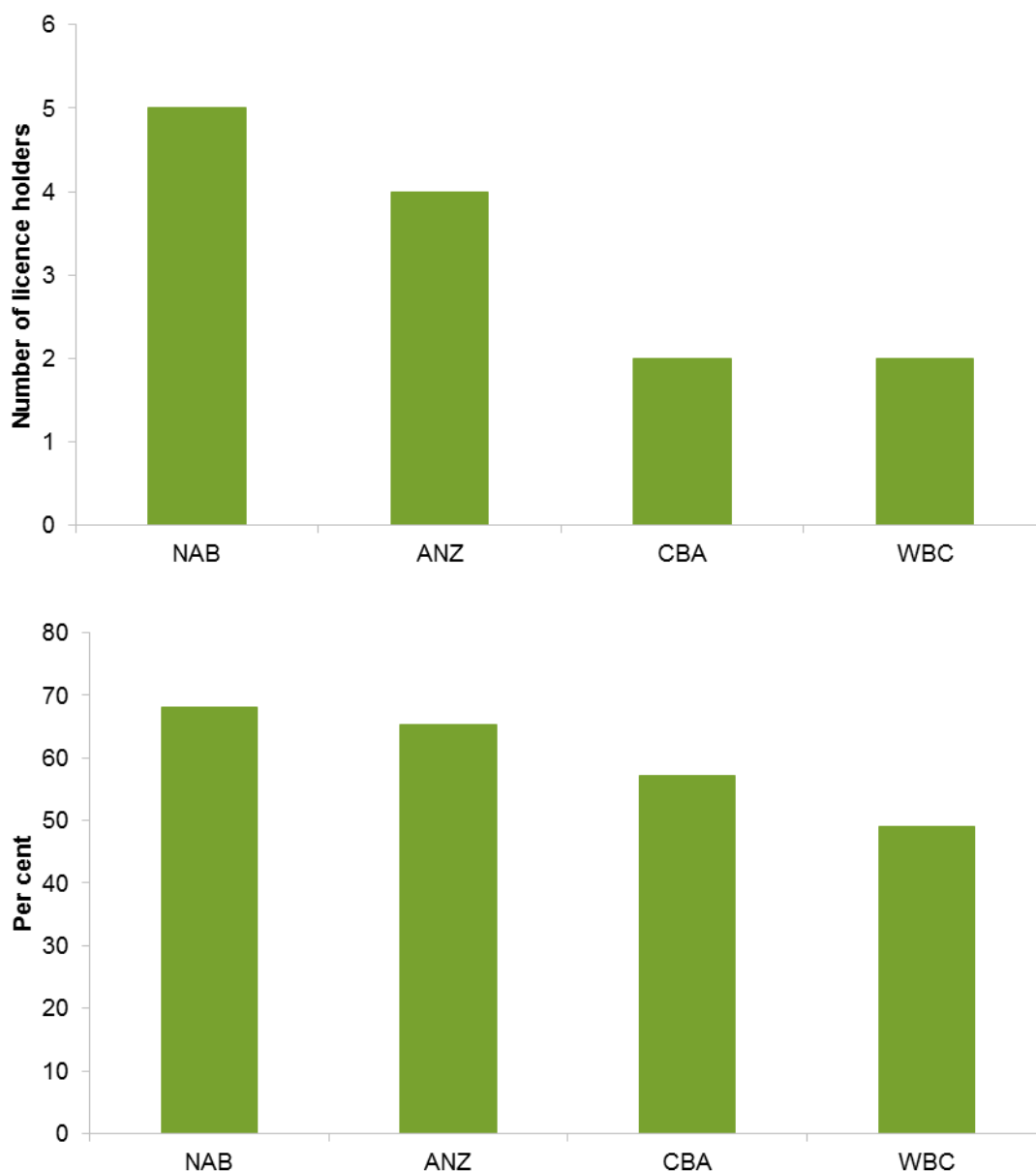


Source: IBISWorld (2017)

Aligned financial advisers often have access to the affiliated financial institution’s platforms and products. Most banks have an approved product list (APL) — a list that contains financial products that advisers have been specifically authorised by AFS licensees to provide advice about. These products can be either ‘in-house’ (products that are provided by a related party such as a bank or other financial institution the adviser is employed by) or from an unrelated product provider (chapters 7 and 12). In practice, many APLs contain in-house products (ASIC 2017r), which can affect the variety of products available to consumers. Depending on the institution, unrelated product providers can pay banks ‘shelf-space fees’ to appear on the list, although volume-based shelf space fees are now banned (Corporations Act ss. 964-964A). ASIC’s Financial Advisers Register contains the product areas that a financial adviser can provide advice on; however, the APL itself is usually not publicly available.

Fees and commissions paid to aligned advisers by the banks have been relatively flat over the past decade or so, and recovered from their decline in the immediate aftermath of the global financial crisis (figure D.24). More recently, total fees and commissions have fallen, but have risen on a per adviser basis.

Figure D.23 Major banks' number of additional AFS licence holders and share of financial advisers operating under these licences^{a,b}
 As at 3 October 2017



^a Licences held in the name of an entity controlled by the major banks, in addition to licences held in the name of the major banks themselves. NAB = Meritum, JB Were, Apogee Financial Planning, Godfrey Pembroke and GWM Adviser Services, ANZ = Elders Financial Planning, Financial Services Partners, Millennium 3 Financial Services and RI Advice Group, CBA = Count Financial and Financial Wisdom, WBC = Securitor and Magnitude Group. ^b Per cent of each bank's total financial advisers operating under a licence.

Source: ASIC (2017f)

Box D.10 What is an ‘independent’ financial adviser?

Under s. 923A of the Corporations Act, there are restrictions on the use of certain words or expressions, to protect consumers and investors from being misled or confused when making investment decisions or choosing an adviser. Restricted terms include the word ‘independent’, ‘impartial’ or ‘unbiased’. A person cannot use these words, or any other word or expression that is of like import, unless the following conditions are satisfied:

- the person (or the person’s employer) does not receive commissions (apart from commissions that are rebated in full to the person’s clients)
- the person (or another person who provides the financial service on behalf of that person) does not receive forms of remunerations calculated on the basis of the volume of business placed by the person with an issuer of a financial product. Asset-based fees (which depend on the amount of funds used or to be used to acquire financial products by or on behalf of the person, s 964F) are not captured by s 923A
- the person (or any other person identified in regulations) does not receive other gifts or benefits from an issuer of a financial product which may reasonable be expected to influence the person
- the person operates free from direct or indirect restrictions relating to the financial products in respect of which they provide financial services (this excludes restrictions imposed on a person by the conditions on an AFS licence or the Act). An Approved Product List (a list of financial products used by licensees for their representatives to consider when providing financial advice to their clients) could constitute a restriction, but this will depend on the operation and breadth of the APL
- the person operates without any conflicts of interest that might arise from their associations or relationships with issuers of financial products, and reasonably be expected to influence the person in carrying on the business or providing the services (ss. 923A(2) and 923A(3)).

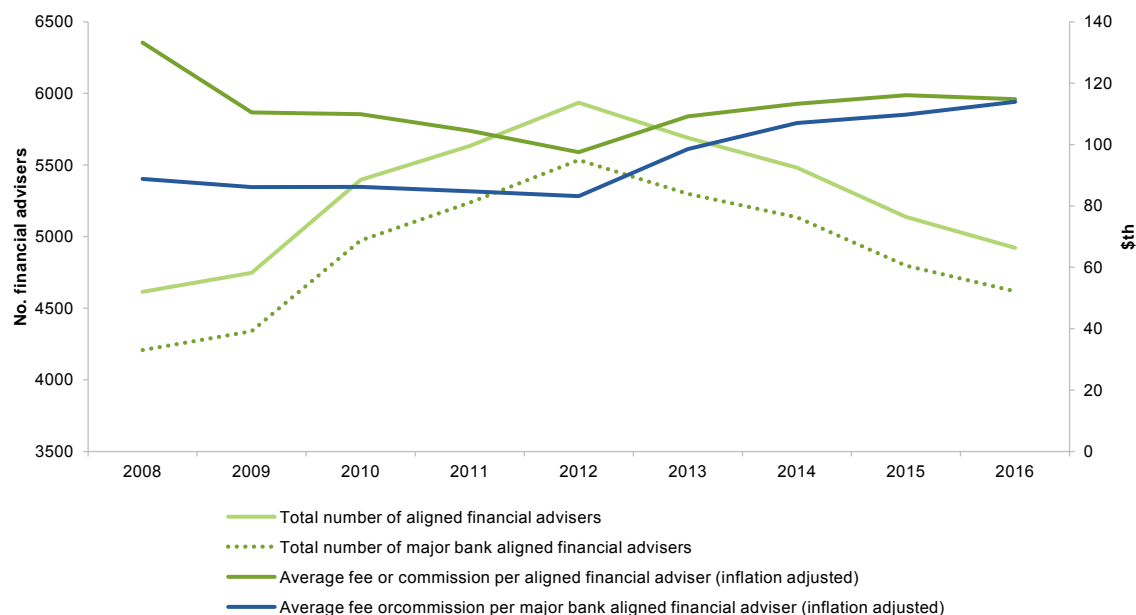
Recently, there has been uncertainty surrounding whether phrases relating to the independence of financial advisers are also restricted terms. These include ‘independently owned’, ‘non-aligned’ and ‘non-institutionally owned’. These terms are often used to convey the ownership and structure of the financial service provider.

On 27 June 2017, ASIC clarified its position, and advised that these terms can only be used if a financial adviser satisfies the conditions set out in section 923A, as these are terms of ‘like import’ to the words ‘independent’, ‘impartial’ or ‘unbiased’ (s 923A(5)(a)(iii)).

In light of such uncertainty, ASIC has provided a facilitative compliance period of six months so that firms that do not satisfy the conditions of section 923A can change websites and documents to remove the terms (there is no facilitative compliance period for the words ‘independent’, ‘impartial’ or ‘unbiased’ as there is no uncertainty). ASIC also notified key interested stakeholders about its position on section 923A by letter, and will update its Regulatory Guide 175.

Source: ASIC (2017d); *Corporations Act 2001* (Cth)

Figure D.24 **Aligned financial advisers' average fees and commissions^a**
2008 — 2016



^a Number of financial adviser series include data from 9 ADIs. Fee and commission series include data from 7 ADIs.

Source: Unpublished ADI data

Platforms

Concentration

As noted earlier, platforms allow investors to hold and manage a portfolio of investments. Currently, there is a relatively high level of concentration in the platform market, which is dominated by large financial institutions.

- In 2014, the five largest platform providers held almost 80% of primary financial planner relationships (Murray et al. 2014b). The two most widely used platforms among financial planners are CBS FirstChoice (CBA) and BT Wrap (Westpac), with 32% and 29% using each for their new clients respectively (Investment Trends 2017b).
- As at 31 March 2017, the top five masterfund administrators⁹¹ — controlled by BT Financial (Westpac), AMP, CBA/Colonial, NAB/MLC Group and Macquarie Group — accounted for about 76% of the total \$748 billion platform FUM, and about 45% of the

⁹¹ 'Masterfunds' is defined by Strategic Insight to include wraps, platforms and master trusts. Wraps are masterfunds through which investors can invest in direct shares and generally charge one consolidated fee; platforms are masterfunds that have multiple divisions — generally superannuation, allocated pension and investment divisions; master trusts include the remaining master fund products (Strategic Insight 2017; ASIC, sub. 40, att. 1).

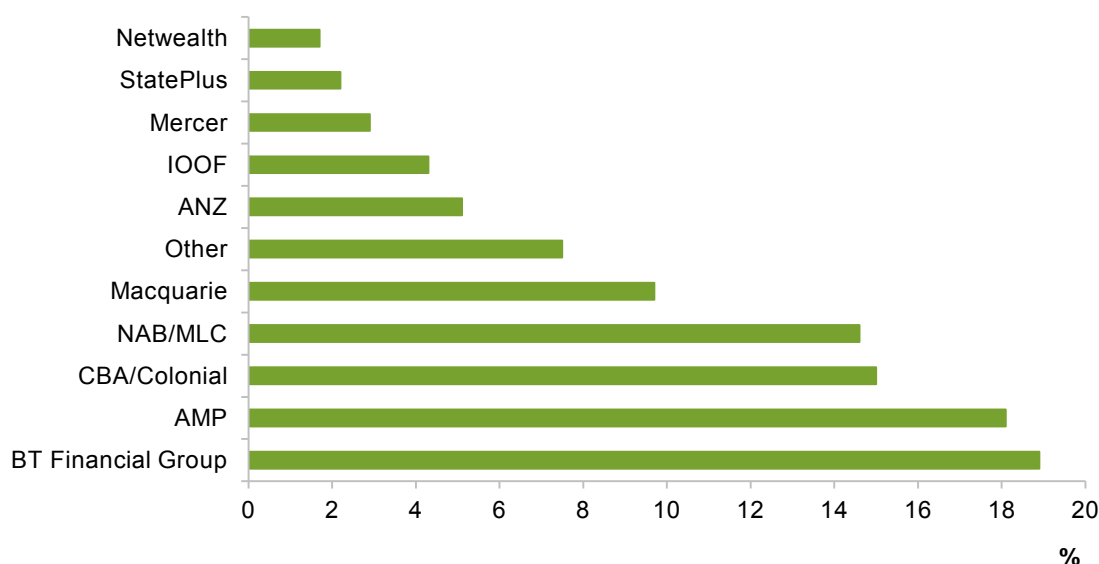
\$16 billion total net flows to masterfund administrators (ASIC, sub. 40, att. 1; figures D.25 and D.26). There has been relatively little movement in the market shares of the top five fund administrators (Plan For Life 2015; Strategic Insight 2017).

- While specialist or independent platform providers (as new entrants) have a relatively small market share by FUM, they appear to attract a sizeable proportion of annual net inflows of the industry.
- Data provided to the Commission suggest that the major banks hold an estimated market share of more than 90% by number of platform customers (figure D.27).

Based on the available data, just over half of the banks' wealth management customers use platforms, with take-up rates relatively stable since 2014. This trend is also evident in terms of AUM, with the majority of AUM invested on platforms. That said, there is significant variation in platform usage rates. The data indicate that platform usage has increased at most banks, although the customer and platform type are unclear. The data also suggest that platform usage by pre-existing customers is highest among the other banks, whereas off-platform usage by pre-existing customers is relatively high at the major banks. Platform customer retention also appears to be increasing (figure D.27), especially at the major banks.

Figure D.25 Platform market share by FUM

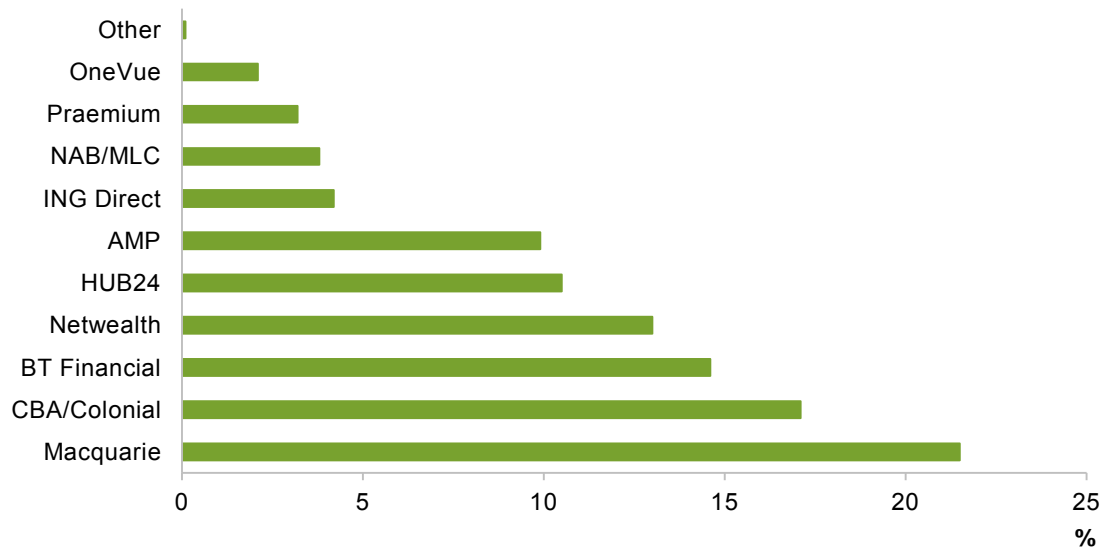
30 June 2017



Source: Strategic Insight (2017)

Figure D.26 **Platform market share by annual net fund flows^a**

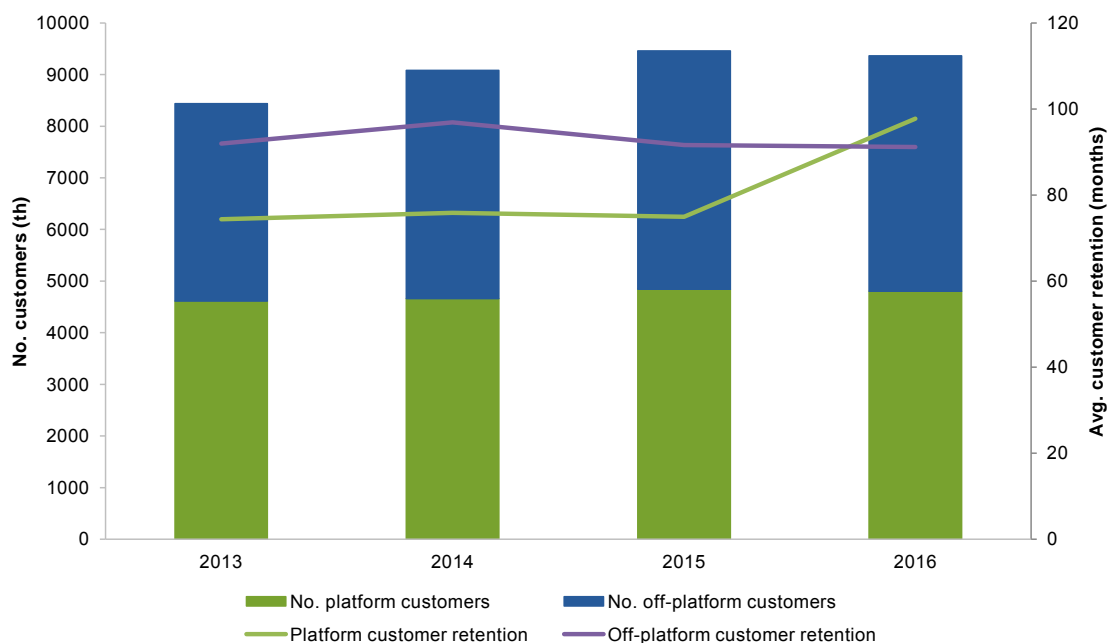
31 March 2017



^a Macquarie includes transition from Oasis (ANZ) to Macquarie.

Source: Thompson et al. (2017)

Figure D.27 **Platform market share by number of customers and customer retention^a**
2013 — 2016



^a 'Number of customer' series include data from 8 ADIs. 'Customer retention' series include data from 7 ADIs. Customer retention data weighted by ADI customer market share.

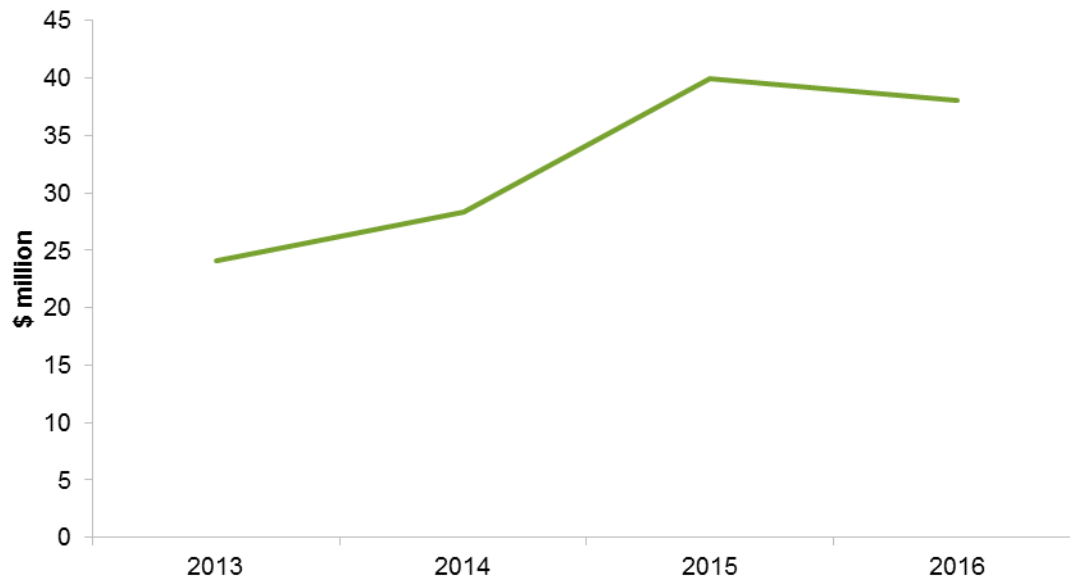
Source: Unpublished ADI data

Performance

Product providers pay platforms fees known as 'shelf-space fees' in order to place their investment product on platforms, which can then be purchased by investors. Such fees can affect the price and variety of investment products available to investors, but the extent is unclear in practice.

The banks' annual shelf-space revenue has trended upwards, but appears to have plateaued more recently (figure D.28). However, it is difficult to determine whether this is due to fees, investment or product volumes, vertical integration, or a combination of these factors.

Figure D.28 **Banks' shelf-space fee revenue**
2013 - 2016



Source: Unpublished ADI data

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