Australian Government
Productivity Commission

PRODUCTIVITY COMMISSION

INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

MR P HARRIS, Commissioner
DR S KING, Commissioner

TRANSCRIPT OF PROCEEDINGS

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INDEX

	Page
CHOICE MR ALAN KIRKLAND MR XAVIER O'HALLORAN	**3-24**
BENDIGO AND ADELAIDE BANK MR RICHARD FENNELL MR TRAVIS CROUCH	**24-35**
WESTPAC MR PETER KING MR CURT ZERBER	**35-51**
AUSTRALIAN COMPETITION AND CONSUMER COMMISSION MR MARCUS BEZZI MS MOLLY CHOUCAIR	**51-61**
XINJA LTD MR ERIC WILSON MS VAN LE	**61-74**
MR PETER MAIR	**74-83**

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MR HARRIS: Good morning, everybody, and I'm going to open the public hearings for the Productivity Commission's Inquiry into Competition in the Australian Financial System. There are three commissioners on this inquiry, two of us are here today. Our third commissioner is delayed by health issues in Melbourne. So Stephen King is on my right, and I'm Peter Harris, Chairman of the Productivity Commission. I would like to offer a welcome to country. I would like to acknowledge that we meet on the land of traditional owners of the Gadigal People of the Eora Nation in a place called Sydney.

The purpose of this round of hearings is to facilitate some public scrutiny of our draft report and we're going to assume that people who are submitters have read the draft report. I would also note I did a speech on Monday to CEDA which tried to explain some of the thinking behind some of the parts of recommendations that appeared to have been the subject of public comment and perhaps may not have been as clearly understood as we would have liked. So for those of you interested in it there is this speech on our website which I did to CEDA on Monday if it's also potentially relevant.

Following this hearing today and tomorrow in Sydney we will hold hearings in Melbourne and then we'll be looking to do a final report that should get to the government by 1 July. What that means in practice for people doing submissions to us is we're looking for submissions on the draft report by 20 March, we'll then go into a phase through April and May which is about recutting and recalibrating findings and recommendations and analyses that we've done.

Then the final report, as I said, will be available to the government by 1 July. The government decides when that report is published, not us, we publish the draft but the government publishes the final. They have 25 sitting days in which to decide to publish. That is a longish period. Based around parliamentary sitting programs, it could be some months.

We like to conduct our hearings in a reasonably informal manner but there are quite clear structures in our legislation for how these hearings are legally backed. A full transcript is being taken, we're also live streaming. We say that we're out of the experimental phase for the live streaming, and today is the first time I think we've done it, as if it is going to be a permanent product of our communications area in the Productivity Commission. So for those who are participants today you are on live streaming as well as being recorded.

We don't ask participants to take an oath but according to the legislation participants should be truthful in their remarks. Participants are also welcome to comment on issues raised not just in their own submissions but by others in the course of the inquiry. There will be a transcript made available, we plan, within a week from each of these hearing dates so you can follow this more permanently in a written form as well.

Now I should ask people in their remarks potentially to ensure that they are not defamatory of other parties. As hard as it is to believe we have actually had one or two examples where people have come along here and sought to - well, we worry that they might be putting themselves in a position of defaming an individual so it's important to be careful about not

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targeting persons with your remarks.

In the unlikely event of an emergency there is an assembly point here, I'm going to rely upon the lead technician where we meet to be able to guide you but you can see the green exit signs and if you hear the alarms and we're all clear I'm sure with that, follow the green exit sign to where the staff will advise you about the assembly point. I think it's Hyde Park somewhere but I guess most people won't necessarily want to go all the way to Hyde Park they may just want to make sure they've exited the building safely.

Our first participants today are going to be representatives from Choice and I invite them to identify themselves for the purpose of the record.

MR KIRKLAND: Thank you, Chair. Alan Kirkland, CEO Choice.

MR O'HALLORAN: Xavier O'Halloran, Policy and Campaigns Team Lead.

MR HARRIS: Do you want to make any opening comments?

MR KIRKLAND: I will just make a few brief opening comments, thank you. In I guess opening the conversation this morning I would observe that it's a perverse thing that at a time when there is plummeting confidence in major financial institutions, particularly banks, which you see recognised by the fact that the banks themselves through the Australian Bankers Association have launched a major series of initiatives to try to rebuild community trust, or to stop that erosion of trust, and also at the political level by the establishment of a Royal Commission, so at a time of this plummeting consumer trust you at the same time have got major banks with a persistently high market share and very low rates of switching.

So those factors indicate that there is a lack of effective competition in the banking market, and that that is indeed something the Commission has obviously observed. To go back to some of the observations in our original submission we would say that in looking at competition there is no shortage of supply side competition. While there has been some consolidation in the ADI market due to mergers and demutualisations in recent years there are still plenty of institutions and there are also plenty of offers in the market for all of the major financial products.

So while there are certainly some things we can do to improve competition and create a more level playing field on the supply side, as the draft report identifies, we would argue that the bigger challenges and problems are actually on the demand side. Just a few thoughts on what that might involve. Firstly, we need to make it easier for consumers to understand and compare products. That's a particularly basic feature of any marketing which shares competitive pressure. That includes making the actual costs of products more transparent and giving consumers control over decisions that have costs embedded in them, and there are a number of examples where that's not the case now.

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We also need to make it easier for consumers to obtain advice that helps them to make decisions that reflect their best interests, given they're often required to make decisions about very complex products and many consumers seek advice to assist with those decisions. Related to that, we need to reform commission structures that discourage consumers from choosing the best offer and from switching to a better offer down the track. So they're a few of the key things we hope to focus on today as we discuss some of the specific recommendations and findings.

MR HARRIS: Thank you for that. Stephen, do you want to open up with anything specific?

DR KING: Yes. Let's just start off with the last one, which is the consumer power bit. We've got some recommendations on improved information, we know open banking is under way, obviously very happy with it building on our earlier data inquiry recommendations. At the same time we get told that consumers don't read terms and conditions, they simply take it as given.

There is no scope for negotiation. In what sense, and we've seen past examples such as tick and flick in Australia, we've seen bank account number portability in the UK, to what extent do you think those demand side reforms are actually realistic? Are they going to have an effect? If they're going to have an effect where will they have an effect? Are we missing anything in what we've looked at at the moment?

MR KIRKLAND: I think that all of those reforms have potential to have effect but if we do open banking alone without looking at some of the other features of the market then we potentially just make it more efficient for current models that produce bad outcomes to operate. So to give you an example, if we introduce open data but without dealing with the way in which commissions are paid then what we're going to effectively have is much more efficient mortgage broker models that still produce significant conflicts in a way that is anticompetitive and favours major players.

So open data has significant potential to make it easier for third parties' advisers comparison services to help consumers to choose financial products but only if some of those conflicts are removed that influence the sorts of recommendations that are made now.

DR KING: A follow-up then on that you raised mortgage brokers and third parties a couple of things I'd like to touch on there. The first one - in fact I will do them in reverse order. The first one is that you mentioned commissions and the way that mortgage brokers are paid. Do you want to expand on that, and obviously we've got a request for further information to look at those commissions, and particularly trailing commissions, and try and understand their rationale better?

MR KIRKLAND: Certainly, it is very hard to understand the rationale for trail commissions, I mean the only rationale you can really see for a trail commission is to ensure that once the consumer has taken out a mortgage that they stay in that mortgage and are

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never encouraged to review their circumstances and consider switching. We acknowledge some of the changes that have been agreed by industry to commissions.

So removing volume based commissions largely, and doing some of the soft dollar payments will result in some improvements but obviously leave trail commissions in place. Trail commissions, particularly if they're accompanied by commission clawbacks, simply encourage brokers to never approach a client again and encourage them to review their circumstances. It's hard to see how that in any way helps either consumers or encourages competition in the market.

DR KING: Can I push you a bit on that, because your response is the exact opposite of the public response about the mortgage brokering industry who have said publicly that they view trailing commissions, or trail commissions, as being essential to ensure that they continue to service the client over the term of the loan. What's your response to that claim, that they create an incentive for the brokers to provide ongoing service?

MR KIRKLAND: Well, the trail commissions are not being paid by the client. The trail commissions are being paid by the lender. So I don't understand the argument that says that it encourages an ongoing relationship with the client. Indeed, it's hard to see how that would create an incentive for a broker if there was a better offer available in the market to encourage the consumer to switch, which is something that you want to encourage. We don't want ridiculously high rates of churn, particularly if commissions are being paid because that will ultimately add costs to end users, but we do want a situation where consumers are encouraged to review their circumstances from time to time and where it's in their best interests to switch products or switch lenders.zer

Trail commissions discourage that. Another sign of the problems that we see is the fact that trail books are for sale on the open market. So we saw one example of a trail book for sale for around $40,000 on the basis that you would expect a trail income of $1600 a month plus GST. So when the trail books are actually being sold to a different mortgage broker it's hard to see how in that situation this claimed ongoing relationship of trust and advice would continue to exist.

DR KING: We also raise the possibility, because it has been raised with us, about moving to a completely consumer pays model for mortgage brokering services, any thoughts on that?

MR KIRKLAND: I think it's important to acknowledge, as indeed the Commission does in the draft report, that consumers are in fact paying now, that commission is added to the cost of mortgages, and the Commission has estimated it could be as much 16 basis points. So the question is if consumers are paying how do we make sure the way in which they're paying actually facilitates greater competition? We would say if there's more transparency about what people are paying then that is likely to encourage greater competition.

That if that replaces the commission model it removes the risk to competition that we've described as arising from trail commissions, and indeed from commission clawbacks. So

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it will be vastly preferable for consumers to pay. That would also encourage more competition on the basis of either price or on differentiation of service offered to consumers. Because there is nothing in the current arrangements that really encourages brokers to try to offer the best value service or the highest quality service to a consumer and who is approaching them for advice.

DR KING: Even though the mortgage brokering industry say that moving to an explicit consumer pays, so ending commissions, would destroy the mortgage broker industry, you don't agree with that or you think that - what's your view on that?

MR KIRKLAND: My view on that is I guess I'm able to draw on advice in other sectors. It's only a few years ago that we faced a similar debate about financial advice and there were very strong arguments from the financial advice industry that said that if we removed commissions from the financial advice model and moved to a primarily consumer pays model that it would destroy the industry. Several years into those reforms being in effect there is no sign of the financial advice industry reducing in size or disappearing. So all I can do is point to that as a parallel that where we had this argument, that if consumers have to pay they're not going to do so, that has not been the case in financial advice.

DR KING: Do you think that - because financial advisers has been brought up, again one of the things that we've asked for more feedback on is the potential for financial advisers who can't currently offer advice on credit products such as a home loan to be able to offer that sort of advice, what is your view on that? Yes, start with that and I might push a bit further?

MR KIRKLAND: We think that idea has merit as long as the current duties that apply to financial advisers continue to apply whether they're providing advice on a mortgage. So that's in summary of best interest duty, a duty to consider all of the clients' circumstances and provide the clients what's in their best interests. So if that duty continued to apply and they were able to provide mortgage advice without requiring a separate licence then we think there's merit in considering that.

It would be interesting I think to look for evidence around the impact of the current models. We understand there are some businesses that are dual licensed with a credit licence and a financial advice licence. It will be interesting I think to speak to ASIC and potentially some of the consumer casework organisations to see if they see any particular problems emerging from those integrated models. But in the absence of any evidence we think the idea is worth considering.

DR KING: Again, the mortgage broker industry response has been, well, it shows a lack of understanding by the Productivity Commission. That it will just mean that there's one class advisers. Do you think, you know, in other words there won't be mortgage brokers and financial advisers any more they just think there will be a broader class of financial advisers, do you see that would be a consequence, and if so can you see any problems with that?

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MR KIRKLAND: I don't believe that would be the consequence. I mean, just to explain what we'd like to see in its entirety, we would like to see the application of a best interest duty to all mortgage brokers and not just those who are part of vertically integrated models. Perhaps we can come back to that issue. But if that were the case and you also allowed financial advisers to provide mortgage advice without being separately licensed then there would still be a lower barrier to entry to be a mortgage broker because there are a number of other qualification requirements which are increasing over the next few years that apply to financial advisers. So it would be, even if the one duty applied, it would still be easier to become a mortgage broker with less obligations than it would be to become a financial adviser. So I think you would still see both models operating within the industry.

DR KING: The last one - - -

MR HARRIS: Don't go too far away from trailing commissions because I want to ask about that.

DR KING: All right, my last one then I'll put back to you on trailing commissions. The last one that I had because it was just raised there, the duty of care obligation that we've raised as a possibility for lender-owned aggregators. You've just said that you'd prefer to see that extended to all mortgage brokers, how would you see - do you see that as being enough, would you prefer to see stronger obligations along the sort of broker lines, do they make sense in mortgage broker and how would you like to see them implemented and enforced?

MR KIRKLAND: We would like to see a duty that is much closer to the paper test of best interests. I mean there would need to be some consideration to the detailed drafting around the degree of investigation of a client's circumstances to form a view on best interests and whether that needs to be exactly the same as in a financial advice area or whether it might be framed slightly differently, but ultimately the test should be about best interests. Because we think it's actually placing a lot on consumers to understand that when they go to different types of service providers who appear to be doing roughly the same thing they actually know - the experience fundamentally different standards of care.

I guess we would also have a concern if any higher duty, whether it's a duty of care or some sort of general duty of care, or other best interest duty, if it was only applied in vertically integrated models. Because we don't see vertical integration as the sole cause of poor mortgage advice to consumers, consumers often get poor advice from independent brokers as well. Often that's poor advice that's about the choice of lender. So unless you actually apply a best interest across the industry you won't be dealing with that.

We'd also be concerned that if the best interest duty only applied to brokers in vertically integrated models then there's still an incentive for lenders with significant market power to establish preferential relationships with independent brokers, it's just it will no longer be as attractive to do that through ownership. They will still be able to do it through commissions and other business arrangements. So I don't think that the - I can understand why from a competition angle it seems attractive to apply a higher level of duty to those in

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vertically integrated models but I don't think it will actually resolve that issue of lender choice conflict as ASIC describes it because I think that other business models will evolve and develop very quickly that maintain that conflict.

DR KING: How would you actually see it working in practice? I mean a criticism of quite frankly broker type regulations is that they all sound very good, how do you make them implementable, how do you make sure that the broker or the broader adviser is actually acting in the customer's best interests, is actually only providing them with opportunities or products that are in the client's best interest? I mean, you know, it's a criticism that exists with the current laws so extending the current laws to brokers is going to raise the same sort of criticism?

MR KIRKLAND: I would argue that while the broker laws are in a way still something the industry is getting to know that they are working relatively well. Because they provide a clear standard the regulatory environment then applies when looking at the work of financial advisers so it applies a different standard, it provides a different standard that is implied by an external dispute resolution body such as the Financial Ombudsman Service when it's dealing with complaints.

It then provides also a benchmark that ASIC can use when it's investigating the processes of financial advisers, whether that's through shadow shopping or file reviews, or indeed talking to a financial advice business about problems they themselves have identified. So there have been a series of cases in recent times where major businesses have announced remediation schemes based on not having complied with the laws. So I think we're starting to see that have effect and it provides a clear standard that external bodies can apply when looking at the work of a financial adviser and I think the same would apply with mortgage brokers.

MR HARRIS: So not having really departed too far because it's still on the topic of progress on this trailing commissions thing. So the insurance industry once was very much dominated by trailing commissions. I don't know the degree in which it has been eradicated but it appears to be fair less common as a sort of driver today. If I recall it correctly, the rationale was pretty much the same, we like to have these arms' length sales parties that will, "look after the customer", but rarely was there any evidence of those parties becoming, if you like, a constant source of information to people about their income protection insurance or whatever and other insurance they had been sold.

So is that experience also indicative of the fact that we wouldn't necessarily see, you know, a complete collapse of the third party sales model if trailing commissions weren't in place? Is the insurance industry a good sort of indicative example of the same thing?

MR KIRKLAND: I think it is. I mean it's similar to financial advice so where we've moved away or at least reduced the role of commissions in the system, and particularly though it's more in favour of user pays, we can see those third party models disappear.

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MR HARRIS: So our focus here is really on these incentives for brokers in relation to information provision because that's the thing that consumers most self-evidently need in a complicated market, they need forms of information that are useful and easily utilised. You would think if a broker was acting on behalf of a consumer via this pay for service that there would be a flow of information, is there much evidence of a flow of information from brokers to individual consumers about the better deals being offered this year versus the deal they got last year?

MR KIRKLAND: We're not aware of any. I mean, our sense of the market is that the broker relationship is very much a point in time relationship and once the mortgage deal is closed it pretty much ends there.

MR HARRIS: What about the banks themselves, I mean, they're quite powerful players in this, they're the ones paying the money as we point out, whether it's asserted or not that it's actually a relationship between the borrower and the broker it's actually a relationship paid for by the provider of the loan. Why don't we see banks dealing with this directly? I mean, you would think they would be interested in this apparent disincentive. We've seen in comment churn is a problem. We'd like to use this to discourage churn. I haven't actually seen it said by the banks but I've seen it said by the brokers, on behalf of the banks I guess. But why don't we see the banks managing this sort of relationship in the consumers' interests, why is that not evident?

MR KIRKLAND: I think, I mean our sense is that the banks have a love/hate relationship with brokers. Because on the one hand, on the hate side I guess, they resent the high commissions that they have to pay to get mortgages that are originated by brokers. On the other hand it's a very effective channel, and we know from the ASIC data that it also tends to bring in higher value loans. So I think in the current arrangements it's very hard for banks to let go of the broker channel because it will have a huge impact on the amount of mortgages that they're writing.

MR HARRIS: We also commented in the draft report and to date I haven't seen anybody come back with any advice so I'm going to ask a few people the same question, but if you go directly to a bank and you obtain a loan you're not getting any reward for avoiding the imposition on the bank of that commission chunk of money up front and trailing commission, why is that the case?

MR KIRKLAND: I really hope some other witnesses can help to answer that question for you but it's a very apt observation and it just I think goes to that point, it sort of helps to demonstrate the point that consumers are actually paying for some things that happen in the system, absorbing some costs, but it's in a way that gives them absolutely no control over many of the services that are provided. So that's where you get these funny distortions where you don't see flow of value to consumers where you would expect to see it.

MR HARRIS: Yes. The introduction of, I will call them financial advisers, has potentially if that recommendation firms up as an alternative source of advice to consumers on, as it were, how to obtain a loan. I mean, in the financial services industry, as I understand it,

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there are actual rebates paid that can benefit investors. There's no such thing as a rebate here, apparently, for a person who says, look, I'm only after simple advice, I don't expect to see a $3000 upfront payment made. Perhaps do you think we might see some alternative forms of remuneration develop if we allowed financial advisers into the brokering channel?

MR KIRKLAND: I don't know but I would hope that it would create opportunities for rebates where they're paid to be passed on to consumers because consumers have really got no way of expecting that at the moment.

MR HARRIS: Yes.

MR O'HALLORAN: Although that said, it becomes a kind of funny business model. We've seen some mortgage brokers offer to rebate commissions to consumers. I think it almost creates an extra complexity for a consumer trying to figure out what the best deal is for them if they're having to factor in a rate as well as a rebate to compare different offers and find the best one for them.

MR HARRIS: But I want to stick with that, I'm glad you raised it because we did get submissions, a couple, from the individual brokers who told us that their business model was in fact going to be based around rebating some part of the upfront payment that on the average loan, the two and a half, three and a half, thousand dollar kind of amount, back to the consumer and that they were deeply discouraged from doing so by other industry parties.

Now, I don't know whether that's common practice or just bad luck for the parties who are proposing such a business model but it does suggest alternative thinking, which is why I asked the question prior to this one, it does suggest alternative thinking about potentially rebating some of that commission up front. So are there business relationships here of an informal kind that can prevent new style brokers, if you like, offering to rebate commissions, and if so isn't that an issue for the banks themselves as well? I mean, they're the ones paying this, wouldn't they be interested in new style broker arrangements which offered back to consumers a bit of a rebate?

MR KIRKLAND: I don't think we're in any position to comment. That's an interesting observation.

MR HARRIS: Just people say we don't understand this particular commission sector, and you can clearly see I don't understand something like that. I sort of don't understand who is the powerful party inducing this kind of behaviour and structure. If there is no powerful party inducing this kind of behaviour and structure, that's a really unusual circumstance. Generally speaking somebody here is instituting this arrangement. Anyway, that's enough on trailing commissions. People are probably bored silly by the whole concept on how far it might go. We should probably turn onto other topics. Again, I - - -

DR KING: Yes, but just before we leave, because Julie is communicating with me via distance.

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MR HARRIS: Sorry, yes, our commissioner remotely in Melbourne.

DR KING: Our commissioner remotely who unfortunately was unable to travel today was interested in just a few more details on financial planners moving into the credit space, if I can call it that, and the sort of risks that you see in there and how you actually would see that operating in practice, you know, is it actually going to be viable. What are the things, you know, if we say, yes, this looks good, we're coming up with a discussion leading up to a final recommendation, what are the caveats that we need to put in there, what are the things that we need to show, hey, don't forget this when you're designing the system?

MR KIRKLAND: I think that we need to be reminded, and if one of the assumptions is that it's safe to move to that system because much higher standards apply to financial advisers, and that's only partially true at the moment because of the nature of the transition period of a number of the changes around financial advisers. So the best interest duty does already apply.

But some of the new requirements around education and qualifications are being phased in very, very slowly so in the financial advice industry there are a number of people who would have levels of qualification that are very similar to some of the lowest level of qualification of mortgage brokers, so at least for the next sort of five or so years. But there's not necessarily a significant gap in the level of qualifications between brokers and advisers so that's just something to be mindful of in the transition period if this needs to be measured.

DR KING: Okay.

MR HARRIS: So here is what might for many who will be considered to be a sort of sub issue in all of this but it's intriguing again for us, so this is this idea of the intensity of policy effort that's gone into from time to time trying to address the ability of a consumer to change banks and this flick and tick kind of process. Now in analysing this, as you probably could see from the draft report, we sort of started out thinking that could be quite important but increasingly it became evident that, to our thinking at the moment, which is why I'm asking you to comment on it, that, look, this may be last century's issue.

It may not be so important now for consumers to be able to readily change banks by shutting one account and opening another, if indeed accounts are, like, cheap. You usually seem to be offered one if you change just a product to another bank and get a credit card to another bank and go to a home loan with another bank even though your primary bank is somewhere else. You can have payment arrangements rapidly forward back. So I'm just wondering whether this whole flick and tick thing is likely to be, as I said, an important issue last century but perhaps less of an issue now and perhaps even without wanting to say that technology solves all problems with a new payment system perhaps even less so today. What's your view on flick and tick in that context?

MR KIRKLAND: I think that the combination of open data, open banking, and changes to payments technology will mean that it's much easier for people to switch banks.

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Probably our focus on some of those more rudimentary forms of switching will be less important in the next little while. So I think that, you know, models that require consumers to sort of go to a new lender and have them change all of their direct debits over are probably less important. So it will be increasingly easy for people to cancel an existing direct debit or automatic payment arrangements and set up new ones.

MR HARRIS: In that comments on the new payment system we did point out that it appears to be currently set up primarily about single individual payments whereas if you could enable your persistent payments, your once a month payments, your health insurance or your, you know, fill in the blank, the sorts of things that are regular deductions, to equally be switched by simply offering a new identifier that linked to your current account that would solve also a substantial part of this problem that has been alluded to in terms of people finding it complicating to shift their regular payments across. Would that be right, are we on the right track there? We're introducing a new payment system, as you might be able to tell, for whether it can actually solve problems in the future rather than simply be an efficiency device.

MR KIRKLAND: We haven't looked at it detail but I think it is, whatever the arrangements, it is important that we think about how we make it easier for people to change to those regular payments. I think probably the solutions are probably different to what we thought they were about 10 years ago. It's not an area we've done a lot of attention for.

DR KING: You mentioned earlier on just on that the importance of third party providers, we sort of side-tracked into brokering from the first discussion, now any thoughts, have you got any particular recommendations of where we should look for examples of these sort of innovations overseas or in other product areas where technology has essentially reduced switching costs by enabling third party providers to use data to better help consumers?

MR KIRKLAND: I'm not aware of any really well developed models. I think in a way the commission looked at this quite well in its work on a consumer's right to their data. I think the examples we're most aware of are in the UK where, you know, the early attempts involved opening up data in a way that will allow consumers to download their transaction data into Excel Spreadsheets and then upload them into something else, and clearly those types of systems don't work, it needs to be as seamless as possible.

We need to make sure that the sort of data that can be extracted is the sort of data that consumers need in order to make decisions and switch. So for example, it's relatively hard at the moment to identify all of your regular payments, it's a very manual process, and if we ensure that open data is implemented in a way that allows you to quickly do that then potentially you've reduced the switching costs quite a lot. Because that's a product that the third party can build, they can identify all of your monthly or quarterly payments and it's then easy to sort of facilitate you moving them to a new credit card or a new bank account.

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DR KING: A side point on this, in your earlier submission you had some switching data from 2014 that you were able to provide us so thank you very much for that, do you have any more up to date data that you're able to - - -

MR O'HALLORAN: I don't think we do, no.

MR KIRKLAND: Unfortunately, no.

DR KING: We're always interested in data, any - - -

MR HARRIS: We'll ask, we've got the begging bowl out for data for everybody, you know. It was a theme in Monday's speech too, like it's really interesting, there's huge amounts of - numbers and numbers collected in this industry and not as much data as you might imagine for analysable purposes.

DR KING: Just a final one, because the issue of different products and the different ways customers interact with different products was raised and the terrible economic term is, "multi homing", for where customers hold, for example, multiple current accounts with different banks. Now obviously not likely to be a strategy many customers do with their home loan, for example, or the banks would certainly get very upset as to order of the rights of everybody's home loans. Do you see differential problems for people, we concentrate a lot on the lending side of the market or of the platform, which is bank, and we haven't concentrated as much on that deposit side because it doesn't seem that they're the same sort of problems. One of the potential reasons for that is customers, well, I'm sick of this bank I'll just go next door and open a bank account there and I actually don't close the one at Bank A even though I've opened one at Bank B, or I'm sick of that credit card at Bank A, there's a Bank C is offering a good transfer deal so I will just open one up but I don't close the other one. Do you see customers engaging in that sort of behaviour, is that why we're not seeing the same sort of angst on that deposit side that we're seeing on the lending side?

MR KIRKLAND: We would say it's interesting. If you compare Australia to the UK there's a much bigger focus in terms of competition on current accounts or transaction accounts in the UK. But that's because the whole market works in a different in that to some extent current accounts there play the role of personal loans and to some extent credit cards play here because there's a much - overdrafts are a very common feature of the UK system whereas they're not here.

So that means that transaction accounts are a pretty low stakes decision in Australia, they don't involve on the whole - well, there are examples of people having to pay unfair fees, on the whole they don't involve significant costs to consumers. So we think you're right in not having so much focus on the area of transaction accounts and having greater focus, relatively greater focus on mortgages and credit cards. That's where the greater costs to consumers occurred.

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DR KING: Following up on that, are there concerns about the bundling activities of banks? So I mean it is now the case that you go in and you're after a home loan and you get a credit card with it and you get an account with it, and you get a mortgage offset account with it, and there's incentives in some of the banks and in some of the brokers to make sure you take out the biggest loan possible and when you say you don't need it they say, well, don't worry about that, mate, because you've got the mortgage offset so you're not actually going to pay the interest anyway but it pushes up my bonus, that sort of bundling behaviour, has that been something that's been on your radar and is that a concern? Because again it's not something that has come up a lot to us, we've mentioned it in our report, in our draft report, but that's about it.

MR KIRKLAND: We are concerned about it, and it's one of the reasons that we think there needs to be a lot of focus on mortgages because the mortgages are from the anchor product for a range of other bundled products, transaction accounts, and particularly credit cards because a package might often involve a waiver of an annual fee for a credit card, perhaps a credit card that's got a high value rewards program or what's described as a high value rewards program.

So the typical pattern would be you take out a mortgage, you get an offset account, you're offered a credit card with this what appears to be an attractive waiver of a high annual fee but that credit card will be a credit card with a relatively high interest rate, significantly higher than the best rates on the market. But the nature of the bundling means that it's a very complex set of decisions for a consumer to understand and compare to what it would look like if they unbundled those products and compared them to others in the market, the mortgage against other mortgages, the credit card against other credit cards.

That sort of the nature of the discounting and the mixing up of fees and charges versus interest means that it obscures what for some consumers might in fact be the most important decision in relation to the credit card which is what's the interest rate, because if they're not repaying their entire balance every month then the interest rate is a very important driver of costs. We see a huge spread in credit card interest rates from the best on the market to those that are typically offered, especially by the major banks.

DR KING: What about the mortgage offset accounts which - I mean, we have heard stories that the way commissions are paid both internally and externally from banks encourages those, I've always wondered a bit about the Australian Tax Office's view of mortgage offset accounts, but from a consumer perspective are these a dangerous product, are they a product that you have concerns with, or are they wonderful and provide extra convenience, what's your view?

MR O'HALLORAN: It's not something that we've looked at deeply, so we haven't really considered what the consumer harm is there, I know the anecdotal evidence is that people do at times like having that facility available to them and can use it as a opportunity to save part of what they might otherwise put into a savings account because the interest rates are much better than they would probably achieve in any savings account. So, yes, but we haven't looked deeply at all the issues surrounding it.

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MR KIRKLAND: We would be concerned if the incentives around mortgage offset accounts mean that people are having a higher mortgage accrued from what they're actually seeking, if that then exposes them to greater risk, but we haven't got a lot of evidence if that is happening now.

MR HARRIS: You've been pretty active in this are for a fair time, and us obviously only since the middle of last year, so there are quite a few things that you will know more about than we will, and one of them surely is this opacity, this uncertainty about what actually is the price when you go for a loan. There are these things that exist in the finance sector, these standard variable rate concepts, and then the incredibly interesting thing called the comparison rate which extends obviously well out beyond home loans to many, many loans.

As you probably can tell from the draft report because the way we do our work is we start from the absolute zero and try and understand why something is the way it is, and this one has been particularly difficult to understand. We're yet to find the industry expert again who can say to us, you know, a comparison rate is absolutely vital and is built this way and that proves it's vitality, it's crucial nature. So I'm going to give you the chance to tell us, particularly in the context that we've otherwise recommended that we can see from digital data today that it is readily possibly to publish what last month's, you know, Sydney Western Suburbs income of $90,000, $350,000 mortgage was in each institution.

It is really possible now to publish the actual real time number. No one has done it but it's not beyond the bounds any more of technology to do it and so we've recommended that kind of reality pricing as against this unusually opaque kind of pricing structure. So can you tell us a bit more about why it is so and whether consumers are in any sense, you know, at risk as a result of this opaque stuff?

MR KIRKLAND: I think the idea of a comparison rate is a good thing because it's very hard for consumers to understand whether the rate that they're being offered is a good value rate or not. To some extent that opacity I think then feeds the market for mortgage brokers because people have no way to be confident that what they're being offered is a good rate so they seek assurance from a third party, although they're not guaranteed that that's what they will get. So the idea of a comparison rate is a good thing but only if it reflects what's actually happening in the market.

So we think that it will be much better to move to a system where you've got data readily available that reflects what rates that consumers are actually getting in the market. I think that probably it would be best if that the data that was published was not just the average rate for consumers in a particular class, whether or not that's in the way that you've described or defined in some other way, but not just the average rate but also the spread. So for people like me what's the lowest rate that people are paying today and what's the highest rate and what's the average or medium?

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Because I think people need to be able to sort of understand what's the scope for negotiation, because that's one of the complexities in this market, is that whatever the published rate is, whatever the average is, there's always a degree of movement in what's the rate you may actually pay. People have no way of knowing how much they may be able to negotiate at the moment.

MR HARRIS: Yes, you can tell from the report we're a bit wary about averages, there's a lot you can do to average within a range.

MR KIRKLAND: Yes.

MR HARRIS: It may not make it indicative if deliberately chose medium simply because it is a reality as well, there is a medium and can be found in each range. So ranges, yes, but certainly medium seems to be a better - well, in the statistical sense anyway a better way to try and offer information in our current judgement. Do you think if we had this that comparison rates would disappear? I mean one of the rationales put to us is well a comparison rate can also absorb the average cost of fees over the average life of the average loan. We think well that's probably useful information if everybody believes they're average, but if they don't it may or may not tell them anything useful. So do you have a view on that?

MR O'HALLORAN: Yes, I guess a lot of people aren't average without feeding in their specific mortgage details then the comparison rate isn't going to give them an accurate reflection of what the rate is that they will actually be paying. So, yes, I think that's correct.

MR HARRIS: As certain fees get phased out but the comparison rate doesn't alter it might suggest that either those fees were irrelevant in the first place or if they're reasonably significant numbers, as some of the fees that have been phased out seem to be, that you may not necessarily have again a market relevant benchmark. Or so we've been advised. Is that - - -

MR O'HALLORAN: If that happens with fees I guess I would be wary of the way banks might try and gain the system by moving fees around to make comparison rates look cheaper, if we move to a different model that didn't include fees as a component of that that would add to more confusion, I think.

MR HARRIS: To the best of your knowledge, does comparison rates include the upfront payment to a broker?

MR KIRKLAND: We have no idea. No, I don't think - - -

MR HARRIS: Yet you've been in the game a long time and you don't know that. People say to us we carry a burden of ignorance, and we say yes we do, can someone tell us why this is the case. Again it's hard to work out but it's 3000 bucks that's been added in the last 20 years, probably less than that, really, and it's an interesting question about whether

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it features in the comparison rate or not. But maybe as a result of me asking you this question some other person listening will tell us the answer to this.

MR KIRKLAND: Absolutely.

MR HARRIS: We'll be very interested. But it doesn't seem to take away the point that it's quite an opaque set of pricing structures that are available to consumers and a very unusual thing for particularly for a really big product of a long term nature. So you would think that at least we can add some value by getting real time pricing out there into the market place. Thank you. What else have we got here that I need to ask?

MR KIRKLAND: We were keen to make some brief comments on LMI.

MR HARRIS: That was actually the next one. I knew there was a link in LMI because it's interesting, isn't it, we were struck by the number of borrowers who are subject to LMI. It's quite remarkable, a quarter or something, a bit less than a quarter of first time borrowers are subject to this. It too is a quite opaque market.

MR KIRKLAND: It's an extremely opaque market. So on the one hand you've got lots of borrowers subject to it, on the other hand you've got very, very few suppliers. Two of them are owned by major banks. So that's says to us there's something wrong. If you look at LMI, I mean, I think it's very hard to justify the existence of LMI in its current form - - -

MR HARRIS: Sorry, for everybody, anyone listening that is up on the stream, lender's mortgage insurance, an insurance which insures the bank but is paid for by the consumer somewhere.

MR KIRKLAND: So that's an important point. Let's start there. So this is not insurance that covers - provides any value to the consumer, it provides value to the lender by ensuring them for risk of default by the consumer. So if we think about it this applies to borrowers who are deemed to be at higher risk of default. It's our understanding that in many cases those consumers are already paying some sort of interest rate premium. Again, I think it would be hard to demonstrate that and it would be interesting to ask other parties to the inquiry about that.

But our understanding is because consumers have got the ability to get a range of rates that people who have a lower - sorry, a higher LVR are more likely to be paying a higher interest rate to start with. Then those with that high LVR are required to take out this or to pay for this product yet they have no ability to exercise choice. It returns no value to them. It further adds to the complexity of decision between providers because alongside having to consider the interest rate, however you might benchmark that against the market, any fees and charges, the impacts of bundling other products in, you've then got to compare the cost of the LMI if you're required to pay it.

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So it actually adds to the complexity of the comparison task. A further complication is consumers don't understand what it is. There's a reasonable amount of research that suggests that most people think that consumers are getting value from it because it's something that they've been told they're paying for, I think, and because they way it's described. So we would argue that LMI should end and far from simply allowing it to be refunded, which would provide some value, some improvement on the current arrangements, we would instead argue for an abolition of LMI.

We think that the extent that some borrowers represent extra risk than that risk should be priced into the loan so the price is more transparent, it's much easier for borrowers to compare products. if lenders feel or for prudential reasons they need to insure for some of that risk there's nothing that would stop them continuing to do that. We just shouldn't dress it up as a product that's being sold to consumers, because it's simply not.

MR HARRIS: Yes. You've commented on this idea of refunds if you replace your loan within a reasonably short period of time so that the insurance is still potentially insuring you but you've effectively just cancelled it and you get no refund. I know that's been tried before so we learned that in the course of this inquiry, and people found it very difficult to calculate a fair arrangement after the event at the time of calculation so we proposed that it be done at the time of the loan.

In other words that you might have a three year period of coverage effectively for your loan and as mortgage insurance and if you change your loan in that period you should get X dollars back from that payment up front. Again, that to us didn't actually sound like we created anything terribly novel, it must have been thought of before by somebody in the industry. To your knowledge, is that the case, is there anywhere we can find someone who has already worked out why this is a dopey idea?

MR O'HALLORAN: Well I guess our one concern with that would be how that product ends up being structured. So if in your example it lasted for three years and you've kind of got a reasonable payback on it if you switch within that period then, yes, that would be probably be fine for the consumers. At least it's been put to me by one of the representatives of the bank that the level of risk drops off very dramatically after a loan is taken out.

Say if in a different example they were only offering products that offered refunds within say the first six months or the first year then we might be back at square one in terms of what realistically refund the consumer might get on their LMI products. That's why we kind of looked at the proposal and thought that maybe pricing the risk begins with the value of the loan, it might be a cleaner and simpler solution. it also is easier for a consumer to compare products without having to compare the cost of this component product as part of their mortgage.

MR HARRIS: This is just because I'm reacting to the outline of your proposition, and we're all feeling our way here so this is not me trying to be dogmatic or anything, but in a circumstance where there was no LMI and instead the loan price itself reflected the relative

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judgement about the capacity of a person to service the loan, and people with different loan to valuation ratios had different rates, all that sounds quite logical, but then what you're really saying is rather than the insurance being paid by the person creating the risk we would shift it into a generic form.

It would be up to a bank as to whether or not they then took those slightly higher priced because they were higher risk loans, bundle them up and brought an insurance product against them. Then that cost would be spread across all borrowers, I would assume, by the bank and therefore aren't you somewhat switching the liability from the party who is the risky party, the borrower, to all borrowers, wouldn't you be doing that?

MR KIRKLAND: We would expect that the banks wouldn't spread the cost across all borrowers, that those that represent a higher cost of lending to the bank would pay a higher cost, a very marginally higher rate. So, no, we wouldn't expect those costs to be spread across all borrowers.

MR HARRIS: Okay, it just seemed the path of least resistance to as it were bundle them up every three months and as it were sell them off to the insurance industry in a risk management sense. But, okay, no, I take your point.

MR KIRKLAND: But I think banks are accustomed to looking at their loan books and identifying the different risk profiles of different groups of customers. I mean, that's something they're required to do as part of the prudential regulation system anyway. So this would fit very neatly with that approach that they're already applying to be identifying those that present a risk for which the bank also needs to ensure. So we would expect it wouldn't be particularly difficult for banks to the build that into the rate. to be clear, we're not suggesting that consumers would pay more under this system, consumers who are identified as being at higher risk at the moment are paying now because they're being required to pay LMI.

Then they're paying interest on top of that because in many cases they then add it to the value of the loan. So if you look at the sort of what happens through that process you've got some banks who are, well right through the process, some of them are making money from running mortgage brokering businesses, they're then making money from the mortgage itself, they're then making money from the LMI business that they own, and then they're making money from the interest on the LMI. That's an incredibly opaque sort of arrangements for a consumer to understand and build into their decisions about which product or which lender they go with. I think it's one of the factors that works against competition in this market.

MR HARRIS: Yes, it's not so much a problem that they make money off any of these individual processes, someone in order to offer the product is going to make money, it's more a question of whether the parties paying are either aware they're paying, isn't it, or if they are aware, that they have got a choice, that's what it comes down to in the end, isn't it?

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MR KIRKLAND: Absolutely, from a competition perspective. I mean, obviously we're concerned that when people don't understand how the payments they're making are being distributed across the system. But from a competition perspective it's the fact that the person who is paying for this relatively expensive product actually has no control over the decision so there is no incentive to reduce price.

MR HARRIS: Did you want to do any on LMI?

DR KING: Just a very minor question, more a curiosity from my own background, and you may not be able to answer this, when first getting into this inquiry and finding out about LMI and that being an upfront lump sum fee where the customer seems to have no choice of who's providing the insurance, any reason why it evolved this way that you're aware of, why isn't it for an example an annual fee whilst you maintain an LVR a low rate or something like that which would - it just struck me as an outsider as being sort of the obvious way that you would sell an insurance product. But any thoughts on that?

MR KIRKLAND: Look, it's incredibly difficult to explain why LMI operates in the way it does now because it just doesn't make sense. The only reason I could give is because it's the simplest and most convenient arrangement for banks and that they profit fairly handsomely from it.

MR HARRIS: Right, that's all I have on - - -

DR KING: Sorry, a couple more things, actually, I will pick up on that last one. You've noted the degree of integration with the banks and the lack of often transparency as to who owns what and who you're dealing with, most obviously the brokers, but also for the LMI products and so on. One of our suggestions is just more transparency there making sure the customers know the data so if I go to Aussie for example and just pick one that's owned by the Commonwealth Bank, if I'm going to Westpac and getting LMI through them and that's actually a Westpac internally provided LMI, or provided by Westpac's LMI company, do you think that sort of transparency will have a significant effect? Is it important or is this sort of just, you know, customers aren't going to care, what's your view on that?

MR KIRKLAND: We're always cautious about expressing a strong view about the likely impact of changes to disclosure requirements because we know that disclosure often has reverse effects, so I think that we welcome a focus on the need for better disclosure in a range of areas in the draft report from ownership structures through to commissions if they remain the system. But we think that the form of disclosure needs to be very carefully tested with consumers to test what impact it has on behaviour. Because there is always a risk that a form of disclosure actually has the opposite effect or a quite different effect to what's intended and it could impact and increase the market power of major players when it's intended to provide a more level playing field.

DR KING: Really a different topic but one we haven't touched on, we do talk about the renaming and changing of general advice, your feedback on that and are consumers at risk

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of misunderstanding current general advice or what falls under general advice, what are the benefits if you see any of change in that and how should we deal with it, is it just coming up with another name that doesn't sound like advice or is more detailed reform in that area needed?

MR KIRKLAND: We think more detailed consideration is needed. We have been long concerned about the term general advice because in reality no advice as a normal person would understand is provided in those situations. That's an additional concern when there are early signs that one of the impacts of the changes to the regulation of financial advice more generally and particularly personal advice means that some businesses are starting to shift to models where they purport to only provide general advice because lower requirements apply. So we think there's probably additional risk around general advice at the moment and in the near future. But again I would say any shift in terminology would need to be tested so we'd need to test whether whatever the new term is or proposed new terms are, how consumers understand them and whether they're actually understood in the way in which we intended them to be understood.

DR KING: Any potential risks of moving in that direction or you see generally this just being a good thing as long as it's tested properly?

MR KIRKLAND: In general we see it as a good thing as long as it's tested properly because we think the current term is misleading about what is actually provided.

DR KING: I just have one other one on another topic again so I'm just flicking topics a little bit. One of our information requests, which I've got up here, 10.1, is looking at - sorry, I'm trying to find it, the ePayments Code. Now I'm not sure if you're familiar with that. Really a question, let me start at a very general level, obviously we're looking at recommended as our draft recommendation expanding the coverage of the ePayments Code.

Our information request is, you know, looking at various ways the ePayments Code might be able to be improved, particularly for dealing with unauthorised transactions and who's liable for those transactions. Any thought on either the ePayments Code generally and our view that it could apply to any party involved in an electronic transaction and then if you're happy we'll go down into some of the details. But again, I don't know your background knowledge on the ePayments Code?

MR KIRKLAND: We've done less work on this issue than some of the other issues before the inquiry. In general we think the ePayments Code provides an important level of protection for consumers so we'd like to see it apply as broadly as possible. We haven't really thought in detail around what the boundaries of that application should be.

DR KING: Okay.

MR KIRKLAND: So we think it's a worthwhile area of inquiry but we can't add much more to that thinking at this stage.

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DR KING: Similarly, presumably if we start getting down to the nuts and bolts of who should be liable for what part of an unauthorised - yes, okay, no, I wouldn't want to push that.

MR HARRIS: The only other thing left is the sort of bigger question of the competition champion, a term we devised to try and convey a party that didn't necessarily have any greater regulatory responsibilities but were in the circumstances where the decisions that impacted upon competition were likely to be taken should be invited into the tent, if you like, before those decisions are finally taken.

Now, not necessarily a sort of consumer level kind of concern but I thought you might have a view on this, particularly the question, and we'll ask most of the participants this if it looks relevant to them, our concept had been the government should designate somebody for this purpose, some entity, we didn't see a reason to create a brand new entity for this purpose because there are a number of parties that could take up that role. The ACCC is reasonably self-evident to most people. But ASIC itself has a role in competition at the product level and therefore has expertise in this area too.

So this question of should the Treasurer designate some entity to take responsibility for competition within the activities of regulators in particular, which is the focus we had more generically across the economy. Clearly it's the ACCC or it's ASIC where statute says so. This is really in the interaction between regulators. Do you have a view on that at all or - and again, I'm not necessarily trying to set you up, if you have none feel free to say so.

MR KIRKLAND: No, we've got some observations on that set of issues. One we'd absolutely think would be valuable to have competition clearly considered in major decisions at the Council of Financial Regulators and for there to be some transparency around the way in which competition is considered before decisions are made. We think there's a need for caution around how the role of - sorry, just to step through it, we do agree that whatever happens competition should be added to ASIC's mandate. We've backed that since it was recommended by the Murray Inquiry and we think that would be important regardless of where the primary responsibility for competition lies in the system.

We think the way in which a competition role is framed is quite important so we would, I guess, have some hesitation about framing it as a consumer - sorry, as a competition champion role because we think it's important that competition is always grounded in the ultimate object of competition, which is to promote the best interests of consumers or end users, as it's framed in several Commonwealth Acts. competition is best pursued by a regulator where it's effectively balanced with consumer protection, which is something that we'd see the ACCC as doing fairly well.

So we think wherever it sits they're important considerations. The other one is that it has to be resourced. So we would say that ASIC at the moment probably isn't effectively resourced to take on a competition role. At this point in time the government has decided to give some resources to the ACCC. Which we think is a good thing. We think there are

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pros and cons between ASIC and the ACCC so we don't have a strong view about where that should sit but we think that those other sort of considerations should apply about the objects of competition, balancing it with consumer protection, and ensuring that whichever regulator gets the role has adequate resources.

MR HARRIS: Thank you very much for that. Others?

DR KING: No.

MR HARRIS: You're done? Is Julie done?

DR KING: Julie is done.

MR HARRIS: Thanks very much to Choice for appearing here this morning and for the breadth of your comments, and for putting up with us asking you things where perhaps, you know, sometimes we put you on the spot but you've nevertheless been very helpful. So we appreciate your time.

MR KIRKLAND: It's always a pleasure, thank you.

MR HARRIS: So I think 10.45 we'll restart so I'll be pretty keen to do that on time, with Bendigo and Adelaide Bank. Thank you very much.

ADJOURNED **[10.23 am]**

RESUMED **[10.44 am]**

MR HARRIS: I think we're going to restart but I need to just look across and make sure that we're recording okay. If we are recording okay? So, I think we have Bendigo and Adelaide Bank now to present. Would you gentlemen like to identify yourselves for the purpose of the record?

MR FENNELL: Thank you. My name is Richard Fennell. I'm the Chief Financial Officer of Bendigo and Adelaide Bank.

MR CROUCH: And my name is Travis Crouch. I'm the Divisional CFO for Bendigo and Adelaide Bank.

MR HARRIS: Okay. Do you want to make any opening comments?

MR FENNELL: Yes, if we may.

MR HARRIS: Sure.

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MR FENNELL: We would like to start by expressing our appreciation of the work completed to date by the Productivity Commission in helping to highlight a number of relevant and significant issues which impact the state of competition in the Australian financial system, and the need for the relevant regulatory bodies to take a more proactive approach to the consideration of competition in the banking industry.

Specifically, we appreciate the Commission identifying the issues relating to the implementation of Basel guidelines on risk weightings for non-IRB banks across residential mortgage and SME lending, which have had a major impact on the ability for banks, such as ours, to compete since the accreditation of IRB banks over ten years ago.

The following finding and two recommendations specifically relate to the ability for smaller ADIs to compete with the major banks here in Australia, and we would like to make a comment upon those. Finding 5.1, cost of funds for different size banks, the materially lower risk weights able to be used by the IRB accredited banks for residential and SME lending have been the overwhelming impediment to our ability to compete in our preferred lending target segments of the market. Since the accreditation of IRB banks in Australia this has resulted in our bank, along with other non-IRB banks, having to accept either lower growth or lower returns, except for relatively short periods of time when competition eases.

In addition, the three notch credit rating uplift under the Standard & Poor's methodology afforded to the major banks on the basis S&P expect these banks will receive government support on the basis of being too big to fail, adds to the challenge we confront. This rating differential does impact on both the availability and cost of wholesale funding for our bank.

Recommendation 9.1. As highlighted in the draft report, the differential in risk weightings for SME lending is profound and results in a vastly skewed playing field between the IRB accredited banks and others. APRA has made an initial concession in its Basel III discussion paper to lower secured SME lending risk weight to 85 per cent from 100 per cent for standardised banks. However, this is unlikely to be sufficient to materially close the gap between IRB and other banks in ability to compete for SME lending unless APRA requires IRB banks to recognise a materially higher risk weighting on their SME lending.

Recommendation 16.1. In relation to the recommendation to review standardised risk weights for residential mortgages, we appreciate the proposed more granular risk weights proposed in the recent APRA Basel III discussion paper. However, as for SME lending, to deliver a more competitive environment APRA will need to align IRB risk weighting floors using a similar granular distribution and at levels which will allow true competition to exist between IRB and non-IRB banks. Of course, this needs to be done in the context of their being an incentive for banks to improve their risk management practices to a level that warrants IRB status, but that will require some careful thought.

In addition, we'd like to comment upon a number of other specific findings and recommendations of the Productivity Commission's report. Recommendations 8.3 and 4 relating to collection and transparency of home loan interest rate data. We believe

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competition within the financial services industry is not limited to price competition. True competition encompasses a much broader consideration of value for the consumer, which includes aspects such as trust in the provider, product features, service levels, accessibility and, in our bank's case, returns provided to the community the consumer resides in.

Accordingly, to further focus the provision of the information upon interest rates and fees risks further entrenching the dominance of those banks who have the inherent advantages of those favourable regulatory and ratings outcomes described previously because they will be able to compete harder on price at the same return on equity than the other smaller banks.

Considering all these factors, we do not support these recommendations 8.3 and 8.4.

In relation to information request 8.2, should brokers pay fee for service, we do support a move to fee for service brokerage to remove the inherent conflicts involved in the commission based structure and ensure fees earned are aligned with the value of the service provided. However, we also recognise such a change will have significant and varied implications which will need to be carefully considered before such a change is implemented.

Finding 13.2, tick and flick, has not been effective. In our experience one of the factors limiting the effectiveness of tick and flick has been the variability in some banks meeting the requirements of making all information available within the prescribed period. We also believe not all customers who seek to change banks are made aware of this service, limiting its use.

Information request 16.1, where can IRB accreditation processes be improved. We believe from an accreditation process perspective it would assist ADIs seeking to apply for accreditation if APRA was to outline its key requirements from a process and timeline perspective, including key milestones that need to be met along the way. In this context an iterative and consultative approach akin to the guidelines and approach adopted for ADI licensing would be beneficial.

Finally, on recommendation 17.1, new competition function for a regulator, we support the Council of Financial Regulators to take a more active role in considering the competition impacts of proposed regulatory actions. I would be happy to open it up for questions and discussion.

MR HARRIS: Just on that last one, could you clarify when you said you supported, any particular regulator you had in mind?

MR FENNELL: We don't have a strong view although I'm looking forward to seeing what the ACCC has to say a little later. They seem the most logical party to take responsibility, given their current remit and the ability to broaden that remit to include financial services, particularly given the work they've been doing recently on the mortgage industry, or the mortgage element of the industry.

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MR HARRIS: So do you want to go back up to the top of the list or do you want me to keep going?

DR KING: I was going to go back up to the top of the list.

MR HARRIS: Go back up to the top of the list.

DR KING: Yes. So really the top of the list, other than you supporting our work, is the risk weights and the APRA discussion paper. Do you mind - are you happy to go into a bit more detail? I realise the discussion papers have only been out for about a week, but can I take it from your opening comments that you sort of felt fine as far as it goes but not enough nuance in the SME area? So does that - are you able to expand on that? Have I got that right and are you able to expand on it?

MR FENNELL: Yes, so Stephen the discussion paper release went into quite a bit of detail and was quite specific around non-IRB banks and the expectations around risk weightings by LVR bands, by type of mortgages. For example, between owner occupied P&I and other mortgages and also SME lending. In relation to IRB banks, it did provide some information around correlation factors and other elements that would feed into the risk weighting, but APRA alluded to the fact that before they finalise where they want to go with risk weights for IRB banks they expect to apply additional scalers and potential floors. They didn't, in the discussion paper, go to the same level of breaking down by LVR how things will work for IRB banks, for example with mortgages, and we don't know what floor the scalers will use when it comes to SME lending.

So APRA is now going to go through a quantitative impact study and a number of banks have been asked to participate in that. I'm assuming that at the end of that when they come out with their next paper we'll get more information in relation to what those scalers and floors will mean for both mortgages and SME lending. If they were to remain largely where they are today then we're going to still have significant issues from a competition perspective in SME lending, as you point out in your draft report, where IRB banks, risk weighting is around 50 per cent. For secured SME lending we will move from 100 to 85. But that's a huge gap still between roughly 50 per cent and 85 per cent risk weighting, which would lead to a situation where non-IRB banks remain in a situation where they have to either accept a significantly lower ROE to price at the same level, or are non-price competitive.

We in our organisation have had plenty of examples where we compete hard for business lending and SME lending and we just cannot get to the same price point as some IRB bank competitors are prepared to go because the ROE on that is well below what is acceptable to us. We assume, given the lower capital requirements, given the different risk weightings, it is still at an acceptable ROE for those IRB banks.

DR KING: Just to follow up on that, and again please correct me if I've got that wrong, but I took from your opening comments that you saw a potential solution for this as being

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to raise the IRB risk weights on SME secured loans rather than to lower the standardised rates?

MR FENNELL: At the end of the day what we're looking for is an even playing field. APRA seems to have made a determination of what they think is an appropriate risk weighting for SME lending for non-IRB banks in the discussion paper, and left open the ability to moderate the IRB bank risk weighting. So the reason I focussed on that is that appears to be the area that is still open for consideration by the regulator.

MR HARRIS: But doesn't that - I mean, this is the whole conceptual problem we've had with shifting of risk weights that occurred after Murray as well, which you can also read in our draft report - this idea that lifting a risk weight for a party that might have done quite a lot of work - I mean, this is not a criticism of either the IRB banks or those that haven't chosen to but have done quite a lot of work in terms of managing our risk structure - but to lift the cost of a risk weighting, a) raises the price of the market which doesn't look terribly smart any way, but b) intuitively looks like it must be driven solely by a focus on safety, on security.

In other words, there isn't a balance here. It's just that the default position is if we have to shift the risk weights because we've perhaps worked out we could be more sophisticated with them, our sophistication leans only in one direction and that's up. Otherwise it doesn't make -it says the more that we find out about how we can manage risk in a more sophisticated fashion the more that we're going to have to raise prices. That intuitively is leaning only in one direction, isn't it, towards safety?

MR FENNELL: It is, and - - -

MR HARRIS: Not towards competition.

MR FENNELL: - - - it reflects the primary remit of the Australian Prudential Regulatory Authority.

MR HARRIS: Which is why you might want at least a contrary view run by another entity.

MR FENNELL: I wouldn't disagree.

MR HARRIS: It's very, very interesting. Can I ask about the 85 per cent too? I mean, the precision of the numbers here, we're in no position at the Productivity Commission to go, "Oh, a better number should be X" and quite possibly you may well feel the same. The number itself is a precise measure of something that is astonishingly hard to be precise about. But 85, if I recall rightly, is still higher than some other countries would require for what appear to be similar lending products. Now, I can't be sure of that either but that's why I'm asking you. Is that right? Is the opening round discussion here on SME weightings pitched also at a level which says well, we might be able to relent a little but not very much by comparison even with other countries?

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MR FENNELL: It certainly appears conservative, and the other element that is interesting to consider is it assumes that all non-IRB banks are taking the same level of risk in writing SME lines. Now, we're all competing in the same market for SME lending, and at that smaller end there's a lot of lending done. What that is intuitively saying is that all of the non-IRB banks are taking a very similar amount of risk in that secured SME lending, however that is recognised as being higher risk than an IRB bank that has done more internal analysis and historical analysis of the performance of risk for that aspect of their business, and therefore they can write that at a lower risk weight which, having - we've invested a lot in our bank to move towards IRB and we would argue that we are well down the path of understanding the risks we take and certainly 85 per cent risk weighting would appear conservative from the analysis we've done, particularly when it comes to secured SME lending.

MR HARRIS: Just to get the position out on the table, in our draft report we suggested that if there were some gradations, some variations to what is otherwise a single line risk weighting for SME lending, that as a consequence of that it might be arguable that a price to a small enterprise for a loan would vary, but certainly against a specific level of allocated capital, which is the way your business operates, you would be able to offer more loans. Is it more likely more loans, more likely price, more likely - I mean, we didn't want to presume the price would actually shift very much but we did want to suggest thought that, taking an existing amount of capital with variation risk weightings you'd be able to take on more loans.

MR FENNELL: Certainly conceptually we can take on more loans, but the amount of capital we are holding is not the thing that is holding us back in writing SME lending. It is actually the inability to price competitively with those that are able to hold a lot less capital against those. We would like to write more business in this space, and in fact we lose business that we've already written in this space to competitors who are able to come and offer existing customers of ours a more competitive offer because of the amount of capital they have to hold.

MR HARRIS: So in fact do you think it's more likely that you will be able to offer better prices to SMEs? We didn't want to presume that, but if that's the case it's quite an important consideration here from the point of view of a person seeking a loan anyway. It would be an important consideration.

MR FENNELL: Yes.

MR HARRIS: So price you think could actually benefit from this shift in risk weightings?

MR FENNELL: Certainly on a case by case basis there have been loans that we have had to forego to a competitor because we have been unable to price at a level that is competitive because of the ROE on that loan because of the capital required, given the risk weighting we have.

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DR KING: Can I just clarify that, because in your opening remarks it came across to me at least that you are suggesting that the IRB risk rate would be raised?

MR FENNELL: Yes.

DR KING: Rather than the standardised risk weight be lowered. Now, presumably to get more price competition it would need to be the standardised risk weight coming down towards the IRB weight if you go the other way?

MR FENNELL: Yes, that's true. Again, our view is we want a more even playing field and I don't think you should necessarily assume if a higher price is being charged because more equity is required to be held against loans by the IRB banks that that will necessarily be a detrimental impact for the industry. It depends on your view, whether you have the view that more stability is required or more competition is required. However, the assumption that IRB banks should go higher was on the basis that the discussion paper was very prescriptive around standardised banks. Now, that doesn't mean APRA cannot change it. I think, however, the way it was written with an indication they expect to apply scales and floors to IRB banks from what they put in the discussion paper, their inclination is to go the other way as far as increasing those risk weights rather than further reducing the risk weights for standardised banks.

DR KING: Yes. I guess I just want to make it clear, or make sure I'm clear on your views, if that occurred that would not - that would level the playing field from your perspective but would not lead to lower prices to small businesses?

MR FENNELL: I think that is a fair assumption.

MR HARRIS: You also comment - I don't want to leave risk weightings but I want to sort of go around it a bit. You also commented on the role of rating agencies and their assessment of too big to fail. There's a logical link here, isn't there, between variations in risk weightings which are skewed towards safer. Even as we learn more and can be more sophisticated in our judgment we're even going to be more safe. Doesn't that whole contribute to this whole idea of too big to fail? In other words, there's a lot of rhetoric now being devoted to the idea that policy is not oriented towards supporting too big to fail, but in fact actions regularly seem to be oriented towards too big to fail. You know, there may be more activity in the SME space but it's going to be safer. Are we not seeing that here as well? Am I being too harsh?

MR FENNELL: I think when we look at what's driving too big to fail and its interpretation by the rating agencies, they take a very narrow view focussed around the size of the entity and its importance to the Australian economy as a whole. We think it's also important to consider the importance of different banking entities to not just the whole economy, but the economies in which they operate. So as an organisation that has over 500 branches, including 90 in locations where we are the only branch in that location, the idea that the Australian government would be happy for an organisation like ours to fail - I shouldn't say happy, but accepting of that and the implications of banking services being

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removed from those 90 locations other than the provision of electronic banking, is an interesting concept and I think an over-simplistic view taken by the rating agencies.

MR HARRIS: Yes. I just - - -

MR FENNELL: I'm not sure I answered the question specifically.

MR HARRIS: No, I think you came tangentially at it but I came tangentially at the whole risk weighting question too because this too big to fail, it's not something that's easy to address directly without making possibly an intemperate remark and I try not to make intemperate remarks, I've learned. An unwise thing to do. Comprehensive credit reporting, what - this is again tangential to risk weighting but it's the same thing to me, anyway. I look at why you might have gradations and variations in what has been - let's stick with SMEs - this single line risk weighting. We're now saying maybe we can break it up. As comprehensive credit reporting becomes mandated and you obtain better information about customers and so do your competitors, and so there's the better sharing of information, I haven't seen too much mental linkage placed by any party in the finance sector about the possible benefits of this to things like variations and risk weighting. Is that just because it's, as it were, behind the scenes kind of thinking and no one really wants to talk about it very much, or what's the story here? Because there's an intense logic surely to this whole idea of once we have this information we'll be able to better price risk. That's why we want it. In which case, it should affect risk weightings but it doesn't seem to be there. It doesn't seem to be mentioned at all.

MR FENNELL: For an advance bank, or IRB bank, I think there is the opportunity with better access to that information with comprehensive credit reporting to better align risk with price, and the ability then to be able to show that that lower risk is based on logic and data should allow a lower risk weighting through their models that they - - -

MR HARRIS: But why the big model?

MR FENNELL: However, for standardised - - -

MR HARRIS: You see, why the big model? This is the question. Why not a selective use of it? We were told in the course of developing the draft report that there is a thing called doctors' home loans, and they're much safer apparently to lend a home loan to a doctor than - I would argue doctors really aren't that well remunerated. You can probably think of a different class of person who is exceptionally well remunerated. Perhaps they're greater risk takers than doctors, I don't know. So there is this informal view about certain classes of home loans are much safer. But that stuff doesn't creep near the formalised risk weightings, and yet I can't work out why it wouldn't at least be perhaps not happening today, but being envisaged as being a mechanism by which we can vary risk weightings in a more sophisticated fashion selectively.

In other words, you don't have to run the giant model. You could just say I'd like a slightly better risk weighting for this class of loans which I can demonstrate to you by the objective

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fact is the equivalent of doctors' home loans. In the case of the SME space, we had one party suggesting to us that tradesmen's utes were similar to doctors' home loans. A tradesman would not want to ever see their ute lost. It was - and so that was an indicator. It was almost they had, as it were, headroom against the value of the ute. That there was a lending opportunity there. And a safe one.

This level of sophistication is rarely alluded to, it seems to me, and I can't sort of work out why, given we are going towards comprehensive credit reporting and therefore it's an obvious use.

MR FENNELL: It is certainly something that within banks is given great consideration. There are a number of factors that we need to consider in writing a mortgage, whether that be an SME mortgage or a residential mortgage. They're factors like LVR which now is being focussed on by the regulator, the type of loan, interest only versus principal and interest, and investor versus owner occupied. But factors like serviceability - I think what you're talking about with your example is the character of the person and that - and also the purpose of the lending.

Now, we do lots of modelling around - and I'm sure a lot of other banks do lots of modelling around different personas, and to try and inform the character piece around credit. You might be interested that one of the personas that performs very strongly is public service. I won't comment on income versus doctors. However, that is an important factor in assessing the risk, which goes then to the pricing. Although, as you say, for a non-IRB bank it does not impact the amount of capital we have to hold. So it informs the risk that we're prepared to take and the price we'll pay for that, but it will not impact the ROE because it's not impacting the E.

MR HARRIS: I should stop doing this because we have a limited amount of time.

DR KING: Yes. I want to touch on a couple of things. I was just going to point out it's MDs rather than PhDs. You mentioned mortgage brokers at the beginning and the payments. I guess a double barrel one for you, you support a change in the way that they're paid but we'd be interested if you could flesh that out a bit more. But I think the more important one from us is understanding mortgage brokers and how they interact with a bank like yours. In particular, how much does your lending business depend on mortgage brokers and how do you make the decision internally as to well, we could open another branch there or we could rely on mortgage brokers. Does it allow you to go into new markets? Have there been situations where you've said well actually, that branch probably isn't viable and we can leave it to mortgage brokers? How do you make those decisions? How do you run the numbers, that sort of thing? Really understanding that interaction with brokers.

MR FENNELL: We are probably less reliant on mortgage brokers than many banks and we have been very focussed on the development of a strong branch network, primarily since the advent of our community banking model some nearly 20 years ago where communities can open a branch of a Bendigo Bank as a franchisee. So we - and that remains a reverse

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inquiry model where we're not out there selling to a community that you should open a community bank. Rather, the community comes to us and says we would like to open a branch. There's a significant process, including feasibility studies, they need to go through to show that that would be successful. But we continue to increase our branch footprint, primarily through that community bank model.

We do, however, recognise the importance of the broker business with roughly half of Australians choosing to select a mortgage by going to a broker. It would be a brave decision not to participate in that market. So we do have an offering there, however that really is quite separate to our strategy around our retail business through our branch network, which we look to continue to grow and enhance. Our broker business, we also want it to be successful but they are run quite separately and I can't think of a time when we make a decision around our branch network based on should we, or should we actually use third party in that particular space? The reality is they both are generally competing in the same market, whether that be a geographic market or anything else, and quite often you'll find one of our branches in the same shopping strip as an outlet of a major broker. So it is not an either/or in our organisation.

DR KING: Can I push that a bit further because the community banking model, when you're looking at a franchisee setting up you have to, both sides have to do due diligence. The last thing you want is an unsuccessful franchisee.

MR FENNELL: Yes, correct.

DR KING: A significant part of their business will come about through writing loans.

MR FENNELL: Yes.

DR KING: If there is a significant mortgage broker presence in that same market surely that comes in to when you're considering whether the branch is viable. So I can understand that there would be situations where they can co-exist, but are there also situations where you say look, the market isn't big enough in this particular community because of the broker presence? I'm thinking if they're in the same market surely the - - -

MR FENNELL: Sure. They're in the same market with different brands from our organisation and different offerings. So our brand that we use in the broker market is the Adelaide Bank brand. The Bendigo Bank brand is our retail offering through our retail and community bank network. The Adelaide Bank brand is effectively an online brand once you take out the mortgage through a mortgage broker. The Bendigo Bank brand is a full service offering with access to the branch network obviously and the 500 plus points of presence, plus a range of other - a broader range of products and services on offer through that brand. Whereas there is a more limited range of products and services through the Adelaide Bank brand. So they can co-exist, and they actually compete arguably for people who are looking for different things. People who walk into a mortgage broker, they are going there without a view, I want to go and bank necessarily with CBA, Adelaide Bank or anyone else. They're going in there to buy a mortgage and to be advised on that.

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People who come to our bank generally come to our bank and walk into that branch because they're looking for the service offering that we provide. It is differentiated, including around things such as what we do in the local community. It is also - they're probably looking for a bank that does things a little differently and arguably old school. We do strange things like publish the phone numbers of our branches. Because we have a branch centric model. So there are examples of things that we do differently that we find, customers find attractive, that they're not going to get if they go into a broker.

MR HARRIS: Just one specific thing on that though. If the Adelaide brand is therefore essentially an online and almost broker channel kind of brand, that must make the paying of trailing commissions quite a - I don't know, an absurd option really. It says it's all online from the time you get it. For the average loan, $665 per year in perpetuity for an online based product seems a very expensive thing. Now, you presumably have very little choice about that because, as you say, you have to play in the market.

MR FENNELL: Yes.

MR HARRIS: But it does rather raise the question about pricing the service, let alone whether there is a conflict. It just simply says the pricing of the service seems pretty high, doesn't it?

MR FENNELL: Probably goes back to the point I made in my early or introductory comments around our view that a fee for service model is more appropriate.

MR HARRIS: Yes, and clarity around that for the person raising the loan. Stephen, I am conscious of the time so if you've got any more?

DR KING: One more. One more. Just on the same area, and it is sort of - in a sense you must face a bit of the Jetstar/Qantas problem. You don't want to make Jetstar look too good because it takes passengers off Qantas. I'm sure Qantas knows internally exactly how much money it makes out of a Jetstar customer versus a Qantas economy customer, and I suspect it makes more out of Qantas economy but that's up to them. Similarly, presumably internally you have a pretty good understanding of right, if it's under the Bendigo brand this is the amount of profitability or value to the bank as a whole.

MR HARRIS: Yes.

DR KING: If it's Adelaide online, this is the value. If it's through a mortgage broker, this is the value. Are you able to give us some insight into those different values?

MR HARRIS: We do that assessment. As you say, it would be unusual not to do that sort of assessment. We do that assessment. The challenge really is around the retail business and how do you allocate the cost of a network such as ours to those products? So a branch, should the majority of its costs be allocated to the job it does in actually raising deposits?

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Or should it be to the job it does in actually generating mortgages? What assumptions you make around that will impact that significantly.

The other option is to say well, do we assume that's just a sunk cost because we've made the decision to have a branch there and then we'll just do it on a marginal cost basis? So all of those factors are ones that we need to take into account. If you allocate the costs in a way that is - let's take a simple approach and say 50/50 between deposits and loans through a branch - then the return that we would get through our branch network is probably lower than that through the broker channel. However, there are so many benefits that come to our organisation in our ability to generate funding for the whole bank because, being roughly 80 per cent deposit funded, the funding we generate through our retail network goes a long way to funding our Adelaide Bank business as well. So we get huge benefit there. Not to mention the reputational benefit we have in having over 500 points of presence for a bank our size and the things that those branches do in their local community which is beyond just selling products and services.

MR HARRIS: Just one thing if I could do the closing off question then, if you were buying a broking business though you would do that analysis, wouldn't you, beforehand? What can we save in terms of our operating expenses by moving more of our business relatively speaking into the broking channel? You would have to do that cost based analysis. It would vary, depending on the business model that you just described which is complicated and potentially unique. But you would nevertheless have to do that cost analysis, wouldn't you?

MR FENNELL: We would, but we've never done it because we've never felt strategically it made sense for us to vertically integrate by owning a broker.

MR HARRIS: Quite, but I'm just trying to make sure because we have been accused of misunderstanding the reasons why banks go and buy broking businesses and it just almost seems screamingly obvious to me so I have to ask the question when banks turn up here. Anyway, I want to thank you for your time presenting today.

MR FENNELL: Thank you.

MR HARRIS: We will probably be further in touch with you because it has been quite truncated, but we're already over time and it's been very useful to get those contributions. Thanks a lot.

MR FENNELL: It's a pleasure.

MR CROUCH: Thank you.

DR KING: Thank you.

MR HARRIS: I think since we're over time we'll race into Westpac. They have been waiting patiently. Peter King is here and he's been waiting patiently to come on up. So

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the gentlemen from Westpac will set themselves at the table and when they're ready perhaps you can introduce yourself for the purposes of identification on the record.

MR P KING: Thank you, Chairman. Peter King, Group CFO, and with me today is Curt Zerber, our Group Treasurer.

MR HARRIS: Opening statement, Peter?

MR P KING: Yes, thank you. So firstly, we welcome the opportunity to discuss the Commission's draft report on Competition in the Australian Financial System. In addition to our remarks today, Westpac is preparing a written response which we will lodge in March.

MR HARRIS: Thank you.

MR P KING: Today really my comments will focus on three areas that we believe require further consideration. The first is that competition and stability settings must work together and cannot be separated. The second is consumers have plenty of choice, but we agree that they need easier ways to compare products. Thirdly, while banks are profitable our returns on equity have come down over the past decade and when compared to the ASX200 they're not out of line with the average of ROEs there.

If I just elaborate on the first point, that competition and stability must work together, we see it as important that the financial system supports the economy through economic cycles, not just in the good times. The impact of the GFC was a stark reminder that when stability and competition settings are misaligned that economies and consumers can see large impacts.

We believe for the most part that Australia's financial system, combined with its robust regulators, has proven to be both competitive and well calibrated to deliver those services over the economic cycle. Prior to the GFC many countries focussed too much on competition and growth, and when the reset occurred economies contracted and unemployment increased. Australian banking policy has held firm on both competition and stability, and since the GFC we have boosted our capital levels and we strengthened also liquidity levels and our funding bases.

For example, just to bring that to life, the new funding regulations, NSFR and LCR, aimed at improving our funding base, saw intense competition for customer deposits over the last decade. In the case of term deposit spreads, they've moved from being priced around 45 basis points below the swap rate, the equivalent swap rate, in November 2007 to approximately 80 basis points above the swap rate in 2017. And deposits are the foundation that gives banks the ability to lend, and we believe that the intense competition for deposits hasn't been picked up in the draft report.

Just in completing this point, I note that the government also has a keen focus on competition as implementing significant reforms. As you know, these include making it

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easy for new entrants into the system and improving data sharing, and these reforms should be given sufficient time to embed after which their effectiveness can be reviewed.

The second area is that, while there is plenty of choice in the system, we agree that it can be difficult for customers to make sense of it all. As outlined in our original submission and noted in the draft report, customers have more choice in banking than ever before. Just as an example, there's over 4,000 mortgage products and 100 providers in mortgages, and for anyone to compare those would be a pretty big effort. So we agree that so much choice makes it difficult to compare, and that's the reason that we support the move towards an open data regime in banking which will facilitate informed decision making and promote innovation and efficiency in the system.

Just while on the topic of choice, I should say we see ourselves as a service company, not a product company. Our strategy is to differentiate ourselves on the service. So to bring that to life, in the last 12 months we've introduced more than 100 features in mobile banking to improve customer service.

The final point is that Australia's major banks are not highly profitable as the draft report indicates. Now, it's true that as a sector we make large dollar profits but that doesn't necessarily equate to being highly profitable. The large profit numbers reflect the sector's significant size and productivity, and in fact as we outlined in a couple of the charts which we provided to the Committee, the returns do not stand out in relation to Australia's large listed entities and are in line with other banking systems, or comparable banking systems, offshore.

Just to bring that to life, Westpac makes less than 1 per cent return on assets and its return on equity has fallen about 40 per cent over the last decade. The decline in the ROE can be traced back to competitive impacts on margin, de-leveraging to meet higher capital requirements, our merger with St George and increased compliance costs.

Just when considering returns, it's also important that the banking system is seen as strong and profitable, given its role in importing offshore wholesale funding into the country. Westpac, for example, has around $150 billion of offshore wholesale funding outstanding, which is the equivalent of 300,000 new home loans. Offshore investors see profitability as a big requirement when deciding to invest in Australian banks.

So just in closing, we believe the inquiry is an opportunity for Australia to reinforce the strength of the system and the competitive environment in which we operate. Westpac is proud of the financial system and it has consistently stood behind the nation in times of stress and has positively contributed to the economy in good times as well. We think it's vital that we recognise the value that strong banks play in underpinning the economy over the cycle, whilst also recognising that reform to improve competition will be good in the long run. Curt and I would be happy to take any questions.

MR HARRIS: Thanks very much. So just on profitability, since you mentioned it and everybody does, are we really debating, if we're debating anything on profitability, the use

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or misuse of not the term "highly profitable" but the word "highly"? Because you have subsequently acknowledged it's important to be profitable and we in our own most evident summary page, the key points did, from our 600-odd pages, get summarised down to the key points right at the front and we did notice that it is - note that it is no bad thing necessarily to be profitable.

MR P KING: Thank you.

MR HARRIS: One would hope that that would contribute to stability. So it's quite important. So we are really debating this question of "highly". Your preferred measure now in this proposition here today, and you did have it in your earlier submission as well, is return on equity. But equity is a funny thing in the banking industry, isn't it, because there are numerous sub-equity products that also provide you with a similar basis as equity but are classified somewhat differently, and so that's not something that is made available to other sectors. So hybrid equity, for example. So we, when we did our draft report, went and started out with banking industry analysts who tended to be more expert than we were, and it was suggested that that interest margin was in fact the industry sort of preferred rough measure of profitability. Which is why, as you can see from our draft report, we cited that as being one of the greater evidence of stability than, as you say, the return on equity has diminished over a decade.

So maybe you could clarify why you think it's more important to concentrate now on return on equity here because we sort of thought we were going in the right direction.

MR P KING: Well, I think - let me give you an analogy for the country. So if you think about pre-GFC we had low government debt, much higher interest rates from today and the dollar was relatively high. So going into the GFC we had the fire power to defend a downturn. So the government had the fiscal capacity to boost spending, interest rates could be lowered to boost demand, and the dollar would come down. So if we roll forward through the FSI today, what the FSI basically said was banks, particularly major banks, you need to be seen as unquestionably strong in a global sense, given your role in importing wholesale funding into the country. It is a big number.

We look at today and we see interest rates very low. Now, there's not a great deal of ability to lower them much more. They could be lower, the impact - - -

MR HARRIS: Official rate you are talking about here?

MR P KING: Yes, official rates. The fiscal position is not as strong as it was. Now, the dollar is still relatively high so it could come down. So what we have spent the decade doing is boosting our liquidity funding and capital resources so that we reduce the probability of the impact of event. So that's the context. In terms of how we think about the bank, the bank is - it earns revenue both in interest income and fees. It's got costs and it's got credit costs. So the thing that the interest margin doesn't pick up is credit costs in particular. So the one - and if you think about the role of a bank, it lends and it's got maturity transformation. Not all those risks are picked up in an interest margin.

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So effectively we hold some provisioning for expected loss and then we hold capital for unexpected loss. The only measure that brings those all together is ROE. So if you were to look at our investor presentations to our investors who give us the capital, that is the one metric that I think they focus on the most.

MR HARRIS: Yes, I can understand why an investor might focus on that if only for ultimately sheer pragmatic reasons. But we were doing a competition based analysis which is less than, or different to, an investor's analysis and so from our perspective we were trying to find whether or not there were reasonably clear indicators of how competitive behaviour is reflected across institutions. Anyway, I'm not trying to defend this. I'm more trying to understand the fact is there is different advice at different points in time about what's a better profitability measure. We weren't questioning ultimately profitability. In fact, we were sort of trying to hint that you wouldn't want too many institutions - - -

MR P KING: The challenge we had over the last period is there's been so many moving pieces that have impacted every ratio on the bank. So if I think about funding, we have materially moved the proportion of our funding base that is domestic deposits because it's a safer organisation. This is through the cycle point, that we don't want to just have a system that works well and is very competitive. We need one that actually works well in stress as well. The learning from the GFC was if you over - if you don't get that balance right the impact on the economy can be big.

MR HARRIS: Just one more, if I could for you, just on this GFC point because it does - and I did say earlier to the Bendigo and Adelaide representatives I'm wary of making intemperate remarks, or apparently intemperate remarks on some questionably strong issue, but it is true, isn't it, we were pretty strong as a banking system going into the GFC and survived reasonably well, but we came out of it with exactly the same philosophy that other countries who did not go into it as well positioned as we did and came out of it much worse, we still emerged with the same desire to make a strong system unquestionably strong. We do rather persist in emphasising something where we - - -

MR P KING: It's this trade-off though between the other parts of the economy are not as strong. Interest rates can - it's difficult to lower interest rates to boost the economy so the banks had to increase their individual strength.

MR HARRIS: Yes. No, I'm more referring to the use of the GFC as a point at which - you know, it's almost implying that we too were in a bad state and, as you have noted in your own presentation, we were more competitive by some measures pre the GFC compared to those measures post the GFC, but the rationale for why we should abandon being, as it were, more competitive in favour of being unquestionably strong - is it really about our performance during the GFC then? Because our performance was pretty good because we entered the GFC in an okay state.

MR P KING: If you look at who was pretty good versus who wasn't, if you look at those businesses that used wholesale funding, mortgage warehouses solely to fund their mortgage

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book, a lot of them don't exist anymore. So this is the point about it's not just in the good times that we need to set up business models, it's also to survive a cycle.

MR HARRIS: Yes, yes. But we have emphasised the unquestionably strong proposition, despite the fact that the evidence would suggest we went in unquestionably strong in terms of that regulated end of the spectrum. There was a freezing up of wholesale markets which was reflected in much poorer financial performance for entities, but we didn't appear to have gone in on a basis, given we were more competitive before the GFC, that said somehow stability was under threat through that level of competition pre the GFC. We didn't seem to have anyway, based on the - - -

MR P KING: Well, those - - -

MR HARRIS: What we can find in the data.

MR P KING: Some of those firms didn't survive. They didn't make it.

MR HARRIS: Outside the regulated space.

MR P KING: Well, we can debate that but Bankwest was bought by - - -

MR HARRIS: Offshore firms did actually have - because they were regulated offshore did actually take more risks. So this is my point about we seem to have imported the philosophy of - because other countries had different systems to ours, nevertheless we must now be under - - -

MR P KING: Just one final point. Australia is one of the largest importers of wholesale funding in terms of banking systems, and so that is a big consideration in the calibration of the system. One that we agree with. We agree that we don't want to turn up to offshore investors and have a question about the strength of the system. It wouldn't be good for the Australian economy because if we get capital flows going out it means the banks shrink.

MR HARRIS: Yes. Stephen?

DR KING: Yes, I want to follow up on two things there. Firstly, when you're talking about those smaller institutions, banks range from the big four through to very small institutions. Am I to infer from what you're saying that unquestionably strong means we should never have any bank fail? So I guess that's the first question. I just want to clarify what you're getting at there?

MR P KING: Well, the reference point for unquestionably strong is international investors see the Australian system as unquestionably strong. Nothing to do with failure. They see it and they want to invest in the country through the banks.

DR KING: Okay. So the second point then comes back to your reliance on return on equity and international funding, and isn't there a problem for a too big to fail bank that

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return on equity isn't really adjusting for the risk that you may be taking because the shareholders - so downsize risk, limited liability means that the worst they can get is to walk away with nothing in their pocket. So wouldn't you expect to see return on equity to have dropped, not because of any competition effect but simply because as the regulatory requirements imposed by APRA reduce the risk for the banks you will necessarily see return on equity drop for those banks?

MR P KING: You haven't - but I think the question there becomes - well, it has is sort of the first point, and if you look at both the ten year trend and the most recent trend is it has dropped, is the first point. The second point is investors decide on the price that they'll invest in the company, so offshore investors. They make the decision on how much they invest and the price they invest, and the rating agency rating is an input into the process. Now, I haven't had - Curt hasn't told me he's had an investor come up and say I'll give you cheaper money because of this government guarantee thing. They make their decision based on what they see. They have alternative choices and that goes into the cost of funding for the group.

So I think that there is the argument that because we are safer organisations investors should lower their returns, whether they be debt or equity. A lot have not. In some cases they've said actually the risks might be a bit bigger than what we were pricing pre the experience of the last ten years.

DR KING: I am going to move on to another topic.

MR HARRIS: Yes. I will probably - well, it depends. No, let me stay in this area before you go to the specifics because I want to ask you about our generic recommendation about a competition champion. Now, you may have no view on this question at all because it's really a perspective around whether there is sufficient advocacy for competition within the regulatory system. Now, I'm sure you're familiar with the nature of the recommendation but you may or may not have noted in the speech on Monday we pointed out that the Bank of England which - and the UK did suffer more from the global financial crisis than potentially we did, and people can argue whether that was the nature of the competition in the system or other effects, but nevertheless the UK has revised its willingness post the GFC to focus a little more on competition by creating a secondary objective for the Bank of England's prudential regulation of entity. Consciously did so in support of this idea that it's quite difficult for the prudential regulator to have regard to competition because in the analysis for the papers that supported that particular position, taking a - came to the conclusion that the prudential regulator will favour stability and that's just a logical conclusion.

So the UK, having suffered more in the GFC and therefore needing obviously to take a position about guaranteeing its system was seen as unquestionably strong, has nevertheless added more to its support for competition as well post the GFC. We haven't in a direct sense via this advice to the regulatory authority. So do you think there is a need to address it as we have suggested in our report, or do you have no view?

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MR P KING: I think I'm not going to comment on who, because I think that - - -

MR HARRIS: I won't ask you to do that.

MR P KING: I think the idea of having someone with a lens on competition is worthy, but the point I made in my opening remarks was how does it come together. So how do - this is a pendulum and you can swing it too far one way or the other. I think you're being clear in your report that it's swung too far one way versus the other. My encouragement would be to try to work out how the two ideas will meet because in running a bank it's going to be no use to me if I've got two polar opposed regulators that want competition, want stability, and they don't meet. So to me it's how do the two ideas come together.

MR HARRIS: We were quite conscious of that. So the idea is, as I said, a subtle one. Subtle to the point where, I guess, we were worried at some stages that people might say this is going to have no impact at all because the competition champion would not be a decision maker. The competition champion would be a point of independent advice, thus APRA's decision making would remain APRA's decision making. It would just be that rather than internalising a discussion with itself, effectively on the topic, it might find someone else to interact with prior to implementing the decisions. In any event, you've been - it was good of you to say something on the record on the issue because I know this is an area where it's often hard to take a public position. You go.

DR KING: Right. Switching direction slightly, on to mortgage brokers, and obviously Westpac owns some aggregators. The RAMS operation, for example, is slightly different to most broking operations in that it writes loans under the RAMS name rather than simply either selling the white label products or the label products. We obviously have a draft recommendation with regards to obligations on both vertically indicated aggregators and the mortgage brokers working under them, and their duty to the client. Your views on that?

MR P KING: I might just clarify on RAMS. RAMS is not an aggregator. So RAMS sells RAMS product. Westpac sells Westpac products.

DR KING: That's why I put RAMS as being slightly different, yes.

MR P KING: In the broking camp. But to your point, I think there is merit in having brokers aggregators, whether they're owned by the banks or separate, with a responsibility that is in the customer's interests. I would understand the differentiation between a bank owned aggregator and an independent aggregator, for that word. I think there should be the same standard in the market, that if you operate in that market you operate with these requirements. I think it's - we have no issue with the recommendation but we think it should apply to the whole industry, not to a sub-set of the industry.

DR KING: By the whole industry - so RAMS' funding for all of their loans would come from Westpac?

MR P KING: The banking entity is - the banking licence is Westpac.

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DR KING: Yes, so you would see that obligation also being on anyone at RAMS writing a mortgage?

MR P KING: But RAMS only sell - yes, but if you go to RAMS you get a RAMS product.

DR KING: Yes, I know.

MR P KING: So that's why I say - - -

DR KING: Your earlier answer is the clear position though. You're saying no problem with the duty of care as long as it applies to everybody.

MR P KING: Everybody.

DR KING: Therefore there's no differentiation. We did give that consideration. The only reason is, or the primary reason - I mentioned this in the speech - we differed between the two is because we can see two different forms of conflict of interest, one ownership, one incentives, but more than that it was the future of financial advice or reforms that seem to have encouraged that form of concentration in the industry which is I'm too small to have absorbed potential liability that might come from this higher duty of care, and so I need to, as it were, see my business absorbed by a larger business, and so we've ended up with some concentration. We don't know whether that's cause and effect, and we wouldn't mind looking at that in this industry as well before we deal with - - -

MR P KING: - - - I would comment there that the FOFA law and the credit laws are two very different laws. I think it needs to be well thought through which path you go down because they're very different laws.

MR HARRIS: Yes, and I think we're trying to - - -

MR P KING: It's not clear cut.

MR HARRIS: We're trying to be careful there as well. The way we've characterised the language was meant to recognise that and we did take some advice from ASIC before we cast that recommendation in the way we did. But we will be careful at the final as well.

DR KING: RAMS is obviously a hard one to deal with because, as you said, it's not an aggregator and our recommendation was in terms of aggregators so I just wanted to make sure you weren't casting RAMS out as being something different. Westpac though, I assume actually and this is something I haven't got the data on in front of me - you would have independent mortgage brokers writing Westpac loans. Any idea of the per cent of your loan business that would go through them?

MR P KING: It ranges, but 45 per cent as a rough estimate.

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DR KING: Okay. You would have heard our discussion earlier on about well, trying to get a handle on what's the cost of having a loan written through a mortgage broker versus through a bank and then in your case through something like a RAMS or a St George - - -

MR P KING: Yes. Let me tell you how I think, because I think the question is how do you think about it, how do you make a decision?

DR KING: Yes.

MR P KING: There's two aspects to that. How the customer approaches buying the mortgage is very important, and a lot of customers will choose to go through brokers, and that's a feature of the market. So we think about the demand out of each channel, and then we think about how we meet that demand. So in the case of proprietary flow of mortgages, or coming directly into Westpac, the decision you have there is how many home finance managers do you have. So do you employ a new person or not. So I wouldn't frame it around do you open a branch. Often we've got a branch there. The question would become do you put a home finance manager in or not. If you do, how many do you put in? That will depend on the flow, the demand coming into that particular region.

So it's not so much - and the concept that you can choose to direct the flow I don't think works because it's a customer choice about where they go. So that I think I would reframe it to say well, if you had a - how would you compare hiring a home finance manager versus using an external broker, which will answer the question you've raised about the relative cost. You can't really break it down. I think it's hard to break it down into a per sort of mortgage cost because of what you heard from Bendigo.

DR KING: Yes, but just picking up on what you have said and what Bendigo and Adelaide said earlier on, so you would see the relevant costs though at a branch level as being that marginal cost. What is it going to - you've got your branch there. What's it going to cost to get another - - -

MR P KING: Do you hire them or not is the decision. That is the decision. Then you want to be comfortable that they're going to write, that they're going to be able to generate enough business to pay for themselves in mortgages per week. So there's a different way to think about the question, is what I'm saying.

DR KING: Yes. Understanding that, and understanding that the customers who go to brokers aren't necessarily the same as go to a branch, but there's still going to be some sort of overlap there. When you're making that simple hiring decision to what degree do you look at the depth of the market? To what degree do you say well, they're going to be able to - - -

MR P KING: You look at it by branch.

DR KING: You look at it by branch.

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MR P KING: Regional.

DR KING: Do you take into account drawing more customers that would have gone to brokers into the branch, or do you keep them completely separate? How do you deal with - - -

MR P KING: We would love to do that but it's not always the case that we can do it. Our preference is first path, that is our preference, but this is the point about the customer chooses.

DR KING: Okay, so your preference is - can I just get you - I just missed what you said.

MR P KING: Our preference would be to write through our branch network, home finance managers.

DR KING: Okay. Why?

MR P KING: Because of the cost.

DR KING: So it would be cheaper in that sense to write it through the branch network than through the mortgage brokers?

MR P KING: Yes.

DR KING: Okay. Can I get you just to expand on that? Sorry, this is the economist in me. Cheaper purely in dollar numbers or - - -

MR P KING: How about we put some data in our submission?

DR KING: If you would be able to do that that would be fantastic. Okay, that would be brilliant.

MR HARRIS: Can I just ask on this question, it's more about the competitive dynamics in the industry. Your preference then is to go with the branch because there's quite a big cost to obtaining a loan through the broker channel, and that's in part presumably the up-front payment and the trailing commission and stuff like that, presumably. Tell me if that's not right. But that's a cost. Yet you're a very active participant in the market place in broking as well but your prices, yours as in the bank owned broker's price, isn't any lower. It's not as if you're using your ownership in the broking channel to reduce the cost of dealing through a broker. That's a competitive dynamics question, and it's really the logical - are we going to earn our return by owning these businesses, by keeping the price high, or are we going to use it for competing on the cost? Why is that the case?

MR P KING: That question is also verging into an area of competition law that I shouldn't be going into.

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MR HARRIS: Okay. I can see a reason why it wouldn't go into that question, but it was more a question of presumably people advising on the business case to enter the broking channel must have made a decision which says we're going to try and do it for simply the high returns that are now evident in this part of the industry, or we're going to do it for a more strategic reason. Can I ask at least was it a strategic reason or a high return reason?

MR P KING: When you say "our broking business" what do you mean?

MR HARRIS: You do have some ownership. I'm not going to go down the path of what RAMS is but you have some ownership in the broking channel.

MR P KING: No.

MR HARRIS: No?

MR P KING: Well, RAMS is not a broker. It's a brand. RAMS doesn't offer anyone else's products.

MR HARRIS: Okay, well that's why I wasn't trying to deal with RAMS per se, but are you telling me that Westpac owns no businesses that - - -

MR P KING: We have a small, very small, investment in a start-up called Uno - - -, a start-up which is - - -

MR HARRIS: Is that relatively recent?

MR P KING: Which is seeking to be a digital broker. It's high risk, and the flow in that business is tiny. So that's just small.

MR HARRIS: I can't really ask you this question because you're not active in the space. Although it's available for me to ask somebody else then.

DR KING: Before we leave RAMS, I'm old enough to remember the "good old days" when you had Aussie and RAMS securitising, using warehouse funds from the big four to fund what was at that stage a vibrant securitised mortgage market which seems to have got, with the GFC, a rather poor reputation it appears, based more on practices overseas quite frankly than in Australia. But if you view that as being a wrong view I'm more than happy for you to say so. That market hasn't really re-emerged post GFC. There doesn't seem to be a big amount of securitisation, except when we look at the data that was a big '90s disruptor and you will note from our report that's where we suddenly circle it and say my gosh, have a look at what happened to the home loan market at that stage. Why hasn't that market re-emerged? Whose fault is it for want of a better word, and do you see that as a future direction? Obviously not for RAMS now, but for others?

MR P KING: No, but I think - well, there's two points to make. One is the business models for those organisations weren't built for a cycle. They funded 25 year mortgages

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way too short and when there was a liquidity disruption it failed. So the business model was high risk and was found out. That's one. Two is there has been a regulatory change that the bank liquidity - so when we buy liquid assets we used to buy a lot of RMBS. We don't now. We buy government and semi-government paper are predominantly what we buy to meet the high quality liquid asset requirements. So there has been a structural change in the market of banks not buying that paper, and there's probably been less investors in that market.

MR ZERBER: There has been a re-emergence of the securitisation market in the last two or three years. So I don't know what data you're looking at comparative to - - -

DR KING: Well yes, it's come back in a small way but it's nothing like it used to be.

MR ZERBER: I'd have to look at the data, but I would say it would be more than just a small one. But I think the challenge is here you've got to remember that through the crisis the government bought $15 billion of RMBS because no one else would buy it, and investors who are looking to make a return are rational beings, so as an economist - they're not buying it because they see a - - - trade-off in other parts of the investment and opportunity. So the investors, I think, are very rational beings and I think they found out that there was challenges, whether it be liquidity, underlying economic values for those investments, which has curbed their appetite for that asset class, all things being equal.

So it's kind of like saying why isn't our corporate bond market bigger as well. There's a number of reasons for that. We as an issuer would love it to be bigger because we would benefit, as would all parties. So I think there's a dynamic here that is as much of an investor question as it is an issuer question. But I think, you know, my experience is at the moment that the diversification of the funding models has been the key differentiator in good and bad times, but clearly in bad times there was a number of models that were sought out, and so this is the balance that we're trying to help the Commission appreciate is that through the cycle the stability versus competition is a very, very fine point that needs to be considered.

DR KING: Can I just follow up on two things there? First, on the fact that you don't now hold the securitised mortgages as part of the tier one capital. That's presumably following - - -

MR ZERBER: On a liquid assets - - -

DR KING: Okay.

MR ZERBER: - - - and to be clear, we hold some.

MR P KING: The thing about our balance sheet on the asset side is having a large amount of liquid assets that can be turned into cash very quickly, so basically the two big parts - - -

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DR KING: Has that changed in your holdings being driven by the change in regulatory requirements?

MR P KING: Have a look at - yes, have a look at the attachment we put on the back of the opening statement and you will see where it was in 2008 and where it was now. Globally the global change for liquidity portfolios is that you hold much more government paper basically, which is deemed the most liquid style of paper. Yes, it has changed.

DR KING: Yes. To what degree has that been - is that decision driven by the changes in the international approach to bank regulations - - -

MR P KING: It's been a big part of it. A big part of it.

DR KING: Yes. The second bit is, is Westpac still active in providing warehouse funds to securitisors, and if so how viable is that business compared to pre GFC?

MR P KING: Well, I think yes we are. It's around $10 million to size it for you. So it's not a large part of the business. Given the nature of the lending, really it is - we think about it as a flow business, not a funding business. So you're effectively warehousing selling RMBS into the market on behalf of a client. Given the nature of those they're quite short term facilities and you wouldn't - I wouldn't see that that portfolio would grow significantly from where it is at the moment.

MR HARRIS: Have your risk weights increased on warehouse funding since the GFC?

MR P KING: Yes, there's changes that are going through but that will be reflected in how we think about that business.

MR HARRIS: Since we've got a limited amount of time before we start next, I would like to do lenders' mortgage insurance while we can.

DR KING: If you can, and then I will just come back to one thing that Julie has asked for.

MR HARRIS: Okay. Just on LMI, we have a recommendation that it would be logical to set up front a refund schedule should a borrower switch loans, but is otherwise required to pay up front for LMI. What is your view on that? I mean, the subject has been attempted to be resolved in the past but with a degree of difficulty because it does not appear that this concept of setting a repayment schedule for - I mean, we are advised that LMI is really only there for the very early years of the loan and therefore presumably has - it's value is reduced to zero inside the first two or three years. What is your view on the idea nevertheless that where someone does switch loans and is less of a risk after two years that they should get some part of that LMI refunded that they've otherwise paid for up front?

MR P KING: The view is it's a fair question. So we certainly can think about it. Unfortunately the answer is not straight forward because the re-insurance arrangements in that business assume that there's no repayment after two years. So LMI sort of exists from

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a customer perspective to give them earlier access to funding, so effectively they get a loan that they probably wouldn't otherwise get. From the bank's perspective it's tail risk. It's insurance for tail risk in the mortgage portfolio. We re-insure a lot of that risk and the re-insurance arrangements that are currently in place assume that there's no refunds beyond two years. So it can be looked at. It would be - a change in the market would be a change in the re-insurance arrangements and - - -

MR HARRIS: What would re-insurers think about the new product?

MR P KING: Yes.

MR HARRIS: Okay, that's an interesting point because I personally didn't know that re-insurers took that view of two years as the expungement, of the expunging issue. Earlier we heard from Choice. I don't know whether you were here for Choice?

MR P KING: No.

MR HARRIS: But their proposition was that LMI is sort of unnecessary and they would prefer to see a borrower that has a more adverse loan to valuation ratio, manage that risk via the pricing alone rather than the need for insurance. In part, although I'm not trying to put the case totally, but just in part the logic appeared to be that there probably, as we have suggested too in the draft report, people are probably, but it's hard to get the data to make the conclusion firm, probably paying for this twice in the sense that they may be a higher risk anyway and they're paying for LMI, therefore they're probably paying a higher loan risk and LMI. I think Choice was saying on balance perhaps, but nevertheless their preference would be no LMI and just do it through price. What is your reaction to that?

MR P KING: Well, it comes back to customers and that is a model that works in other industries, but I think you'd have to work through the identification of when people can get credit. So it's not like you can move to a price based solution and everything stays the same. So one of the reasons that LMI exists is to - people save a certain amount and then they top up through the insurance which means they can get the loan earlier. If you did it through price there would be a different point of getting a loan.

MR HARRIS: For the marginal customer that goes over the price the internal model that you're prepared to - in other words, the cost of the risk is so high they would simply be denied the loan.

MR P KING: Yes, so you'd actually have to look at that proposal and the LMI proposal together to work out which is the best model.

MR HARRIS: Yes, okay. Sorry, you had one last thing?

DR KING: Yes. I think two just because we haven't asked anyone else this this morning.

MR HARRIS: The ACCC is - - -

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DR KING: Yes, I know. Banning interchange fees, views?

MR P KING: I think interchange has got a role. So we need to have payment systems that are invested in and interchange helps that. It also shares the cost between acquirers and issuers. So no, I don't think we would be in favour of an outright ban on interchange.

DR KING: Okay. Do you mind expanding just on - you've touched briefly on FOFA and those sorts of obligations. You suggested caution in bringing together, I guess, the financial advice and mortgage broking, or expanding financial advice into credit products, and you discussed FOFA briefly. What do you see as driving that? Why do you see that there is - is there a problem you see there or - - -

MR P KING: Well, they're different requirements. One is effectively a not unsuitable and one is in the best interests. So they're different requirements. So if you're a planner operating in both wealth and credit markets, how does it come together? Are you - have you got two sets of laws that you need to meet? Practically can it work?

DR KING: It's the practical putting in place of - okay.

MR HARRIS: I want to do interchange fees since you've raised it, just a simple question really. Probably not a simple answer, but a simple question. So would you be confident, would Westpac be confident that if we asked for data that demonstrated there was an ongoing cost that this fee managed or ameliorated or related to, we could be given such data? Because the number of inquiries that have gone down this path in the past and looked at this and said oh, it doesn't look like there's actually much of a case to keep recovering costs, that would have once been - do you think we could be, in a mature system - - -

DR KING: We know the fees for - - -

MR HARRIS: Do you think we could get data on cost?

MR P KING: The RBA has had good looks at this, so I would suggest they're the first point of call.

MR HARRIS: Which we have done, and as I said inquiries support - nevertheless seem to have gone - not RBA per se, but Murray for example. It's hard to find evidence that would actually put the fee in place, that has that - and not every time is there a charge, is there a cost directly related to it. I mean, markets don't work that way. But nevertheless you would think in this case under the sustained reviewing pressure, if the fee remains therefore there should be some evidence that this is what we're doing, this is why we're doing it in a cost recovery sense or some other cost sense. So you think there are no sources other than the RBA that we could tap?

MR P KING: I think the RBA is the best source because they've had a good look at it, in a cost place.

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MR HARRIS: I think we can access that, so I'm trying to find any other data source that you might want to hypothesise might exist out there.

MR P KING: I'm not sure what the specific question is but maybe we can talk about it.

MR HARRIS: Well, there are other players in the payment system who may actually have information.

DR KING: Do you view that the RBA has got the cost based interchange fee right? If you're saying just look at the RBA data, presumably we infer from that that you say yes, they've got it right. They had it wrong up until last July because they suddenly changed it, but yes they've got it right now.

MR P KING: They're regularly reviewing it every three months so I think the point about payments is you've got to look at - we've got cash, you've got MMP coming in, you've got EFTPOS, you've got debit, you've got credit cards. Are the incentives sending people the right signals? That's always a good question to ask.

MR HARRIS: That's why I alluded - I'm interest in costs. I agree incentives - as I said, price is not always there just on a cost recovery basis. But we'd like to look at foundation - - -

MR P KING: - - - just go to cost on this stuff then no one will invest. That's the challenge.

MR HARRIS: There are other payments that - - -

MR P KING: - - - was late to the party on chip and cards and now they're fighting from behind.

MR HARRIS: Okay. We should keep going. I'm just primarily interested in identifying alternative data sources because there's a bit of a struggle on data here. Anyway, thank you very much for your time and your contributions and for the submission that you are planning to put in as well, and we will probably be in further touch. Thank you.

MR P KING: Thank you.

DR KING: Thanks Peter.

MR HARRIS: So we will get the ACCC now. All right, would you guys like to identify yourselves for the record please?

MR BEZZI: Certainly. Marcus Bezzi, I'm an Executive General Manager with the ACCC. My responsibility is the Specialised Enforcement and Advocacy Division.

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MS CHOUCAIR: Molly Choucair, General Manager of the ACCC's Financial Services Unit.

MR HARRIS: Do you guys want to make opening remarks of any kind.

MR BEZZI: That would be excellent, yes thank you. The ACCC welcomes the Productivity Commission's draft report into Competition in the Australian Financial System and the opportunity to appear at this hearing. Among the Commission's recommendations was the need for an existing regulator to be given the role of championing competition in the financial sector. The Commission anticipates - that is, the Productivity Commission, I should say - anticipates that the regulator would have a number of functions, including but not limited to conducting transparent analyses of the impact on competition in the financial sector of prudential regulation and other regulatory measures.

The Productivity Commission has made a number of other findings and recommendations in its draft report, and the ACCC will respond to many of them in our written submission. We would like to focus our opening remarks on three issues. Competition advocacy and the ACCC's role in financial services. The ACCC's Financial Services Unit, embedding greater transparency in decision making and the commitment to competition.

On the first of those topics, competition advocacy reminds policy and lawmakers that competition drives innovation, choice and better outcomes for consumers. We agree with the Commission that there is a particular need for greater competition advocacy in the financial system. In the 2017/18 budget the Treasurer announced that a permanent team will be established within the ACCC to investigate competition in our banking and financial system, and Ms Choucair leads that team that has now been established. With our strengthened mandate from government we believe the ACCC is well placed to bring its singular focus on competition to important regulatory decisions in the financial sector. Our approach seeks to be driven by market dynamics and be unfettered by the limitations of regulatory regimes.

We believe there is considerable scope for us to work more closely with APRA, ASIC and the RBA in considering and providing advice on the impact of key measures they take, or in helping to inform their decision making in relation to competition issues. Such an approach would ensure that nothing falls through the cracks. Currently regulatory and macro prudential measures apply only to those entities subject to such measures. For example, ADIs or financial licence holders. Focussing on competition means that all competitors within a market, whether or not they hold ADI, including those who are outside the remit of specific regulators and potential competitors, can be considered. The ACCC will seek to play an important role in achieving an appropriate balance between the objectives of system stability and competition within the financial sector.

Access to consumer data is a critical competition and consumer issue, and there has been an important development in this area since the Commission published its draft report. As part of its response to the Commission's report on data availability and use, the Treasurer announced on 9 February that the government has committed to introducing open banking

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using a dual regulator model. With the ACCC as the lead regulator, we will be strongly supported by the Office of the Australian Information Commissioner. At the heart of the proposal is giving consumers access to the data that is held about them by business, including the ability to direct that such data be copied and provided to a third party.

International experience, especially in banking, has shown that consumers, giving consumers access to their data, known as the right to data, increases competition as it gives consumers more scope to compare competing offers, make more informed choices and more easily move their business. Data portability increases competition, particularly for more complex products and services, and creates scope for businesses to make more tailored offerings, including to innovate new or different products that better meet their needs.

The ACCC welcomes this development and is looking forward to working towards open banking for the benefit of competition and consumers.

I would like to talk a little bit about the ACCC's Financial Services Unit. Following the Treasurer's budget announcement we established the FSU. Many of the responsibilities proposed by the Commission for the competition champion are allied with the FSU's mandate. The FSU was established in 2017 to undertake regular inquiries into specific financial competition issues. It will generate - this will facilitate greater and more consistent scrutiny of competition matters in the sector. The FSU currently comprises 12 staff but it is supported by in-house expert advisers within the ACCC that provide legal, statistical and economic analysis. Accordingly, the capacity of the FSU is larger than the notional staffing numbers suggest and it has scope to concurrently undertake a mix of market studies and investigations, among other matters, as required.

The residential mortgage price inquiry is the first task of the FSU and our interim report will be issued shortly. From July 2018 onwards the FSU will commence its market studies work and the precise scope of that work is still being determined, but it could include assessing the impact of regulatory measures which affect the ability of the smaller banks to compete against the majors, barriers to entry in financial services markets and consumer switching.

I would like to just talk about embedding greater transparency in decision making and commitment to competition next. The ACCC supports increased transparency in regulatory decision making impacting the financial system. Ideally new or amended regulation would be developed in consultation with, or input from, the competition regulator. That input would be reflected in consultation material or otherwise publicly available information to allow the merits of the proposed regulation to be debated. The ACCC stands ready to work in this way with APRA, the RBA, ASIC and the Council of Financial Regulators.

The ACCC is also keen to work with APRA, the RBA and ASIC should they require specialist competition expertise when seeking to balance their respective statutory completion objectives with their other statutory objectives such as financial system stability.

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We note the Commission's view that the competition champion should be a member of the Council of Financial Regulators. Membership of the CFR is appropriately a decision for government. Whatever mechanism or process is ultimately adopted, the ACCC is firmly of the view that it is important for competition to be given greater significance in the regulatory decision making process. A threshold question to resolve is which matters should be considered by the regulator with the role of the champion in competition. In our view, priority should be given to measures likely to have a significant impact on the competitive process in the market and measures which prevent new competitors from entering a market, or otherwise increase barriers to entry.

Thanks again for the opportunity to appear before the Commission today and we are very happy to answer any questions.

MR HARRIS: Thanks to the ACCC for that opening comment. Could we go straight to this - the largest structural change in our report which is this nature of having a competition champion and you have alluded to it in your opening remarks in a couple of different ways. As you said, membership of the Council of Financial Regulators is a matter for government, which is of course literally true but will not necessarily help us come to a decision on who might best do this. I am going to try and concentrate on capacities and capabilities of a party, but I'm going to do it with our recommendation in mind and hopefully you will be able to work along with that.

So from our perspective we see membership not just being another seat at the table, kind of thing. We see it as clearly a source of independent advice to the primary regulatory structure when it deals with the nature of regulatory interventions into the marketplace that could have an impact on competition, and thus sort of almost characterising it as membership. Indeed, it's not about membership at all. It's about the ability, appointed by the Treasurer in our position, to be the advocate for competition as an independent source of advice.

Thus we did see two parties, and you're obviously one of them, that might do that and I'm not going to ask you to make comment individually about them other than on this question of resourcing. So the capability of the ACCC to undertake such a role isn't just limited to the number of people. In fact, it's really not reflected at all by the number of people you can throw into the task. It's this ability to assess the sorts of questions that we've been discussing here this morning about the, if you like, the risk appetite that a regulator, primarily focussing on stability of the overall system, has in mind for the industry. So it's a capability question, if I could go beyond it, than just an inquiry kind of question. Would you be willing to comment on that at all, this question of having the capability or obtaining the capability?

MR BEZZI: Well, I think there are aspects of our structure, our experience, our history which give us a unique capability to provide advice about - from a competition perspective. We are used to giving advice within government. We give this, for example, to the Minister for Communications when - - - is dealing with issues such as spectrum limits. We provide

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advice to the Foreign Investment Review Board. We currently provide advice to the Reserve Bank if they're considering designating payment systems. So this is something that we currently do, and we're currently resourced to do. We've done it for a number of years. Not to a great extent in the financial sector, but it is certainly something that we do do.

We also have the capacity to draw on our experiences dealing with a range of oligopolistic markets. We deal with energy. We deal with telecommunications. We deal with a number of markets where there are small, powerful players, and we do find that many of the issues from one market to another are similar and that lessons in one can be drawn in to another.

Now, I think that is a unique capability about a generalist regulator, and one of the strengths of having a generalist regulator provide competition advice to other regulators. Look, I think that we've got the - a depth of understanding and depth of experience in these competition issues that is very substantial and it exists at a whole range of levels within our organisation, from Commissioner level right down to relatively junior levels within our organisation. So that's another important capability, very important capability. It adds credibility. It also enables us to really bring a fresh perspective to issues that - and perhaps look at things slightly differently.

Look, we are also used to working within government and, as I say, giving advice to other regulators when they call on us to do so. We have very good, constructive, respectful relationships with other regulators. We understand and respect their role. I think they understand our role and our expertise and our experience and often that works very well. We very much welcome the government's mandate given to us last year to increase our role in the financial sector. It's a gradual increase, as I outlined in the opening statement, and that we will continue to develop that role.

I'm not sure whether I've answered all those bits of your question? I think I did.

MR HARRIS: No, I mean the core sort of consideration we've been given here is this question of capability which probably better exists offshore. For example, as we have noted in the report, foreign regulators in this area - we use the UK as quite a good example - have had experience in this field. It's that kind of capability I'm talking about, not necessarily historical or even recently generated capacity which I have no question about the ACCC's general capacity. It's this question of debating in a field where the systems stability regulator needs to hold some form of common understanding of a competition adviser, if you like, or the competition champion. It's that kind of capability that I think we were questioning. Of course, it's presumably available. It would have to be made available. So I note that - I think we've heard this question of resourcing is perhaps being viewed as a question of do we have the people in terms of numbers, or has the government given us a funding mandate, and it's capability really of a slightly different kind that we were thinking of.

MR BEZZI: Look, I understand and there were certainly - in the Financial Services Unit we've got people from a range of bodies, including some of the regulators that we've

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spoken about today, and actually also including the Financial Conduct Authority from the UK. So we've got a whole range of people with experience of the sort that you're talking about, and deep knowledge of the sector, which of course is complemented by the broader knowledge that the agency has and the broader experience that the agency has in dealing with a range of sectors.

DR KING: Can I just follow up on that, because in some ways the task that we see of the competition champion is quite different from anything else that, in my understanding, the ACCC would do. You will notice in our report we refer to the Hilmer type test that we expect the champion to be looking at. Is this a change where the costs in terms of competition are larger or smaller than the benefits, and the benefits will be in terms of stability existence. So it's being able to make that evaluation.

But the second part is well, the second part of the Hilmer test which is to the degree that there are competitive effects of a proposed intervention, what other ways could the same objective be achieved at less cost to competition? Now, the ACCC as I understand it currently doesn't carry out that sort of analysis annually, and would - I'm not sure who does.

MR BEZZI: Look, I think we are heading into that territory in some of the market studies that we're currently doing. We've done market studies into gas and electricity markets, and they're not within my area of responsibility but the sense I have is that we are touching on some of those issues in terms of the recommendations that we're considering and the issues we're touching on. I think in the last couple of years we've really taken on a much more significant market studies role. I think we've got five or six directions to commence large market studies, many of which touch on exactly that issue. We're doing one in relation to North Queensland insurance at the moment, which touches on some of those issues. The gas one certainly does. Perhaps also electricity, although I'm not as familiar with that.

DR KING: I guess one of the bits of feedback that we immediately had as soon as the draft report came out, and we put forward the ACCC as a potential candidate for the competition champion, was people have long memories and they go back to the early 2000s when credit cards first came into play and they note that the ACCC seemed very keen at that stage to handball competition analysis in that part of the financial system off to the RBA. So I guess one response we've had is well, the ACCC has shown that they're not - they don't have the appetite to work in these financial markets. How would you respond to that?

MR BEZZI: Well, I think we're a much larger organisation than we were in the early 2000s. We're a more sophisticated organisation. We're also differently led, and I suppose my feeling is that in those days we were probably a third the size we are now. We have - it's not about staff numbers. It's about experience and sophistication, and I think we are much more focussed on a broader range of things and that's demonstrated by the responsibility that has been given to us in relation to these market studies in very complex areas.

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MR HARRIS: Would you think a — we will call it resourcing capability — a resourcing capability that might add value here would be the appointment of a commissioner with specific interests in this area? I know this is - - -

MR BEZZI: It's always - - -

MR HARRIS: Government views notwithstanding, just that the concept of somebody with that kind of - - -

MR BEZZI: We've got commissioners, or certainly one commissioner, with a lot of background in financial services issues. But yes, it's always helpful to have someone with a background in an industry. Yes, I agree.

MR HARRIS: Particularly if there's interaction between the stability of the financial system and - anyway, it was just a thought, I guess.

MR BEZZI: One of our commissioners was a longstanding senior officer at ASIC, for example, for a long period.

MR HARRIS: Yes. Transparency, you mentioned in the course of transparency, which I see as relating to this whole question here - so one of our propositions was in order for the Council of Financial Regulators to lift its influence really and also show the balance between competition and stability, and its proposed actions was to publish its minutes in the way the RBA does when it's proposing to take an intervention. We call that a transparency device, and I assume you would too. But you alluded in your opening remarks to new regulations to support transparency. Now, it's quite possible in terms of our recommendations that the recommendation for what I call reality pricing could be considered to be a transparency device. So when you said new regulations, were you referring specifically to any particular area in relation to our recommendations?

MR BEZZI: No, I don't think I said new. We support increased transparency in regulatory decision making. I don't think I said there'd be new regulation to increase transparency. I think we had in mind that when new regulations were being developed that it would be done in a - - -

MR HARRIS: Oh, a transparent fashion. So it wasn't a regulation for transparency.

MR BEZZI: There would be more open consultation and there'd be a capacity for greater engagement with competition issues.

MR HARRIS: Okay, thanks for that.

DR KING: I have a slightly different direction.

MR HARRIS: No, I'm out of this area.

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DR KING: Really I'll start off on integration, and what we're now facing in the financial system is mortgage brokers, being the obvious case, although we have talked also about LMI this morning, but focussing on mortgage brokers, 70 per cent of mortgage broker loans are written for institutions that are vertically integrated. I think it's approximately the right figure. Does the ACCC see an issue with the current vertical integration in the financial system? So that's the first part of the question. The second part of the question is obviously a lot of this integration occurred under the existing merger laws and was not stopped by the ACCC, and Aussie and RAMS being the obvious example that had some publicity at the time. Do you see any issues with the current rules that the ACCC faces in being able to prevent integration?

So the first, is it a problem. If not, then the second part becomes partly redundant. The second part though is that the powers in this area that exist under the merger laws, are they enough? Is more needed? Is it different in financial services?

MR BEZZI: Well, this was one of the very interesting parts of, particularly interesting parts of the report. Look, we're giving thought to these issues and what we'd like to do is to put in a written submission that addresses these issues. I'm sorry to sort of skirt the question, but rather than commenting on the issue in detail now I'd really like to finish our internal discussions about it and then make a submission about it. I mean, we do see it as an important development in the market. I think you noted before the competitive impact of the mortgage brokers before the GFC. It's much greater than it is now, and there's no doubt that a case can be made that is as a result in part at least because of the vertical integration issues.

You've identified I think in the report some issues about disclosure of information and representations that are made in that, in the broker area. As you note, consumer protection in financial services is the responsibility of ASIC, but it is a very interesting part of the report and we will comment on it.

DR KING: I will have to change topic. Have you anything more on integration of that area, or I'm happy to move on to another topic which is the NPP is the next one I have. I'm just noting the allusion to the further advice coming.

MR HARRIS: So that's good.

DR KING: NPP, so obviously the ACCC isn't one of the Board, unlike the RBA which is on the Board. So you're able to offer perhaps a fairly unique perspective of being a party that deals with access regimes quite broadly over the infrastructure and isn't on the Board of the NPP. So it's difficult for us to obviously ask the RBA about things like a deemed declaration of the NPP. What is your view on - so we've suggested, put a draft recommendation that it be declared for access, an access regime be put in place under the RBA. What is your view of that? Is that a sensible way to go? Do you feel that it's too early for that? Yes, general views on that and then we might get into specifics.

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MR BEZZI: So the specifics are once again, is one of those topics that we would like to address in our written submission. In general, I would say that that is exactly the sort of issue that we would see ourselves as being in a position to engage with the RBA on, and indeed on other payment system issues. That's been something that has happened. So for example, the issue of cost routing. I might ask Ms Choucair if you are interested in understanding some of our engagement with the RBA in relation to that issue?

DR KING: Yes please.

MR BEZZI: Molly, if you could explain some of the work that we've done closely with the RBA on that?

MS CHOUCAIR: Sure.

DR KING: So this is the - - -of debit transactions?

MR BEZZI: Yes.

MS CHOUCAIR: That's right, in the context of - - - So we've been there as the regulator with the RBA in relation to this issue. We're watching this space quite keenly. Obviously the RBA has a primary responsibility in terms of the declaration it might make in that regard. So we as the ACCC certainly support this cost routing, and we would support merchants having that choice. In merchants having that choice we would also be keen to ensure that consumers were aware how their transaction was being routed. So there's a transparency element in all of that, which could very well be an issue for ASIC in terms of misleading and deceptive conduct in relation to financial services. But more broadly I guess the Commission is keen to watch potential reactions in this space from other participants of the market who might be impacted by this cost routing coming into effect, and specifically how the international card schemes might respond. So very much through a competition lens we're watching that space and obviously will note any development, but there might be scope for us to look at that issue more closely, depending on how it all plays out.

MR BEZZI: I think that's a good example of the way in which we can work with the RBA. We've got an MOU with the RBA under which we can agree to provide advice on designated payment systems or systems issues. We've got good relations with the area within the RBA that deals with those issues, and we think that is a great example of how the agencies can work closely on the competition issues.

DR KING: As we've got into the routing of debit transactions, there appear to be different choices or different approaches used in different countries. In our draft report we tend to focus on the merchant choice. I think that maybe the US allows a customer choice approach. Does the ACCC have views on which of those is best or would be more desirable for competition?

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MS CHOUCAIR: Yes. So I think it's fair to say that we don't have a considered position. We're certainly aware that in different jurisdictions there have been different approaches undertaken and you're right, in some jurisdictions it's the consumer choice that ultimately prevails. I think in Australia we're certainly moving more towards a merchant choice. I guess what our position is is with being agnostic on those two options, is just ensuring that consumers are aware of the network over which their transaction will be routed, so they're making an informed choice even if it's ultimately the merchant that decides how the payment will be routed.

DR KING: I have nothing further to ask.

MR HARRIS: You don't? Okay. So you mentioned access to data and the importance of open banking, and although that regime is - - - stage and have only just been announced. You see the ACCC's role as being a party involved there, as being a significant shift. Is there - the purpose of our final report I think going into - and the assumption might well be there is probably not going to be much by way of developments in the next three or four months that we could assess and cover off on the final report, but you did refer I think to arrangements with the Information Commissioner as well. So are there likely to be developments in this area? We've seen progress as being important and it looks quite positive, but is there anything else that you could offer on the record about what is likely to happen with open banking?

MR BEZZI: Probably not, between our role and the office of the Australian Information Commissioner, it - - -

MR HARRIS: No, it was more I don't know - we had seen what we've put in the draft report as likely to be what we will come out with in the final report, which is this is important. Open banking is quite an opportunity as a catalyst in this area. The design though of what the data is that is shifted from one institution to another is crucial. We've had some background briefings on banking but I just didn't know the degree to which, for example, you were involved in that ongoing decision making or - - -

MR BEZZI: So we're going to be responsible, as I understand it, for writing the rules. We're going to be responsible for setting the accreditation criteria, as well as enforcement and overseeing the data standards. I think you're right, it is early stages. I think probably, although this isn't my area of responsibility, but my understanding is that there is a process going on where the Treasurer has invited comments on the report. I suspect that those comments will be considered and then that process will be taking place before you finalise your report. There probably won't be much to add to that process in the meantime.

MR HARRIS: In the intervening period, okay. That's fine. I don't think I had anything else from recollection. I did, but I haven't written it down if I have. No, I haven't written it down. So I think we will be happy to close at that point unless there is anything specific you would like to get on the record before we finish?

MR BEZZI: No, that's great. Thank you very much.

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MR HARRIS: Thank you very much for your participation and for the future submission that you are going to be putting in. So I think for everybody's benefit we could probably take lunch now until 1.30 when we come back with the fabulously named Xinja. So be here at 1.30. Thanks very much.

ADJOURNED **[12.45 pm]**

RESUMED **[1.30 pm]**

MR HARRIS: We're going to restart and I think we have representatives from Xinja at the table who I think I'm going to ask to identify themselves for the purpose of the record.

MR WILSON: Thanks, Commissioner. My name is Eric Wilson, I'm the Chief Executive Officer for Xinja.

MS LE: And I'm Van Le, the Director for Strategy and Innovation at Xinja.

MR HARRIS: Do you have some opening comments you'd like to make?

MR WILSON: We do, if we may, thank you. Commissioner, ladies and gentlemen, thank you for the opportunity to speak to the Commission. We'd like to commend the inquiry and the work of the Commission generally. We'd also like to thank all of the industry and the non-industry participants who contributed, what we judge to be, an incredibly important discussion. We'll keep our presentation reasonably short, and well we love the sound of our own voices, but hopefully to allow plenty of time for the Commission for questions.

Xinja will be, if all goes according to plan, Australia's first neobank. We began building Xinja at the end of 2015 and applied to be granted ADI status in September 2017. We've raised about $10,000,000, have a waiting list of thousands and thousands and thousands of people, been granted our ACL and draft AFSL by ASIC recently and hoped to be granted our IDI status by APRA and become a bank between April and June this year.

By happy coincidence, our first product is also shipping today to our early customers and I'd like to thank, if I may formally, our regulators ASIC and APRA and the policy makers for that vision, assistance and guidance on our journey so far.

We aim to be a for profit but also a for purpose business, and revolutionise the Australian banking industry, in favour of everyday Australians. If successful, we'll be the first new retail bank since Macquarie, some 20-odd years ago, and we feel it's time that Australian's got access to the same neobanking technology and experiences that have been available overseas for a number of years now.

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If it's helpful, we'd like to share with the Commission, our experience of competing as a start-up and trying to build a neobank in Australia. It's worth mentioning that, in many ways, we're dealing with regulations that never envisaged the possibility of a start up being a new entrant in the banking sector. It's worth remembering that it will take time and experience to expose and rectify all of the regulatory booby traps that are waiting for new banks.

I think what is critically important to talk about here is that this review comes at a very important time for Australians and for the Australian financial services industry. We are on the cusp of a revolution within financial services, one that is already sweeping the world outside of our shores. The old moulds of high margin and high cost operating models are passing, and the time of smaller models, highly flexible, lower costs, super levels of transparency are already starting to sweep into financial services markets around the world.

Neobanks may be a new concept here and people may sort of looking at us curiously, but they are already well established in the UK, well established in Europe and spreading throughout the world. I believe there are 86 at the last county. That Australia still doesn't have any at all, I think is, in of itself, an interesting statistic.

Xinja supports the key findings and recommendations of the draft report, and we'd like to address a number of areas specific to competition in the retail banking sector, if we may, and my colleague, Ms Le, will talk about this in a little more detail in a second.

The report echoes very much what customers have told us about what frustrates them about banking and about money, in that it's not easy to make the right choices. It's difficult for customers to currently compare products effectively. There's a lack of accessible information. Products are complex. What appears to be one rate in a mortgage product, for example, means something completely different.

There's a really strong case to be made for a new regime of transparency across these products. There really are brand or marketing smokescreens, which the report raises and I think it's one of the greatest threats to this new neobank movement is that neobanks are impersonated by the older, more traditional banking organisations, but with a shiny new brand slapped on the front. Indeed, we're starting to see those in the market today and you have to look through five or six pages of disclosure before you can actually spot that this business is a joint venture with X.

One of the things that has struck us much – as somewhat a surprise, and I am an ex-big four banking executive, is that the trust between many Australians and their banking institutions is deeply broken, and I personally have no understanding of the depth of that break, until I started this business some years ago. There are concerns about the lack of effective competition and flow of commissions, creating an environment where advice that appears independent is not independent.

Finally, we hear from our customers all the time that breaking up is really hard to do. Customers tell us they'd like to switch, they're happy to switch, they want to do so, but

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from their perspective all of the existing players look the same. Where do they go? Why go through the effort if there really isn't much variation? Of course, secondly, it's a lot of work to switch. The ability to switch bank accounts, to port data simply and easily, is simply too discouraging.

We're enormously encouraged by the PSD2 developments in Europe. We believe open banking is a critical part of the open data movement generally for consumers and is a revolutionary tool for competition within Australia. We applaud the open banking review recently released, and we think this is a key contributor to consumer choice and convenience.

I think it's mentioning specifically, the objectives behind the recommended reforms that we would like to call out and pinpoint for their importance. Firstly, clarity, about how products are priced, how the features vary, what the minimum scope for a provider or a group of providers is to provide that for that clarity, and how they can – and an examination of how they can exert significant influence over price.

We're also a huge supporter of sufficient information, for both providers and consumers to be able to make informed decisions. The flow of data allows customers to make really strong decisions and it allows us, as product providers and as bankers, to be able to give a risk price for individuals, to be able to make really intelligent decisions for our customers.

Thirdly, low barriers. Industry participants have to enter this market and we have – if we wish to expand within it, we have to make sure that there are low barriers to entry, and we don't believe that that is inconsistent with making sure that our financial infrastructure is safe and secure. I've been a banker most of my career. The last thing I'd want to see is our financial infrastructure fall pretty to weakness.

Finally, and perhaps most difficult, we need to make sure we install a regulator environment that doesn't impose undue distortions, that doesn't favour incumbents or doesn't overly favour start-ups. The access, or the provision to access a particular financial product or particular providers, need not to be influenced by the regulatory environments in which they're operating.

I think possibly the most important thing for us out of this report is that we strongly agree that the key to new competition or to – sorry, that the key to real competition in the market is to encourage new entrants, and this passes the pub test. I remember recently the conversation in the media about the bank tax, quite disregarding whether you think it's a good thing or a bad thing, the conversation was all around the bank tax will be passed on to the customers of the bank. But that, of course, assumes that the customers of the bank have nowhere else to go. If you make it easy for them to move, they have viable other non-big four alternatives, it's a – it's then a conversation for the banks to how to deal with that tax, and not a customer that's locked in and can't escape it.

ASIC, in January, changed the requirements around crowd funding. Now crowd funding is an important thing for start-ups, but I wouldn't want to overstate its importance. We've

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been very fortunate and raised over a million and a-half in equity crowd funding over the last three or four weeks and it is important, and our duty to those shareholders is massively important. However, to build a bank, a million and a-half is not a material amount of money. The types of money we talk about are 15, 20, $25,000,000. So it's important to make sure that we don't use crowd funding as an excuse to make other reform – not to make other reforms.

We look forward very much to the passage of the legislation currently before Parliament that will make it easier for start-ups, like Xinja, to enter the market and create competition, allowing them to use the term "Bank", allowing us to hold less regulatory capital in the first instance.

Perhaps two most important points around this, we'd like to highlight the need for regulations relating to ownership to take into account the impact on start-ups. Whilst Australia doesn't need a whole bunch of new banking honour guards, it's not that we wish to hang on to equity, but the current requirement that only one individual can hold 15 per cent of a bank makes it incredibly difficult. I think there's probably only me and two or three other people in this country, dealing with this problem. I say, the issue isn't that I want to walk away with 80 per cent of the bank, the issue is I have to sell that equity at certain times to allow me to raise more money to build the bank. If I'm forced to do that in a fire sale, not only does it cheapen the equity, but it also limits my ability to actually get the bank up and running.

The other thing to consider, of course, is that many ventures of this type are backed by venture capitalists and corporates and the level of risk required to back a company like ours, often necessitates and investment of more than 15 per cent of the equity. So these limits place constraints on us in terms of raising capital and allowing it to grow. I appreciate the easy pathway down there is to go, obviously, the principal shareholder just wants to hang on to it. But actually, it's a little more complex in nuance than that, allowing us to build a bank and to take it forward.

Finally, I think we'd like to also think a little bit about how the interplay of ADI licensing and ACL licensing works. So with a credit licence, Xinja can issue mortgages to the extent that we have funds to lend. Our first challenge, of course, is to access wholesale funding.

But the second challenge is then that where we can access whole funding, a restricted ADI limits our ability to offer offset accounts with those mortgages. This means we have to make difficult choices around how we split our $2,000,000 cap as a restricted ADI on deposits between offset accounts to provide a better outcome for home loan customers which means a smaller number of mortgage customers, or that we allow ourselves to use that $2,000,000 to raise deposits which again allows us to – it turns into a vicious circle for us.

Finally, before I hand over to my colleague, I'd just like to talk about the role of technology. The role of technology is massively significant in this change and this revolution that is coming to banking. Just to give you some numbers, a legacy bank is likely to spend

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somewhere between 25 to 30 to 40,000,000 to build a new, or to alter their new bank end banking platform. Currently large banks spend about $600,000,000 a year on these bank end banking platforms. However, we're able to bring a cutting edge back end banking platform, probably two or three generations ahead of this country from Europe for about $20,000 and then a monthly - - - as a service fee.

So these barriers to entry are falling, and it's incredibly important that our regulatory environment allows people like me, and hopefully lots of other neobanks, to come into this market in a safe, regulated fashion, but not constrained from competing and offering some real, genuine alternatives. So to talk for a little bit about some specific additional recommendations, I'll ask my colleague, Van, to speak.

MS LE: I might start with that point on technology and some of the very early conversations that we've had with customers in terms of what they'd like to see next, brought into the Australian banking sector, especially our younger customers, our millennials. One of the most striking quotes that we've come across is a millennial who said, "We do everything differently to our parents, except banking. Banking is the same". I think that, in some ways, captures the opportunity that's available to this sector, not just in terms of technology, but also how we compete on a national stage.

So in addition to the recommendations that have been put forward by the draft report, there are a few additional proposals that we'd like to put forward and they cover four key areas, the first one being recommendations – additional recommendations to empower consumer choice; recommendations around encouraging new entrants into this space; recommendations that specifically address competitiveness in the home loan market; and finally, recommendations around further expanding the benefits of competition.

So I'll start firstly with some recommendations focussed on consumer choice and confidence. We would like to recommend that ASIC's existing work on financial education by MoneySmart as well as its work on the National Financial Literacy and Capability Strategy be incorporated into the broader framework of empowering consumers to make good choices.

One of the first barriers to consumer power in this market is the level to which consumers actually engage with financial products and services. Some of the research we've done has highlighted that 39 per cent of workers spend over two hours a week thinking and worrying about finances while at work, and that's time spent just worrying. Yet, only half an hour a week is actually spent engaging with financial decisions or financial activities. You compare that half an hour a week to the 1.8 hours per day that people spend on Facebook. So we believe there's a real challenge and opportunity around encouraging consumers to actually engage firstly, if they're going to be in a position to have more consumer power in a highly complex market.

We also note that 41 per cent of people actually want to spend less time on money administration. This, I think, speaks strongly to the potential for technology and open

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banking, to be able to achieve these stronger consumer outcomes without placing the full burden of the effort of achieving competitive outcomes, on consumers themselves.

We also note that good financial advice is particularly important for consumers to be able to make good choices. Many of our customers have told us that they trust the Barfoot Investor more than they trust their banks when it comes to advice on money. We note that only 14 per cent of the work force actually use a financial planner, and some of the concerns for customers is the perception that financial planning is expensive, is too sales-focussed and lacks independence.

There are a number of initiatives in the National Financial Literacy Strategy and Consultation that starts to address these and I think they need to be considered in conjunction with the broader framework of the level of competitiveness in this sector, so that consumer power is balancing with market structures themselves. We believe a strong national financial capability strategy is absolutely crucial for empowering consumer choice and that needs to start with existing consumers, but also take into account future consumers, especially those going through our education systems.

The second round of additional recommendations we'd like to add, is specifically around encouraging new entrants into the banking sector. Firstly, we'd like to propose that prudential regulations, while critically important for protecting the stability of our financial system, also takes into account the relative risk of new entrants to the overall stability of the financial system at a whole. We think it's disproportionate to expect start-ups to meet the same high prudential standards designed for larger organisations to ensure that they don't fail to a level that impacts the whole market.

Secondly, we propose that any regulation affecting licensing banks the financial services sector, takes into account the differences in business lifecycles of different participants, especially early stage participants. When you introduce regulation that's designed to change the conduct of existing players, you may inadvertently prevent or stifle new players from coming into the market. So it's really important that regulation is viewed, not only in terms of its impact on existing participants, but also those who might want to enter the market.

Along that same vein, we also believe that to the extent that there will be a regulatory body or a competition body or competition functions that come into play in the financial services sector, those functions should specifically include analysis of the competition impacts on start-ups and early stage competitors, particularly because that is where the highest risk and opportunity is for disruption, competition and innovation in this sector.

I'd like to now address how do we improve competitive outcomes, particularly in the home loan market. If you take a step back for a moment, if we look at the benefits of competition in the financial services sector, I think it's worth looking at where those benefits ultimately impact the everyday consumer. For many consumers, the primary financial product or service that impacts their pocket is their home loan or mortgage. So one of the questions

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that we should be asking ourselves, with all the recommendations coming out of this review is, how does this play out in competitiveness in the home loan market?

One of the recommendations of the review was to enable the central collation of home loan rate data. What we'd like to propose is that there is a technology aspect to that that enables consumers to not only access that data, but more importantly access it in real time at the point at which customers are trying to make those decisions, being able to compare home loan rate data that is days old, even weeks old, in a market that is moving so fast can, inadvertently, disadvantage consumers.

The second additional recommendation is that consumers have visibility where their brokers or advisors are lender owned. We are not suggesting that brokers and advisors not have a role or that it isn't appropriate for commissions to be a part of the economy. But we do believe that consumers should be empowered with visibility of the relationship between lenders and brokers and advisors where there is one.

We also propose that customers have visibility when they are being recommended a home loan that happens to be one which pays a higher level of commission compared to other alternatives. Again, this is about ensuring that consumers are fully informed.

An additional recommendation specific to home loans is ensuring that regulation includes analysis of barriers to entry, specifically into the home loan market, not just for lenders but specifically home loans that are attached to offset accounts. It doesn't work to consider the loan separately from the deposits because, for the majority of Australian consumers, how those two elements work together is key to their overall financial wellbeing. So we recommend that in assessing the competition in the overall financial services sector, we give particular attention to competition in offset-based home loans.

Finally, we believe that the ACCC's experience in dealing with wholesale markets, may provide some learnings that are relevant when considering the competitiveness of wholesale funding in the Australian banking sector.

Finally, we have one key recommendation around expanding the benefits of competition. We believe that whilst it's important to look at improving the level of competition within the Australian financial services sector, Australia has the capacity to think beyond our current markets and consider how does enabling a competitive financial sector here, position Australian businesses to compete on a global stage.

To that end, we note other sectors, such as software development, where we've had amazing Australian start up stories, such as - - - and also Atlassian where they've been able to take a leadership role, not only in Australia but internationally. So a really great sign that we have a strong competitive financial services sector here is looking at the incidents of Australian businesses that are competing well here, but that are also competing on the international stage. We'd now like to invite questions and comments on our submissions so far.

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MR HARRIS: Thank you very much for that. Can I start with this 15 per cent ownership element? You may know more about the progress of this because, I presume, you have been consulted as this – as well. What we currently understand to be the case is that there is a draft regulatory reform buzz around to change the ownership level from 15 per cent.

But the way you presented your case, as I understood it, was you have to have a very high ownership level in order to, as it were, sell down equity in tranches over time to bring in additional capital to – as the business needs to grow. So is your proposition that you start out at you know 80 to 100 per cent owned by an individual and have a sort of sell down strategy? Is that the idea? Without necessarily going into things that are terribly commercially sensitive for you, I'm trying to work out whether this proposition on 15 per cent is to lift 15 to 25 or to lift 15 to a very high number and go down?

MR WILSON: I think perhaps the easiest way to answer that question is truthfully and openly. So the current founders of the venture own about 70 per cent of our business still. I think at the point where you reach a capability to apply for a restricted ADI and you've been through that process, it's very unlikely that the founders would have 80 to 100 per cent, simply because you have to gather capital around you. I think, even without – banks are capital hungry businesses. So even without any regulation, it is likely that that founder number will fall to 25 to 30 per cent, even without any kind of effort.

I think the key for us isn't around what that final number is and we're comfortable, to be honest, if it's 10, it's 15, it's 20, it's 25, whatever – wherever that ends up. I think the issue for us is the certainty about that pathway, and we've seen it in other sort of financial services industries here. The issue is when it comes in a hurry and it can't be prepared for. So APRA may sell, "You need to sell to get to this point". All of a sudden there's a glut of equity onto the market because it has to be sold in order to keep – to ensure they remain compliant.

So we would like to see a pathway where, perhaps, it starts around 70, 80 per cent but there's a clear considered action approach, through a number of years, where that equity falls. We would have, for example, no problem at all where APRA say to us, "Okay, Xinja, these are your requirements when you go off for a restricted ADI, but within three years we expect you to be compliant with the 15 per cent". So it's not about the numbers for us. It is about being able to take that pathway in a careful, considered fashion and not having to create a fire sale.

MR HARRIS: Is that what happens overseas? You've alluded to other neobanks, but you're the sort of – well there's – I don't want to say you're the only, but you are a pioneer here.

MR WILSON: - - -

MR HARRIS: Is that way – is it the way other countries deal with this?

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MR WILSON: So I haven't had these types of conversations with any of the founders of the overseas neobanks. They - it is not a consideration that comes up for them at all. So I'm not familiar with the regulation in Europe and the UK.

MR HARRIS: But it means their regulators must be finding a way to deal with this because presumably, whilst you might not be asking us specifically about that, in the trade press there'd be a sell down of option known.

MR WILSON: Agreed.

MR HARRIS: So is it your general impression that people do start at a much higher level?

MR WILSON: Yes, I believe so. I believe so. I think the general impression is that the process is less closely monitored. We're not necessarily advocating that, as I said before. You know, we object – our outcome is not that we wish to see a whole bunch of banking - - - created in Australia. Our outcome is that we see a whole bunch of neobanks created in Australia and we're given the opportunity to move to an equity position over time that we can control it and use that equity to funnel our businesses into growth.

MR HARRIS: You referred to using the term "bank", and yet we also hear the term "neobank" or something like that you used. There's a lot of sensitivity around this, or historically there are reasons around using the term "bank". So is it the case that there's a settled view now on the right terminology or is that not yet here?

MR WILSON: Look, certainly we've been getting a very clear feed from our regulator on this. The word "bank" is tightly controlled. It doesn't matter whether you call it a "neobank" or you start it with a "Q", at the end, or however it is. It's a regulated word and you can't go near it. I think the interest in this legislation is that once it goes through, those of us that are on a restricted ADI will be allowed to call ourselves a bank. Some of the credit unions will be allowed to call themselves banks. Personally, I think that's an outstanding development, because it allows us to compete on a much better playing field.

If your question is, should the term "bank" be freed up further so that you can use it before you get a restricted ADI, I don't believe so. I think that would be quite a dangerous place to be.

DR KING: Can I just push a bit on that?

MR WILSON: Of Course.

DR KING: Is the name "bank" that important? I mean, you seem to be putting a lot of weight on it?

MR WILSON: Yes. I think for us, it synonymous with the – that the government guarantee the deposits. So you know, and I get asked the question all the time by investors, they say, "Okay, well that's great. Well, you know what happens if you run off to the

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Bahamas with everybody's money", you know. The answer to that is (1) I'm never going to run off to the Bahamas, but also that the government provides a guarantee of $250,000 per person on those deposits, and the word "bank" signifies that and often links, in consumer's mind that if you have a bank, they're government guaranteed and the money is safe.

DR KING: Okay. Even though, the legal situation is significantly more complex than that?

MR WILSON: Absolutely.

DR KING: Okay. To the degree that it then, as soon as you get the name "bank" you're underwritten by the government, there's a - both an implicit and expectation by depositors and the electorate and explicit role there by the government, you said that new interim – so you know let's say the new interim's got the name of a bank, it should be subject to less prudential regulation.

I mean, is there, from the government perspective, actually more risk from – not a system's stability point of view but simply from you know if you think of the government as a reluctant insurer you know, the 18 year old driver is a lot higher risk than the 65 year old who's now – let's bring it down to someone, 50 year old experience but not going eye sight problems or anything – driver, is it the same in banking really but from the government's perspective, new interim's called "bank" and with all that goes with the name "bank" can be considered a higher risk?

MR WILSON: So I think there's a couple of good questions in there. Firstly, we don't in any way advocate that the non-capital restrictions should be waived or varied at all. So, for example, of the enormous plethora of things we have to prove to our regulator, everything from credit policies through to disaster recovery planning, we're very comfortable for those to remain in place. We feel that those types of things are absolutely critical to the security of the financial infrastructure and we support those 100 per cent.

I think the things we've looked to change in the regulation, and they are starting to change, is those blanket statements. So, for example, recently it was, "You can't become a bank unless you have 50,000,000". Well, what does that mean? We're looking for regulation based on risk and risk weighted assets. In terms of you know are neobanks more risky than traditional legacy banks, I think probably we have to look overseas for that. So we've not seen an implosion of any of the neobanks overseas. There's been no horrific stories of people losing money and so forth.

On an individual level, you'd have to say that the likelihood of a neobank struggling financially was obviously greater than CommBank or Westpac, absolutely. The impact of that however, when covered by the government guarantee on consumers, is massively mitigated. The amount of capital required to hold at the moment on 3 to 3,500,000 in capital for 2,000,000, you know just off the top of your head that seems a pretty comfortable

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coverage ratio, and indeed far higher than any traditional bank maybe would be required to hold over its deposit base.

So I think the proposed legislation is probably in a position where it imposes a considerable level of capital cover on us. But because the absolute numbers aren't too massive, I think we're pretty comfortable with the way it's going in terms of capital coverage.

DR KING: I just wanted to change the direction on that slightly and just see – in terms of barriers, I'd like to get just a little bit more information on the offset accounts and that's rolled in terms of lending. I just also wanted to - get back to that in a second – but before that do, just to understand the lending side of your business. You've got, I think you said, 2,000,000 in deposits at the moment. For lending, would you be requiring – you said "wholesale funding" – would you be looking at sort of warehouse funding and securitisation type of model or would you be holding the mortgages on your book? What sort of model are you looking at pursuing, and then I can ask you questions about - - -

MR WILSON: Just to clarify, so we don't hold deposits yet. We're not a – we don't have ADI status yet.

DR KING: Yes.

MR WILSON: And 2,000,000 is the number that the restricted ADI allows us to hold.

DR KING: Sure. Okay.

MR WILSON: So in terms of a book, the best way to think of us to start with is as non-bank lender. So we don't have large amounts of deposits to draw on. So in order to be as safe as we can, we seek various, and are seeking various funding lines. Some of them are all the usual suspects that you'd expect in Australia. We also look overseas for overseas pension funds. We also look to private funding lines. So our cost to funds, certainly at the beginning, is substantially higher than the perhaps the big five. So and then obviously, we look to securitise over time as we mature in our market. Then as our deposits start to pick up and we move on from the restricted ADI into an ADI with ADI with conditions, we then perhaps look to a more traditional funding sources from our own deposits.

DR KING: Do you see issues at the moment with the regulatory constraints around the wholesaling funds? My small historic knowledge on that is just to note our you know Aussies and Rams were the big innovation of the 90s, big competitive affect and of course dried up as soon as the wholesaling fund dried up and the securitisation market has been – come back but fairly flat.

MR WILSON: Absolutely. This is an absolutely core strategic question to organisations trying to build neobanks. One of the conversations we had two to three years ago when we were trying to decide the strategies and would it be – actually, should we go down the non-bank lending route and do exactly as you've described. Our decision not to do so, to go down the bank avenue, was exactly for the reasons you just outlined, what do you do when

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the wholesale markets dry up? What do you do when securitisation markets start to become a little difficult? That was a decision to move down a full bank and to seek an ADI because it allows ourselves to gather deposits and to grow a deposit base in order to insulate ourselves from exactly those problems.

DR KING: You mentioned offset accounts. Do you mind, a bit more detail on that, because I think this is the first time I've heard it raised. Others may have heard this raised elsewhere. But you said "restrictions on offset accounts related to mortgages".

MR WILSON: Yes. So just for clarity, an offset account is effectively where you allow customers to hold a pool of money, and that pool of money counts as if they paid it off their mortgage. The difficulty that we're discussing here is around the restricted ADI which only allows you to hold 2,000,000 in deposits. And as a new bank, I have conflicting priorities, I want to build deposits and I also want to make as great a deal as I can for the people taking home loans from us. So if I need to offer offset accounts for our home loans, obviously, I have to put that into the deposit file.

DR KING: Yes.

MR WILSON: But hang on, I can't use those deposits because they're required for the home loans. So treating deposits in offset accounts the same as deposits, which might be in a savings accounts which the restricted ADI does, will cause us some complexity in the first early months of this – of the restricted ADI. I think the solution there is potentially either some distinction between those types of funds and that can be done by a - placing restrictions on us as to what we can do and what we can count those funds for, or potentially examining the ability to increase the amount of deposits we can take when they're specifically related to - - -

DR KING: To a specific loan.

MR WILSON: - - -

DR KING: Yes, okay.

MS LE: The other competitive impact of that is, is if we need to go down the path where we are limited to $2,000,000 in deposits initially, then the kind of products and services that we can bring to market to compete when it comes to home loans will more likely to limited to standard vanilla loans that don't have an offset capability. Meanwhile, our for purpose intentions are to be able to offer you know greater financial wellbeing for customers. So on the one hand you may have less competition, less new competition in those types of home loans, or we may need to be a situation where we have a little bit more flexibility to grow as an overall bank that is competing both on home loans and deposits, otherwise it may be quite some time before we see genuine competition, especially in features and innovation and pricing for customers on home loans without the ability to do offsets and home loans together.

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DR KING: I've only got one other on technology, so I sort of - - -

MR HARRIS: No, no, that's it. I was going to ask the offsets question myself. You've done that.

DR KING: Okay.

MR HARRIS: So you're on the last question.

DR KING: All right. Technology. So was it 20,000 up front plus a monthly fee that you pay for the software? We know that the existing banks had significant troubles with their IT systems and incompatibilities, simply getting products – all their products which were traditionally on different IT systems, onto one IT system. When they have had attempts to integrate, they haven't been so successful. Yet, you're –and we're talking about billions rather "20,000" for traditional banks.

Where do you see this going? I mean, you've just suggested – I mean, in a sense it suggests the economies of scale. Technology is going to rip the economies of scale out of banking. Am I getting that right and, if so, does that mean that really we've got a current system that supports a bunch of dinosaurs and we should be getting – thinking about how they should exit the system rather than support it within the system?

MR WILSON: Look, I think the – I think it's worth saying that I think there is a growing train of thought, and I'm certainly a proponent of this, that there is a want, in every couple of generations, change, structural change coming to the finance industry. I'm not saying it will happen tomorrow or next week or next year. But within three to six years we're going to see substantial changes in the cost mould and the cost bases of banks.

Right now, you know we're talking about back end banking platforms, so the ability not to have to build your own, the ability not to run a branch network, the ability not to meet 30,000 people sitting in a branch network. That's just the cost side. So you know our ability to operate banks without these massive barriers to entry around cost and high cost are disintegrating before our eyes, as we see that now.

I think what creates a double whammy there is we're also starting to see a complete revolution in the way services are provided and how much they cost, how much they charge to customers. You know, we have distributed ledger technologies. We have you know supranational and supracurrency arbitrages across different product sets. It won't be that long before individuals who want a – you know who want to get a mortgage, are able to arbitrages lenders from around the world. They're able to arbitrage different currencies around the world and it will all be packed up – packaged up nice and easily in a consumer retail bundle.

The ability that you're – idea you're only going to have four people or four companies to choose from, is done. That market already exists. It's just a case of it maturing a little bit and us being ready to enter into it. It is of major concern to me. I mean, I'm a banker by

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background and, Xinja aside, it is a major concern to me that one of the key hearts of our economy is completely unprepared for this tsunami of change that is coming towards it.

That means there are people unemployed. It means there are families that are impacted by it, bankers – I know no one sheds a tear for the banker. But you know these are big economies, big companies that support many families. There is massive change coming and I think you know the wave of some of the redundancies that we're seeing now, some of the big four, you know the profitability levels are simply not sustainable and it concerns me deeply. But look we're sticking our head in the sand rather than stepping up, making regulatory changes, which we've started to. We're making technology changes and business model changes to cope with, survive this massive tsunami of change that's coming.

MR HARRIS: Okay. Thanks very much for making your time available today and for your contribution to the inquiry.

MR WILSON: Thank you. Thank you very much.

MR HARRIS: I appreciate it and we'll probably be in touch further, before we finalise it.

MR WILSON: Thank you.

MR HARRIS: Thanks a lot.

MR WILSON: Thank you.

MR HARRIS: Now I think we have one last submitter this afternoon, which is Peter Mair. Peter, come on down.

DR KING: Peter, is it "Mayer" or "Mair"?

MR MAIR: Mair.

DR KING: "Mair".

MR HARRIS: Just for the record, Peter, could you identify yourself?

MR MAIR: My name's Peter Mair. I've had a bit of history in the business of financial system reform. Well, thanks for the opportunity to come here today. Among others, I owe it to Keith Campbell to be here today.

In 1981, Keith certainly did not envisage a financial system like we have today. He had something else in mind and, as you know, things develop differently. I was interested, Mr Harris, in your address to CEDA the other day and I'll just touch on a couple of key points you made that draw out the correspondence of our views and understanding of things up to a point. You talked about the "degree of competition is a factor created by regulation and

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the regulators". I agree with that. You talked about "the most important underlying theme being a proactive regulator for competition". You talked about "the link between competition and instability" and you "understand the way regulators had applied controls to protect stability but limit competition". You and I agree that regulators must be at the heart of the Commission's report.

We started to drift a little bit apart when you were talking about nuances and subtleties in regulatory arrangements. We had a bit of an overturn of both peace and competition in our time. When you're dealing with these powerful focus, intangible sort of institutions and power brokers, there's not a lot of room for nuances and subtleties, I can tell. A little bit of four by two capped between the eyes would be a helpful bit of equipment to take with you.

You then - against that sort of background of general agreement, we part company because you see the way ahead as being through the council of financial regulators augmented with a competition voice or spokesperson. I don't go along with that prospect at all. I think the critical question that we are agreed on is what regulatory arrangement for Australia is likely the best managed, the practical reconciliation of stability and competition. You've got confidence in the council of regulators augmented with the ACCC.

My approach, similarly, in visions a coordinating oversight body but one that is very clearly independent of existing independent regulators. May I say, that between us I think history is against you. I gave the secretariat some reference points that I suggested for today's discussion.

MR HARRIS: Yes.

MR MAIR: One of them was to say that regulatory history is relevant. I'm disappointed that so far, the report has not given an assessment of what went wrong nor, having regard to what went wrong, what elements of that can now be corrected. There's not actually a lot of room to move from – or at least quickly from where we are now. I would suggest that the Commission consider aiming for a financial system that operates as if it were competitive. I'd like to see the Commission outline a framework, an institution framework, a narrative of how the system would ideally work in the best interests of the people, in the sense as if it were competitive, as if it had been competitive and had delivered us something closer to the ideal than the bit of a mess that we seem to have.

When looking at the history, I have made the point that in the early hours, under the guise of deregulation and so on, there was a big mistake made in that the major banks were deregulated in circumstances where that played into their hands. In the Commission's report, I could find not real sort of allusions to that important bit of history and that elephant, if you like, is still in the room and still dominating anything to do with the prospects for competition and proper operation of the financial system. Over the past – yes?

MR HARRIS: It is hard though, to unwind history. In Productivity Commission Reports, we will tend to take quite a lot of analytical consideration about history, but we won't tend

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to write very much up unless it's going to contribute to – and this is why this solution will work better. The unwinding of deregulation through the 80s, it's just simply not a practical possibility today.

MR MAIR: No, no, I understand that. But having regard to the history and that history involves all the institutions that are around today, the Reserve Bank and APRA, ACCC, ASIC, so on. That history didn't happen in a regulatory vacuum. It happened with the institutions that we have today and I suggest to you that the way history has unfolded should have a bearing on your assessment of the role of those institutions in correcting whatever way you consider it to have gone wrong and addressing the shortcomings.

MR HARRIS: Now you've talked about a - sort of an oversight entity or quite a separate entity to the current set of regulatory bodies.

MR MAIR: Yes.

MR HARRIS: How would you see such an oversight entity intervening? In other words, on a day to day basis, presumably APRA still exists and does what it does and ASIC exists and does what it does and the RBA, even though it's, in a sense, one step removed even from APRA and ASIC on a day to day basis, nevertheless does something of what it does, I assume, and then there is this separated entity. Is that the idea?

MR MAIR: More or less. Ahead of that, I think, the history of the ACCC and ASIC is such that the community would no longer regard them really as credible organisations in the consumer protection area. I know people in both organisations well and there are excellent people there. It's not the people's fault. It's rather that, in the case of ASIC, they've not been empowered to do the things that they actually want to do. In the case of the ACCC, the ACCC was told to get out of the road of the financial business a long time ago. That was when, 20-odd years ago, when they had a very well-respected chairman. But these regulatory games are not played gently, I tell you.

But to go to your more important point, we do need an institution and agency that can bring a credible competition policy role to the table. I see that as being an agency akin to what the Americans have established in the Consumer Financial Protection Bureau. It starting may well bring people directly from ACCC, from ASIC. But I think the idea of consumer protection needs to get a new start. I think, the handicaps that have been placed on the ACCC and ASIC need to be recognised from the history and addressed and removed from the functions of a new institution.

DR KING: Can I just press you a bit on that so that I can understand? I mean, ASIC has the financial consumer protection role.

MR MAIR: Yes, they do a stop, stop - - -. It took them 10 years to even get their mind around financial planners being required to act in the best interests of the customers. I was on the front row all through that. Just last year or two, I stumbled into another racket called

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"funeral insurance". If those agencies can't take those products out and demand the customers be given refunds, then there's gone very seriously wrong.

DR KING: Yes. So that sort of gets exactly where I wanted to go. You're saying, well we need to set up a new body.

MR MAIR: Yes.

DR KING: Is it that it needs to be a new body because the risk there is that you're just saying, okay, well let's go back to – you know let's turn the clock back 10 or 15 years and we'll start all the learning process again?

MR MAIR: No, no, no, no.

DR KING: Or is it that ASIC needs different legislation to give it different power?

MR MAIR: It needs a different – it's – after 20, 30 years with these organisations, there are cultural problems the same as there are cultural problems in the banking industry. I suggest to you, commend to you, the idea of a new organisation that brings from – brings together the competition and consumer protection functions of both the ACCC and ASIC, but let's put that to the side.

You go with whatever you may choose, including considering that option. But whoever's going to be promoting competition and protecting consumers, has to have the power to do it and they have to be accountable for doing it. It's all very well the ACCC coming along and on a road to Damascus saying their mind is nearly focussed. They've had 30 years to stand up and be counted and they have not. ASIC, I don't want to go through the catalogue of the way consumers have not been protected by ASIC when they should've been. It's not because the people in ASIC are necessarily not the best, but rather they are not empowered to do the job that the think they've been given to do.

MR HARRIS: So, you're not really proposing are you then, an oversight entity because - - -

MR MAIR: Well - - -

MR HARRIS: Because the Murray Inquiry had such an option. We did look at that. We don't actually think – just another not necessarily going to go you there. You're really proposing structural change amongst the existing set of regulators to focus on consumer financial protection?

MR MAIR: Well, sorry, I went – I diverted from your question before to cover that issue about competition and consumer protection possibly being put into a new organisation, at which point you would have the Reserve Bank and APRA, which I see as a consolidated group, and you would have the competition consumer protection people.

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Now the supervisory oversight that I've got in mind would be made up, obviously, of competent independent people. But they wouldn't have a role to be on the front page of the paper every day and so on. They would just be there to make sure that the other regulators, the regulators that are in place, were actually doing their job and they'd be free to take – I actually call it a "Standing Royal Commission". That may sound a bit pretentious, but it would give the power to the people doing this oversight to hear from and listen to people who have issues and complaints about why the existing regulators are not doing the job properly.

That's why I come back to this history being relevant. We've had 30 years or more since Campbell to find the right path and we haven't done it.

MR HARRIS: Okay. I think I saw that more clearly now.

MR MAIR: I talked about the elephant in the room or alluded to one. The Commission - the terms of reference, which I didn't have high regard for, nonetheless did extend an invitation to the Commission to examine personal deposit accounts and arrangements. I don't know where you look for that one. But you know, you missed the importance of the one trillion of free deposits. It beats me. That is the single most important impediment to competition, efficiency and fairness. Not only that, this is where the history again becomes very relevant, we've got a trillion dollars today when interest rates are down around two and a-half per cent. Imagine if we were back in the mid-18s, the cash rate's 15 to 17 per cent and they've still got the trillion. That's what they had. They went on a competitive rampage that basically took over the system.

The pillars have got this advantage, and if you're aiming to have anything approaching a competitive level sort of playing field, the competitive advantage that the pillars are getting from holding the $1 trillion dollars of free deposits which, incidentally, is tied up, entrenched in tax avoidance scheme where the banks take your money for free and they give you services for free. That stuffs up the efficiency of the retail payment system.

Not only that, they don't spend all the money on cheap payments. A lot of that money was misused to run rampant through the system taking over everything in sight, driving people out of town. Look at all those foreign banks, 15 to 16 of them. They only came in in 1985 and they were gone within a few years because they were ridden out of town. They couldn't stand the heat.

MR HARRIS: Yes. But what would you do about – you call them "free deposits", right. So it implies that you think they shouldn't be free. So are you proposing that in some way there should be what, a fix price for putting deposits into - - -

MR MAIR: Let me come at it obliquely. There was a time when pensioners were ducking the means test by putting money on bank deposits where they got paid no interest and the government, social security people, said "Well, we'll put a stop to that".

MR HARRIS: They put a deeming rate on it.

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MR MAIR: We'll put a deeming rate on. Now why you've get after the aged pensioners and leave everybody else untouched, I've got no idea. That's the first step I'd do.

MR HARRIS: But a deeming rate will only make any difference, because it's a notional charge.

MR MAIR: No. Well, hang on.

MR HARRIS: It won't make any difference to the banks themselves.

MR MAIR: It certainly does. It certainly does. If you're an old age pensioner like me, you'll realise that banks start paying you interest at the deeming rate.

DR KING: I think one of your proposals is that the ATO, essentially, deem income to those deposits.

MR MAIR: Yes, on the daily balance and the banks calculate that and put a – they either give you the interest or they put a credit – in fact in your account on which becomes taxable interest.

DR KING: So that would be - - -

MR HARRIS: So it's like a price fixing for deposits then?

MR MAIR: I beg your pardon?

MR HARRIS: It's like a price fixing arrangement for deposits.

MR MAIR: Well, not – it's certainly a better - - -

MR HARRIS: You're not proposing – you're proposing a deeming rate on it. It becomes - - -

MR MAIR: At the minute they've agreed on zero.

MR HARRIS: No, no. But I think what you just said is, you're proposing a deeming rate that becomes money deposited in someone's bank account. So that says that whether it's from the ATO or anybody else, you still have to have a regulation to do this. It certainly wouldn't regulate a price for deposits. That's really what you're saying.

MR MAIR: As they've done for pensioners.

MR HARRIS: Well, in the case of pensioners, they deemed – and it didn't really matter whether the banks paid them the money or not, they were still deemed, weren't they?

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MR MAIR: You are deemed. If you've got assets, you are deemed to earn.

MR HARRIS: Yes. But you're going one step further, you're saying a regulatory arrangement should impose a price on deposits which banks then pay. That's what you're saying.

MR MAIR: The regulation would say that whether banks pay interest or not is their business. But in terms of a relationship with their customers, this tax avoiding barter scheme that's in place would be disrupted by requiring banks to deem that they had paid interest to their customers or actually pay it.

DR KING: Well, a potential outcome though of what you're proposing is that customers – those customers who currently have these deposits and are receiving services, say, for this in return, they end up worse off and they're in a situation where they've got four banks in an industry where, as I understand, you've agreed is not particularly competitive. I just see there's a substantial risk there if the consumer ends up bearing the cost of the deemed interest rate without you know - - -

MR MAIR: Well, I mean, if you follow it through, the first thing that the customers would get would be interest.

DR KING: Why?

MR MAIR: Sorry?

DR KING: Sorry, so the banks aren't paying them interest at the moment.

MR MAIR: No.

DR KING: Yes. The tax office says, "Well, sorry, you're not getting any interest on that account but you're paying some tax on it".

MR MAIR: Yes.

DR KING: Okay. Why are the banks suddenly going to come and just say, "Well, yes, gee, we'll lower our profits and give you some interest on it"?

MR MAIR: The object here is, apart from equity in the tax system and stopping tax avoidance, barter and so on - - -

DR KING: Yes, I understand that.

MR MAIR: The object here is to neutralise an unfair advantage. It's not only unfair, it's an unassailable competitive advantage that the major banks have. The history, that's why I keep suggesting you look at the history, why do you think all the State banks, all the

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foreign banks, all of your building society banks – where have they gone? They've gone home with their tail between their legs or they're now part of the pillars.

DR KING: Yes. But just coming back - - -

MR MAIR: Yes?

DR KING: I mean, so I'm just imagining a customer's response to this. The customer's response is going to be "The ATO has said I'm paying tax on money I've never earnt and I'm going to somehow the big four banks to give me that money". I think that's – I – it's possible, and if there was competition, I can imagine that interest rate you're talking about would start being paid. But the problem is there isn't competition, that's your starting point.

MR MAIR: I think you should let your mind wander a little further than that because the reaction of the consumers will be something to behold. Not only will they be getting deemed interest on which they have to pay tax - - -

DR KING: Yes, pay tax in. Yes.

MR MAIR: - - - or may be getting actual interest, on which they have to pay tax, but once the banks don't have that easy money, which they've getting off the free deposits, they're not going to have as much money around to subsidise the provision of free services. So the customers may well be starting to confront the idea that they actually have to pay for the advantage services, instead of this ridiculous culture we have allowed to take root which is free banking. In this country, we have a culture of free banking.

I know there's a lot of media talk and complaint about so called "exception fees", if you don't pay this on time, they kick you to death. But the real racket is back in this one trillion of deposits. When you're looking at competition, we're not so much looking always for competition, what we want is the product of competition which is efficiency and fairness and so on, and innovation. By allowing the retail payment system to have been corrupted in the way that it has been, we have not had efficiency. We've not had fairness and we've not had the innovation that we would have.

Just before leaving the retail payment system, the credit card racket. That's another element of it and that's another element, especially, of the way in which this free banking nonsense has been allowed to take hold. When you use your credit card, you don't pay. It's free, right. You use your EFTPOS card, you might get charged 50 cents. The banks use free and price to get you to use free. When you use free, that means you're not paying, but the merchant is copping a merchant service fee of up to 1 per cent.

I certainly like your idea of – you've got an idea of removing interchange fees. I would suggest, perhaps, you modify that in – the one I'd like to see globally is that there are no ad valorem fees, no percentage fees. The European community now has an arrangement which allows a 30 - .30 per cent interchange fee for credit cards and a .20 for debit cards. Australia hasn't even gone down that far.

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This is a very interesting point when you're talking about the ACCC. You go back to around 2000, which was when I had a hand in driving those inquiries and the eventual reforms, the initial report was a joint one written by ACCC and Reserve Bank and I don't think the Reserve Bank was all that keen on reducing those fees.

That goes to this other nonsense about the competition and stability. The authorities in always looking for stability, are – have got these arrangements in place, the free deposits, and this credit card business that underwrite. So not only do they want stability, but they're underwriting that by giving these pillars this very soft income from the free deposits and from excessive credit card charges. So I commend you for the no interchange fees, but just suggest, yes, either no percentage fees or at least, very least, go to the European standard.

MR HARRIS: We do expect to do a bit more on interchange fees.

MR MAIR: Having suggested you might do more, I would discourage you from getting involved in the academic nonsense that parades as sensibly analysis. This is "how long is a piece of string" stuff. There is no need for a percentage fee on transactions. The transaction is a transaction. If they're lending money, they charge interest. This credit card business, and if you go back – I won't waste your time today, but if your secretariat goes back to the very submissions I've made over the last 20 years to all these inquiries, it will set out clearly for you, the way this racket has been run. It's just been round and round in a circle. They're still playing around with – they've put a cap on the fees, but then the issue was, issue some cards with no fees and some cards with – it has been gaming the system and it's been permitted. These are organisations that are setting around the council of financial regulators, they're the ones that have been knowing what goes on and have done nothing about it.

Within the Reserve Bank, incidentally, there is a payment system board which is sort of separate. Yes, I would, frankly, remove responsibility for the retail payments stuff out of there and put it, probably, in this organisation that I was talking about before, this new organisation.

MR HARRIS: We probably have time there for about one point, if you have got a series and then maybe – because you've put the submissions in.

MR MAIR: I have put the submissions in, that's - - -

MR HARRIS: If there is one more point though, I think you've got a couple that are highlighted. Could you just pick one and maybe we can finish on that one?

MR MAIR: Well, in relation to the new agency that I propose, the guiding light that I'd put above its door is the golden rule that banks and others should not offer and sell financial products which they would not want offered and sold to their parents, their kids or anyone else. If you're looking for a simple illustration of this defective product that should be proscribed, funeral insurance. If you watch, ever watch the SBS World News - if you're

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ever silly enough, you're sick at home one day and watch the morning TV, they are flooded with this nonsense. You ring them up, the first thing they do is instead of them contacting you, they sucker you into you ringing them. That changes the whole dynamic. Then ASIC says, all they have to do from that point is disclose and they disclose in ways that befuddles old people like me that are wondering if they need funeral insurance.

MR HARRIS: We've got insurance here. We might look a bit more of funeral insurance as a consequence.

MR MAIR: Well, it's not just funeral insurance.

MR HARRIS: No, no. But we don't want to get - - -

MR MAIR: But it makes the point, the golden rule point, you've got executives selling this stuff over the phone and taking commissions, and they'd be outrages if any of their own parents bought this.

MR HARRIS: Okay.

MR MAIR: Thank you for your time, gentlemen.

MR HARRIS: Thanks very much for coming here today. So the hearing's going to be suspended now, so that I can go to Senate Estimates in Canberra. Then, I think we start again tomorrow morning at 9.00, -10.00?

DR KING: 10.00

MR HARRIS: We're starting at 10.00 for anyone who's dedicated enough. So hearing is now suspended. Thank you very much.

MATTER ADJOURNED AT 2.47 PM UNTIL
THURSDAY, 1 MARCH 2018 AT 10 AM

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Australian Government
Productivity Commission

PRODUCTIVITY COMMISSION

INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

MR P HARRIS, Presiding Commissioner
DR S KING, Commissioner
MS J ABRAMSON, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT WESLEY CONFERENCE CENTRE, SYDNEY
ON THURSDAY, 1 MARCH 2018 AT 10.00 AM

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INDEX

	Page
FINANCIAL SERVICES INSTITUTE OF AUSTRALASIA MR CHRIS WHITEHEAD MS CAROLINE FAWSHAW	**86-93**
MASTERCARD MR CHRIS SIOROKOS	**93-104**
BUSINESS COUNCIL OF COOPERATIVES AND MUTUALS MS MELINA MORRISON MR PETER HUNT	**104-113**
BANK OF QUEENSLAND MR ANTHONY ROSE	**113-123**
CUSTOMER OWNED BANKING ASSOCIATION MR MICHAEL LAWRENCE MR LUKE LAWLER	**123-133**
COMMONWEALTH BANK MR ROB JESUDASON MR ANGUS SULLIVAN	**133-153**
NATIONAL AUSTRALIA BANK MR ANTHONY CAHILL MR SHAUN DOOLEY	**153-178**

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MR HARRIS: Welcome to the resumed Productivity Commission inquiry hearings in Sydney into the nature of competition in the finance system. I have Stephen King with me today, who is the Commissioner on the inquiry. I'm Peter Harris. I'm Chair of the Productivity Commission and our other Commissioner, Julie Abramson, is on the - she's in communication with Stephen and will occasionally ask a question via him because she has had to remain in Melbourne.

The way we conduct the hearings is everybody should be aware that you are being recorded and, in fact, we are live streaming as well. This is for us anyway, live streaming is for communications purposes. The Productivity Commission is charged with communicating the nature of its inquiry and discovery processes as a contribution to public information and transparency in Australian public policy making, and you are being recorded as well because we may use some of your comments in our final report. In fact, that's part of the reason we desirably do this the way we do it.

Participants in the inquiry are strongly encouraged to be truthful in their testimony. In fact, if you look at the legislation it goes beyond "strongly encouraged". But here, today, in the nature of the way we conduct things it's just a reminder. I should also note that we meet today on the traditional lands of the Gadigal people of the Eora nation and I pay our respects to elders past and present.

I should finally tell everybody two things in a practical sense. One, try not to be defamatory of any individual. We do worry about this, and from time to time we have actually had, sailed close to the wind, so defamation is not encouraged because we are broadcasting live, amongst other things. And as well, the practical things are if the alarms sound and everybody, as I'm sure you are familiar with from all your buildings, there's green exit signs there. Follow the instructions of fire wardens. I'm told the assembly point is somewhere like Hyde Park, but I'm sure you will make your way with practical advice from the wardens to somewhere else safe.

Our first participants this morning, could you guys introduce yourselves please for the record?

MR WHITEHEAD: Certainly, yes. Chris Whitehead and Caroline Fawshaw from FINSIA, the Financial Services Institute of Australasia.

MR HARRIS: Do you have an opening statement to make or any opening comments?

MR WHITEHEAD: Yes, if I may. FINSIA is Australia's peak professional body for financial services professionals. Its origins date back to the Australasian Institute of Banking and Finance in 1886, with over 8,000 members working across retail and business banking, funds management, superannuation, financial advice and capital markets across a range of institutional types, including the emerging fintech market. FINSIA's mission is to deepen trust in financial services by raising standards of professionalism, and that's been our focus from the very start of the organisation.

With regards to the professionalisation and competition, we believe that professionalisation is fundamental to improving industry standards of competency, conduct and culture, and the competitive principals should be enshrined as part of this. We believe that raising standards of professionalism in banking and finance is best achieved as an industry led initiative to define

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and monitor the standards of competence and conduct that should apply to all individuals working in the industry. This will help instil a sense of professional pride for the individuals in the industry, and also improve levels of consumer trust.

Competition is an important part of these standards, and indeed recently FINSIA has been engaged in the definition of global banking education standards, and it is enshrined in the standards of that body also. This is vital to ensure that customer choices are fair and transparent. Many of the recommendations in the draft report will help ensure that the consumers are better informed about financial products and services, and where they can find the most appropriate services for their financial needs. And we believe that is certainly best served by transparent advice from a professional.

The customer's best interests, FINSIA supports recommendation 8.1 that ASIC impose a clear legal duty on mortgage aggregators owned by lenders to act in the consumer's best interests.

With regards to the general advice, FINSIA concurs with draft recommendation 12.1 that the term "general advice" defined in the Corporations Act has the potential to mislead consumers. The term "advice" should only be applied where it is given by a provider that is appropriately qualified and skilled to do so, and is bound by a code of professional conduct. Where fintechs develop global advice tools, consumers should be given clear guidance as to the degree of personalisation that is provided by those tools. FINSIA supports the Commission's proposal to test alternative terms with consumers.

With regards to the financial advisers, in preparing a written submission on the draft report FINSIA will take more detailed feedback from its financial adviser members to respond to information request 12.1, increasing the scope of financial advice to include some credit products. Advisers who offer advice on credit products should have demonstrated professional knowledge of the products that they advise on, and should also be bound by a code of professional conduct. If the scope of financial advice is expanded in any way proposed by the Commission, advisers should have the duty to act in the customer's best interests.

With regards to the mortgage broker commissions, FINSIA cautions that any recommendations on mortgage broker commissions not create incentives for brokers to look to churn customers through alternative products. This would include the careful consideration of trail commissions and the changed incentives that would apply to brokers. Most importantly, mortgage brokers should act in the customer's best interests.

In terms of the regulatory sandbox, FINSIA has supported the development of ASIC's regulatory sandbox and APRA's phased approach to licensing. A condition of being in the sandbox should be a plan to get out of the sandbox. This would include satisfying regulatory requirements, as well as building professional expertise. FINSIA notes that the fintech industry is attempting to define an industry code of conduct. Naturally we support these moves and recommend that the fintech code be developed in collaboration with financial services industry incumbents.

Thank you for the opportunity.

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MR HARRIS: Thanks for those opening remarks. I might just ask you first, although I'm not the expert and Julie is, so Stephen should be monitoring any questions that Julie has here. But on general advice, so this is the sort of thing sometimes we encounter what might appear to be tangential issues when you go into inquiry. You have to make a judgment how far you go because you can run down, you know, every rabbit hole that you encounter. But this one seems to be a thorny area where almost everybody seems to agree the current language is wrong. Almost no one knows what to do about it. I'm sort of hoping you might be the first person to say, "I have a solution." We'll probably chance our arm on a solution here because it seems to be a common view that it's not working, the terminology is not working, but (a), do you have a view on is that the common view, and then (b), do you have anything by way of sort of a thought for substitute language?

MR WHITEHEAD: Yes, we do. I would certainly concur that it is the common thought. I think in terms of an alternative language, really as we will state in our submission, we think advice really should be coming from individuals who have a sense, and a real sense, of personal accountability. And we think that that perhaps is one of the problematic areas at the moment that general advice doesn't require, for instance, membership of a professional body. It doesn't require adherence to a code of conduct, other than an institutional code of conduct. And reliance is being placed wholly on institutional compliance rather than professional standards and individual standards. So we think that to use the term "advice", that should be a requirement otherwise we do need to come up with another term which much more reflects that it is information, that it's scripted, rather than being advice based, if the source of that information is someone who doesn't have that level of professional competence, demonstrated professional competence, including ongoing maintenance of the competence through professional development requirements, continuous professional development, and also adhering to a code of conduct.

MR HARRIS: Just another option is to simply delete the category entirely in its nature and only allow the term "advice" to be used in connection with the word "professional", and try and lift the quality and emotability, if you like, of the fact that I'm offering you professional advice and no one else is allowed to use the term. I mean, it might sound a bit weird but then we do that with banks. We use the term "bank" only in selected circumstances. And it is the word "advice" that seems to be causing the problem.

MR WHITEHEAD: Yes. I think if we headed down that direction then I think that may be a positive direction, however I think we need to be careful that the costs of preparing that individual advice are reasonable and competitive, and don't mean that advice ends up beyond the reach of many consumers. And whilst I don't at this point have specific research to point to, I am concerned we've looked at other jurisdictions such as the UK, the levels of complexity, the costs of providing advice, have got to the point that now it's essentially impossible to get advice at a High Street bank in the UK. So I think we need to be just careful that we don't end up in a situation that changing the definition actually moves advice beyond the reach of many Australians.

MR HARRIS: That's a point.

MR WHITEHEAD: There's already very low usage of personal advice and we wouldn't want to make that worse.

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MR HARRIS: Yes, and survey work does encourage a view that people really aren't prepared to pay perhaps for as much advice as might appear to be, in an objective sense, wise but that's an uncertainty factor that's quite important here. So that's a worthwhile comment for you to have made. Do you have something, Stephen?

DR KING: Yes. Just from Julie, particular products, are there - so if general advice is kept as a category should it be limited? And you said the limitation, your limitation was across who can provide that? It seems professionals - another way to cut it would be to say well, which products are you able to offer general advice on. If - well, would that be another way of keeping the term and limiting customer confusion and, if so, what sort of products do you think it would be useful to keep that on, to make that advice accessible?

MR WHITEHEAD: Yes. Essentially we have that cut now with ...(indistinct)... 146 tier 1 and tier 2. And so I don't think it's one or the other. I think that also clearly someone needs to be able to, or can only give advice in an area in which they're qualified to give that advice, including appropriate product knowledge and so on. So I think that really comes from that kind of regime.

In terms of general advice, perhaps the area we would be most concerned about is when you're providing advice on credit products to customers. I think that's quite different in terms of the implications and potential impact on customers versus, for instance, a term deposit. So I think you need a very clear idea of your customer responsibilities. And obviously we have the responsible lending regime in place to really try and ensure that credit is not being inappropriately provided, or advised upon, and I think that level of business, it does need to remain. So I think credit products in particular do deserve the higher level of requirements.

But otherwise there are products where the consequences, if you like, of the advice being more general than personal, ultimately are not that significant. A term deposit with an ADI, there may be some basis points of variance, but it's fundamentally a relatively simple product and the consequences, if you like, of not getting good advice are nowhere near as severe as they may be with other products.

DR KING: Can it be connected to - I'm just thinking, you mentioned codes of conduct for the professionals. So we've suggested for brokers acting for integrated aggregators that there be a duty of care, a best duty of care obligation, with regards to their clients. I mean, is that also something that we should be thinking of in terms of the sort of advice that is being given? Does that cover off?

MR WHITEHEAD: Yes. It would be FINSIA's contention that anyone providing advice should be subject to a professional code of conduct, and much of FINSIA's work currently is working on the professionalisation of important roles within financial services which today are not seen as professional roles, and we believe should be. So advice is really the key, I guess, determinant of those who we believe should be required to operate in a professional manner. That means that they have defined levels of competency which can be tested, that they have requirements to maintain their competency with regards to ongoing professional development, that they're subject to a code of conduct and obviously disciplinary process attached to that code of conduct.

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MR HARRIS: The problem with doing this in the case of broking though, it seems to me, is there isn't a professional requirement in the same way there is for what I might call wealth advising, and so the sanction of a code of conduct in a wealth advising sphere where professionalism is increasingly being valued and represented by, as you say, maintaining competencies and things like that, doesn't apply here, if I understand it correctly.

MR WHITEHEAD: And we believe it should apply. There is, I think, a real danger of a conflict of interest between the principals and owners of firms versus their responsibility as advisers or the responsibility of their staff to advise. And I think if you look at any professionalised industry then there is a professional body that is independent, if you like, of the owners of the businesses that work certainly with the industry. But we do need to manage the conflict of interest between owners and advisers.

MR HARRIS: Yes. So we're on common ground there for sure. And the value in a code of conduct that emphasises professionalism and maintaining competency in a measurable sort of form is that then it's more enforceable, isn't it? You haven't maintained your competencies and therefore you can't claim the professionalism. So the two have to go together don't they otherwise you don't have the sanction inside the code? You've lost your professional status.

MR WHITEHEAD: Absolutely, and I think what's important by that being imposed beyond the firm's own code of conduct is it's also visible across the industry, that where you have a professional institute in place then that membership is, if you like, stays with the person. The record stays with the person. And having them subject to the discipline of their peers I think is a well proven effective method over centuries in order to drive better levels of conduct.

MR HARRIS: Yes, yes. I interrupted your turn so keep going.

DR KING: That's fine, I'm right.

MR HARRIS: So I think you said you also were supporters of the regulatory sandbox kind of concept that's being used by ASIC in particular to, I guess, experiment a little with innovation in this sector. Can you just link in though - I mean, it's something that - I did read this in the notes for your presentation and it's the one thing that struck me as a query. I thought that's interesting, a professional standards body is actually supporting technology shifts. I'm not saying there's anything inconsistent in that, it's just that in my own experience from inquiries like this often professional standards bodies just eschew anything at all but the educative concept, and you're prepared to go further on a quite important issue, I think.

MR WHITEHEAD: Yes. I mean, it would be - I mean, we believe this industry, financial services, will be transformed and is being transformed by technology, and I think our challenge as a professional organisation is actually to support that and to help enable individuals who'd like to change, as well as organisations to change. So we're conscious of the disruptive effect on people's careers, how do we best position people for new careers, and to maintain their skills. So we're looking at our qualifications which FINSIA is introducing, and certainly considering within those qualifications how do they pick up concepts such as agile working and the adaptation of technology.

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Having said that we think competitive principles should be enshrined in a professional code, then obviously I think recognising that the - and supporting the growth of innovative small organisations does require perhaps the kinds of concessions or staged regulatory approach that's being proposed. FINSIA is considering how it could support those organisations, and indeed has been approached by a number of fintechs in that regard in terms of how do we help them build their competency, demonstrate to regulators the competency and conduct to which they wish to be held. And so we think we have a role to play both within incumbent organisations, but also to support other organisations to raise them to the standards of the industry. And we have concern with regards to fintechs. It is of course - there should be no regulatory arbitrage. It should be seen as a staged approach to full regulatory surveillance.

MR HARRIS: Yes. You get relief for a period in order to test your idea, but you don't maintain that permanently as an advantage - - -

MR WHITEHEAD: Absolutely.

MR HARRIS: - - - as you become more significant in the system.

MR WHITEHEAD: And you require similar levels of competence. Ultimately you need to demonstrate similar levels of competence. One of the things that FINSIA can do, given its very senior membership across the industry, is actually connect fintechs up with experienced senior industry individuals, and that certainly can help as well. So beyond education we think there's a, like an industry networking opportunity, a connectivity opportunity.

DR KING: Are you thinking of it being almost a mentoring type of role?

MR WHITEHEAD: Yes mentoring, absolutely. And indeed fintechs may provide good opportunities for, new employment opportunities for senior members of the industry.

DR KING: I want to just switch track slightly. Just on the difference - I understand you're talking with your members on this, but our look at whether advisers who provide credit information, or who have wealth licences should also be able to provide credit information and we would be interested to get just your views on if you see any problem with that. I guess a starting point is to your knowledge do many of the wealth advisers currently also have credit licences or are they really very, very separate at the moment? Do you see any problems with allowing wealth advisers to move into that area?

MR WHITEHEAD: It's, as I say, something we would really like to consult with our members on. I think at first look we don't see enormous problems with that at the moment. Many would have referral type arrangements if they don't have their own, within their own organisations for instance, credit advice. Provision that they will have some kind of referral arrangements very atypically. So they are already involved, I think. To extend that, given appropriate safeguards around ensuring they have appropriate qualifications and going back to a code of conduct, then I can't see any reason why that would be a great issue.

MR HARRIS: And they have a different methodology. You mentioned commissions and the need to be, and to take care around the issue of churn, and I think we are conscious of churn. On the other hand, one person's churn is another person's competitive opportunity so there is

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a, as ever, a balance to be struck here. But in the case of financial advisers, they have transited substantially to a different kind of model than a commission based structure. I'm not saying completely, and not saying in any sense it's absolute for either of the parties, but introducing them does introduce a different kind of potential for a charging structure, doesn't it?

MR WHITEHEAD: It does, and for instance I think one could consider to what extent does the effort and reward in terms of providing mortgage advice vary, depending on the size of the loan. Is there a substantial difference between the effort of a $200,000 mortgage and a $1 million mortgage? And should they have substantially different commission arrangements and so on? So I think there are opportunities to look at the impact on changing the approach that perhaps might better reflect the association of cost with effort.

DR KING: Do you think that - let's assume that the approach moved forward so that there was wealth advisers that could provide credit product advice, appropriately trained and appropriate professional code of conduct, but just to follow up on that point that currently their award structures are quite different, do you see that creating problems? In a sense, do we have to think about two things at the same time? You can't just say well, go into more credit as well as wealth without changing the current remuneration structure from mortgage brokers.

MR WHITEHEAD: Yes. I think you absolutely would have to look at remuneration structures. Of that I have no doubt because I mean you wouldn't want to take the advice industry back. It's been on this journey towards professionalisation to a large extent. It's the same journey that we're advocating more broadly across financial services, and therefore I think inevitably you have to look at remuneration, in the same way as the banking industry has looked at remuneration through the Sedgwick report, in the same way as remuneration has been reviewed under the financial advice changes over recent years. The two absolutely go together, and so remuneration is an important driver of outcomes in the mortgage broking industry.

DR KING: You notice the issue of potential churn, you notice the issue of is payments aligning with costs and time. Do you see any problems with moving the current reward structure for wealth advisers into the mortgage broking space?

MR WHITEHEAD: This is not something that FINSIA has done a lot of work on so perhaps it may be more of a personal comment based on my experience working in another jurisdiction and working closely within the UK banking and mortgage industry where there are no trail commissions. I think there is the potential for a significant shift in terms of product recommendations and so on that would - I understand your comment that one person's churn is another person's opportunity, but if you like you can generate more opportunities by putting customers into shorter term products which need more regular review and so on. So I think you can't just look at the point in time of a customer who is on this product, is there a better product. I think you have to say well, are we changing the product dynamics of the industry potentially? And that's why I think it would be worthwhile looking at other jurisdictions, and where there's a significant broker market which does not have an ongoing, for instance, trail commission what other mechanisms are there to ensure that we don't create some kind of distortion, not just in point of time advice but, if you like, in the industry structure and product structure.

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MR HARRIS: What seems to be though exceptionally obvious in those kind of comments is that other markets don't necessarily need to use trail, and that's not just the UK as you mentioned but it's other finance markets in Australia have managed to shift themselves substantially away from trailing commissions and moreover that fee, that ongoing fee which implies, and brokers have stated this publicly, that it's their apparent intent to continue to service the customer as a consequence of that fee. Nevertheless they're not obliged to do so in the customer's interests. So this whole question of serving a party in the customer's interests seems to be the pivotal element of all this. It's like the claim appears to be you can have a payment and not create the conflict simply because we assert it as so, but the absence of some kind of enforceable standard which says you're receiving this payment and continuing to service the customer, fine, are you doing so in the customer's interests or in the interests of the party from whom you are receiving the money? It's quite an arguable proposition, isn't it?

MR WHITEHEAD: And behind my comment is really that those are jurisdictions that don't have a prevalence of trail commissions but do have other mechanisms for remuneration.

MR HARRIS: That's right. These do exist.

MR WHITEHEAD: And hence going back to yes, they have to be looked at in conjunction. If you change the advice model you have to look at how that advice is paid for.

MR HARRIS: Right. I don't have anything more for you. Do you have anything more?

DR KING: No, that's me done.

MR HARRIS: Okay. Do you want to check the remote monitor?

DR KING: And I think we've covered off on what Julie was after.

MR HARRIS: Excellent. Have we failed to ask you something that you otherwise would have liked to bring out and didn't make in your opening statement?

MR WHITEHEAD: No. I would like to thank you for the opportunity and commend you on the draft report and look forward to further progress.

MR HARRIS: We appreciate you making the time to come along and talk today, and for the submission that you are going to put in. Thank you.

MR WHITEHEAD: Thank you very much.

MR HARRIS: Okay. We are almost exactly on time and I think I have Mastercard down as the next group. Could you identify yourself for the record please?

MR SIOROKOS: Sure. Good morning, my name is Chris Siorokos. I am the Director of Public Policy for Australia for Mastercard.

MR HARRIS: Chris, do you have any opening comments that you would like to make?

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MR SIOROKOS: Yes, I do. Thank you very much for allowing me to appear today on behalf of Mastercard. My comments are mainly going to focus on the recommendation regarding interchange. That's draft recommendation 10.3. And I will also touch on the recommendation relating to merchant routing. That's draft recommendation 10.4. But before I do that I just want to make a quick comment about Mastercard. I just want to, for the benefit of the room, Mastercard doesn't issue cards or provide credit. It's the issuing banks and financial institutions that do that. To put it really simply, we're not a bank. The banks are our customers. We're a payments network.

Getting on to interchange, as most people know interchange is a small fee. In Australia it's an average of 0.5% for credit and $0.08 for debit and it's paid between banks to support the card payment system. And interchange helps issuers cover reasonable costs they incur. That's things like processing and authorisation, fraud and fraud protection and funding interest free days on transactions. I want to be clear, Mastercard doesn't earn revenue from interchange. In Australia we set interchange rates within the regulatory limits set by the Reserve Bank, and our interchange rates and categories are completely transparent and they're published on our website.

In terms of interchange it's important to set the balance, the level right and to get a balance, because if interchange rates are too high merchants may choose not to accept cards or deter card payments, and if interchange is too low issuing banks don't have an incentive to cover the risks of issuing cards. And we think flexible interchange rates make it possible for electronic card payments to deliver maximum value at the lowest cost for both merchants and consumers.

On debit, interchange supports the ability for consumers to safely spend their own money, not only in store but online overseas and over the phone. And in relation to credit, we know interchange supports the use of credit cards which increase sales. And according to the RBA, credit card sales at large merchants are on average about three times as large as cash transactions. And we know for retailers interchange delivers enormous value. It provides convenience, security and fraud protection, increased sales and guarantees that retailers are paid even when a cardholder doesn't repay a bank.

Retailers get guaranteed payment when they accept credit cards, freeing them from the worry of credit risk. And so every year banks write off two to four per cent of credit card balances as losses, a cost which would almost unavoidably sit with retailers without interchange, and the fact that interchange supports card payments.

Australian businesses benefit from overseas visitors using their cards and average transaction sizes for tourist transactions are significantly higher than domestic transactions. And we know that the value retailers receive in card payments is greater than the small cost they pay to accept cards. Some 2015 Mastercard data shows that the value provided to a merchant by electronic card payments products - credit payment products, I'm sorry - is at least two times greater than the total cost of acceptance to the merchant.

The RBA has been regulating interchange since 2003, and in 2017 the bank introduced an upper limit on the highest level of interchange for both debit and credit. The RBA's payment system board's decisions on interchange regulation followed extensive reviews that took into account the public interest, impacts on the economy and were based on a thorough understanding and

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knowledge of the payment system. And while we didn't agree with all of their outcomes, we did acknowledge the thoroughness of their processes and their analyses.

We believe interchange is an incredibly efficient way of managing costs in the system. Having a whole range of different costs and charges at different points is unnecessarily complex for consumers and for merchants. And we know that international and Australian experience shows that when interchange is cut it's cardholders that pay the price.

The RBA has acknowledged that the costs to consumers for using their cards are now higher since regulation began in 2003, and they also acknowledge that the higher the interchange fee, the lower the cost to the consumer. So while cardholders are now paying more to use their cards, there's no proof that any savings to merchants have been passed on to consumers.

Banks and credit unions have already said that with lower interchange they'll have trouble continuing to offer low interest rate cards, and will have to look at interest rates. They've also previously warned that changing interchange will reduce their ability to fund innovation that benefits consumers like tap and go. Setting interchange at zero means the cost of running the system has to be made up elsewhere, and what we know is that elsewhere tends to fall on consumers in terms of higher fees, higher interest rates, shorter interest free periods and a curtailment of other benefits.

The way the system should work is that participants in the system get tremendous value from using cards that's greater than the costs associated. Merchants and cardholders benefit, and interchange is a good way of apportioning the costs to achieve that value.

Very quickly I want to touch on merchant routing as well. We will work with our customers to implement the Reserve Bank's efforts relating to least cost routing of transactions on contactless cards. We intend to remain competitive in a least cost routing environment, and indeed we believe that for low value transactions we're already the lowest cost.

So in conclusion, I'd just like to say we strongly believe interchange is an efficient way of allocating and managing costs in the payment system. We think interchange arrangements in the Australian market have been thoroughly examined several times already and are regulated by the Reserve Bank, and we don't see the need for further changes and we would urge the Commission to reconsider this recommendation as you work towards your final report. We have commissioned some research to help inform our submission that we will be making, and we will be happy to sit down with Commission staff to share the information we get from that research and to provide more information as required.

MR HARRIS: Thank you for that, and in fact particularly thank you for the data offer. I mean, you might have noted yesterday we did ask Westpac a little bit about their data sources that they thought might be available for this because they did make a comment on it, and we have found, as I have said in my speech on Monday, we've found quite an unusual lack of data in some areas, particularly where we're interested in making policy shifts. And so I think we do want to ask you for some more data based information, and therefore we would be taking advantage of your offer where you're able to provide it, and I guess it's - - -

MR SIOROKOS: Happy to help where we can.

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MR HARRIS: - - - still a matter for judgment, but I guess - I don't think this context is going to go away as you've noted in there, but I'm going to turn the coin over and say yes, this has been reviewed many times in recent, well in relatively recent, in the last decade or so. And often the recommendation has been to cut it back to zero but the outcome has not been because the RBA will then take it on and it becomes a negotiation and most of us know in commercial negotiations that rarely one side walks away with all the goodies, and therefore zero is an unlikely outcome via a negotiated solution.

But anyway, that's all yet to be seen and experimented with. We are interested in getting better data and in particular we're quite interested in trying to separate out the trends in the use of debit and credit cards for transactions across the economy and the different cost impacts that are being imposed as a consequence of them. We know there are different prices, there appear to be different costs. Cost isn't the sole driving factor in all of this. I know it's often used as the basis for settling the negotiation. Let's find some costs and therefore we can attribute them and that will set the new price. But in this particular case I guess we're very much interested in the trend in the utilisation of different cards and the prices that seem to accompany them.

MR SIOROKOS: I don't have that information to hand on me today but we would be happy to sit down with the Commission and go through that stuff.

DR KING: I mean, just on that there's been a variety of what we can call natural experiments over time. We've seen a significant drop in Australia in the interchange fees. You've had - on credit particularly. You've seen debit cards interchange fee reverse at the same time as you've had ATM reforms, which obviously impact on debit. I don't know if Mastercard has done any work to try and tease apart the various effects that these have had. If you have done that sort of work then we would be very interested in seeing it and being able to understand it.

MR SIOROKOS: We have commissioned some research that is underway now and we're happy to share that with you. But I'd also say that what we have seen where interchange has been regulated is that benefits have been cut and those costs have been shifted. The costs don't leave the system.

DR KING: No, no.

MR SIOROKOS: They have to be paid somewhere.

MR HARRIS: Someone has got to pay the costs.

MR SIOROKOS: That's right. We believe interchange is an efficient way of allocating those costs.

MR HARRIS: It's interesting, because you did use some data points in your presentation and just so in a generic sense if I can refer to this as the half a per cent charge for interchange, you noted though as well that banks absorb two to four per cent every year in terms of fraudulent transactions, so clearly the pricing of the system overall involves a number of points in the chain where different parties are paying different fees. And I think the question with interchange fees is really whether it isn't a unique sort of factor of the Australian market that

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we've developed for historical reasons, and that in other markets it doesn't seem to feature. So that's a point I'd like to get your view on. Clearly Mastercard is a global operation and it must know how these things operate in other jurisdictions. We read that they're different. Is it different and, if so, why is it different?

MR SIOROKOS: Look, interchange features to the best of my knowledge across most of Mastercard's network around the world. There are different regulatory arrangements in different countries. The thing about interchange is it tends to cover system wide costs. Fraud is a system wide cost. Processing and transactions are a system wide cost. Fraud prevention is a system wide cost. They need to be covered and met somewhere, and in Australia those costs are regulated. There's a 50 per cent weighted average and an 80 basis - sorry, a half a per cent weighted average and an 80 basis point cap. So the costs, as I said before, those costs still exist. It's much trickier in a regulated environment to manage those effectively, and what we have seen overseas as well, particularly in Europe and in the US where interchange has been regulated as well, is that those costs tend to fall on consumers even though merchants and others get value from using electronic payment products.

DR KING: Just on that - - -

MR HARRIS: Can I just ask one thing on that?

DR KING: Sorry, yes.

MR HARRIS: But it is quite hard for the small business to pass on a set of specific fees in the way that the Commission, sorry, the way the fee structures are set up here. As you say there are multiple, clearly there are multiple charges for the utilisation of the payment system. If for no other reason we can say that because this one is covered by a half a per cent and, as you say, it's apparently linked, mentally at least, to generic costs across the system but banks are losing two to four per cent every year just through fraud and there's more costs than just fraud. So clearly there's multiple charges here. It is just very difficult to imagine that a merchant is ever able to - a smaller merchant is ever able to pass it on in the sense of saying I've got to pay my contribution towards this interchange fee here, my contribution towards my general access to the payments. You know, all that set of fees. It's very hard to imagine that any smaller business is able to pass that on. We see larger businesses quite capable of doing this in their own utilisation of credit cards. We see, you know, hotels and airlines and things like that. But it's a relatively rare event it seems to me to encounter this at the bulk of smaller businesses.

And the motivation for us was really market power. This is a competition inquiry. Is market power being exercised here by the payment system upon the small to medium enterprise via this kind of charge, and might it not be better for there simply to be a single cost for utilisation of the payment system which then at least a merchant is able to say well, I know what it is in total. I can pay it or I can pass it on. But you get greater clarity. So it is almost a philosophical question about your preferred approach. Does multiple fees allow market power to be exercised? That's what it comes down to.

MR SIOROKOS: Can I just go back a step just to clarify something?

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MR HARRIS: Sure.

MR SIOROKOS: The two to four per cent I mentioned, that was credit losses, not necessarily fraud. That could be me walking into a department store, buying a TV on my card and deciding not to pay back the bank because I've lost my job.

MR HARRIS: Sure, sorry if I - - -

MR SIOROKOS: No, that's okay.

MR HARRIS: - - - wrongly shorthanded you. I was more thinking there's a lot of costs.

MR SIOROKOS: Yes, absolutely.

MR HARRIS: They're being recovered. We know they're being recovered.

MR SIOROKOS: Absolutely.

MR HARRIS: We're all going to agree someone is recovering them somewhere, and so this threshold question is do these multiple allocations of fees allow exercise of market power which larger businesses are probably able to track and aggregate it and make sure that they're getting it all back. Smaller businesses are just there copping it. That's the question.

MR SIOROKOS: Look, I guess from our perspective I will just reiterate the point that we don't make money from interchange. Our interest is in growing the electronic payments network because the more the payments network grows the better it is for us and our revenue because we make small amounts of revenue on transactions. So for us, we don't make money from interchange. So we have no interest in seeing interchange being distorted in a way that doesn't maximise the efficiency of the system. Like I said earlier, that means making sure that there are incentives for people to issue cards and there are incentives in the marketplace for people to, for merchants to accept electronic payments and not try to deter them.

So in terms of a payment system, that's where we sit and we think that interchange is an efficient way of allocating some of those costs. And there's absolutely an argument to be made about transparency, particularly for smaller merchants, in the information they get from their acquirers about how costs are made up, and I think the ACCC has gone some way to helping deliver that by providing, by requiring the acquirers to provide statements that kind of, to a degree, break down and give smaller merchants better information about the costs of acceptance. And we think there needs to be more done in that regard, particularly in relation to education.

But I would also go back to the point that - and again, happy to share this with the Commission in separate discussions - that merchants get more value out of accepting electronic payments than the costs associated with accepting them.

MR HARRIS: I don't think anybody here is going to debate the immense value of having, as you pointed out, a reliable payment system that simply says if you accept this piece of plastic and it goes "beep' you're going to get the money. I mean, as a confidence inducing measure,

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as a technological advance, fine stuff, absolutely. The question is really mentally for us how does the structure of fees translate into the potential exercise of market power where we know some parties are probably better able to deal with this via their ability to onward charge than, for example, I think smaller businesses in sort of the highly competitive markets that you get in - you know, spaces without trying to pick out particular businesses, although I could if anyone wanted to. But anyway, we won't. I think that's a - - -

DR KING: Can I call on an example of that, because until recently - and I understand the Reserve Bank rules changed in July last year - but one of the issues that creates some concern for us is when merchants face very non-transparent acceptance fees. So I can wander in with a card, let's say a Mastercard issued by a bank in Australia, and depending on the colour of that card, for want of a better term, whether it's a platinum or a black or a gold or a grey, the merchant can be paying quite different fees and they go back to the interchange fee. So there's different interchange fees, or there has been different interchange fees, for each of those cards. Some of those you can say well, they reflect different costs to the issuer, and certainly they do. But some of those costs are reflecting payments by the issuer to customers to use the card. I mean, reward points being obviously a negative payment by the customer. They're a reward to the customer for using that card.

So it concerns us from a competitive perspective when we see a bank on one side paying customers an incentive to use a card that has a very high interchange fee, that leads to a very high merchant service fee, where that merchant cannot know the exact cost of accepting that card when they accept it. Maybe we're naive, but it sounds to us like that's a route for an abuse of market power.

MR SIOROKOS: Well, I think at the end of - and I'm just trying to jog my memory here. It's either at the end of every month or after a period of months the ACCC now requires acquirers to provide cost acceptance information to merchants and split up between debit and credit. So they can start making decisions based on that information about how they accept cards and what they want to do in terms of things like surcharging, which we don't support but we understand that the ACCC allows acceptable costs to be passed on. Most merchants don't do that.

MR HARRIS: Mostly by big businesses who are successful at passing on a surcharge.

MR SIOROKOS: Well, most merchants don't do that because they recognise the value of card payments. And I know anecdotes don't prove anything, but my local butcher shop is now run by the sons of the butcher who recently retired and I was talking to them a couple of weeks ago, and one of the first things they said is they love tap and go because it speeds up their Saturday mornings. It's just one of those things. They understand the value and they're happy to do it. Dad didn't have any form of electronic payments. It was one of the first things that they did when they took over.

MR HARRIS: Yes. No, I don't think anyone is questioning the quality of the technological advance. It's more the ability of the smaller business to decide for itself whether it must absorb this or - simply because it's too complicated a), to work out the nature of the fees they're being charged, and b), to decide how potentially to pass that on to a customer. And thus, you did make the point which says when the interchange fees came down there's no evidence

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consumers got a benefit out of that. And here is the crucial question. But did they ever, did consumers ever receive in the first place the higher charge impact or did the merchant absorb it because - particularly again this is at the small to medium enterprise level where it's a complicated thing to decide how much to pass on and there's such ruthless competition in their space of the business, versus the larger duopoly businesses that do operate a lot in Australia who can pass on those fees and have got the capability in the back office to work out what the hell they were and what's a reasonable number.

That's the big question. It comes as Stephen said, we're trying to emphasise this is not about us saying isn't it dreadful that there's a cost to using the payment system. That is not our view. We're simply saying does the structure of this create the potential for exploitation of market power? That's the key question for us.

MR SIOROKOS: We certainly think that there should be more transparency for merchants in costs so that they can make informed decisions and have negotiations with their acquirers about what those costs should be. And, for example, you know in a merchant routing context least cost routing is an important thing but there - in order for that to work properly merchants need to understand what the breakdown of their costs are, interchange, acquirer fees, everything else, so that then they can - - -

MR HARRIS: They know what least cost is.

MR SIOROKOS: That's right. That's right, they know what least cost is and then they can have that negotiation with their bank or their acquirer. And we have no issue with that kind of transparency.

MR HARRIS: And you will have seen in the draft report, because we were advised this and we think it's right - in fact, I think you guys might have advised us this as well. But anyway, we received information which says in other markets this choice of least cost pathway is relatively readily available. In some cases it's actually mandated, but in other cases it's driven by market pressures, I assume. But it's relatively readily available. And in Australia it may be the case that it is available more optionally, and so for us it is a threshold question. Is this going to, as it were, take hold without any regulatory support, or does it need regulatory support to see this choice made readily available?

MR SIOROKOS: Last week the Payment Systems Board released the update of their meeting and they said that they were happy with the progress being made to date and they look forward to it being rolled out. So the indications are that it will happen, but for it to be effective there needs to be that price transparency in our view. And ultimately the other thing we think is important in that whole discussion and debate is consumers need to have the final choice about what rails, I guess, their payment goes down.

MR HARRIS: Quite, and so they need to know what is least cost as well. Again, and we shouldn't do anecdotes - so I tried this in my younger daughter's business, just asking some customers did they know what the least cost payment was. And nobody knew what the - which is, you know, not surprising. But do you see what I mean? So they're not even able to make the choice either.

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MR SIOROKOS: But again, it means different things to different people, I guess. I mean, to some people least cost might mean least cost of time or I don't want to be carrying cash around, or whatever.

MR HARRIS: And that's a good point, because it relates to tap and go doesn't it? It's the utter convenience. As you say, the throughput for the butcher shop example that you used, just the Saturday morning crush. So the utter convenience, and people - perhaps they don't really want to know. But it goes to this question mark about if they don't know can they ever exercise decent choice or not?

DR KING: Can I just follow up a couple of things on that approach? So Mastercard doesn't impose any conditions or put any barriers in the way to a merchant choosing, for example to use the EFTPOS network for a direct debit rather than the Mastercard network?

MR SIOROKOS: I will need to double check that. I'll come back to you on that.

DR KING: If you could that would be fantastic. You did say that it should be the customer's choice of the network, but the customer doesn't pay the difference in the network charges, as I understand it. That would be a merchant cost. So that's a bit like the customer saying, "Well gee, I want my stuff kept in the gold fridge over there, not my beer kept in that other fridge over there." I mean, we don't normally say that a customer should have a choice over a production decision by a merchant, and this is just a production decision.

MR SIOROKOS: Well, probably not in our view because, for example, our cards may hold different benefits to a generic EFTPOS card. There are certain merchants who say if you pay with your Mastercard you will get blah. Like, you will get a free packet of chips, whatever.

DR KING: I understand, but is that also down to the routing on the Mastercard network? So would you expect consumers to be rewarded for using Mastercard?

MR SIOROKOS: No. If the consumer thinks that they're - they have reasons for thinking they may get particular benefits using a particular - - -

DR KING: Points and things.

MR SIOROKOS: Yes. There's not that many points on debit cards, but there may be other reasons they may wish to use their debit card, and they should know that if they tap that they won't be using their debit card, and if they - it will be going down other rails because there may be reasons they may want to use that card, that Mastercard debit card, as opposed to an EFTPOS function for other reasons like a competition or something else.

MR HARRIS: Okay. I would actually - I must confess I'd be worried about the competition implications if it suddenly became the equivalent of please make sure that your merchant gets the beer out of the fridge branded - - -

MR SIOROKOS: No, no, we're not saying that at all. That's not what we're saying.

MR HARRIS: - - - because we'll give you some reward points.

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MR SIOROKOS: No, no. People have - probably not a great example. People have different reasons for wanting to use different payment methods and ultimately it's their money. They should know what's happening and they should be able to override that in some way if they choose. And that's consistent with the RBA's position as well.

MR HARRIS: Yes, I understand all of that, but it just seems to be that it's the way that the network used to transmit the transaction, coming out of the same account for the customer, I must confess I have problems, that that's a production system that should be completely irrelevant for the customer.

MR SIOROKOS: Well, there are things like chargeback rights. That up until very, very recently you had much better chargeback rights using a scheme card than an EFTPOS card. There have been countless examples and every second weekend there's a story in the papers about a wedding dress shop that goes bust and the bride and groom lose the dress and their clothes. The chargeback rights with a scheme card are different, and up until recently were much different and much better using the international scheme cards. So they're the kinds of decisions that people may wish to make.

DR KING: And should be empowered to do so.

MR SIOROKOS: Yes.

DR KING: Just on that, I just wanted to come back to one of the figures you mentioned earlier which is the two to four per cent written off on credit cards. How much of that is borne by the merchant bank acquirers versus the issuing banks? I mean, are you able to - - -

MR SIOROKOS: Not right now, but I can see if I can get that information to you.

DR KING: Yes, because obviously if you are justifying the interchange fee on that basis it should only be the part that goes to the issuing banks.

MR SIOROKOS: Yes. I mean, I presume it's the issuing banks because they're the ones that are extending the credit but I'll - - -

DR KING: Yes. I'm not sure how much with the card not present, or something like that.

MR SIOROKOS: I don't - yes, I'll get back to you on that.

DR KING: That would be good, thanks.

MR HARRIS: Finally, new payments platform?

MR SIOROKOS: Yes.

MR HARRIS: Everyone is very keen on the new payments platform. It took us a while to work out what it actually did do beyond the impressive technology. So is Mastercard engaged with the new payments platform in a direct sense?

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MR SIOROKOS: Not in a direct sense, no.

MR HARRIS: No?

MR SIOROKOS: No.

MR HARRIS: This goes to, I guess, the core concept of the business and therefore might be - I'm not asking you to bind Mastercard. Is it likely, do you think, that - let's just say entities in your part of the payments business would find the new payments platform a necessary and valuable place to take some form of - I guess "ownership" is a term that can be used here. Some form of ownership. Would you look to being directly engaged?

MR SIOROKOS: Look, I can't comment on that specifically. We do run faster payment networks in other parts of the world, but in terms of the NPP I'll have to get back to you on that.

MR HARRIS: And what about overlays, as they call them? Apps that run across the system, that kind of thing.

MR SIOROKOS: Potentially, yes.

MR HARRIS: So it's more likely - I'm going to put words in your mouth and you're going to tell me still I can't tell you that, but more likely that you're going to be a sort of - how can I put it? A one step removed user of the convenience, to the extent the convenience extends to your part of the payment system. Would that be right?

MR SIOROKOS: You're right. I will say I can't tell you that.

MR HARRIS: You can't tell me that? Okay.

MR SIOROKOS: It seems that yes, that what you said seems logical, yes.

MR HARRIS: Okay, that's fine. Anything else?

DR KING: Yes, just on that, I mean internally does - I mean, in a sense NPP is a competitor to Mastercard and to Visa so is it viewed that way? Is it viewed as a competitive threat by Mastercard?

MR SIOROKOS: Look, the payments landscape is changing incredibly. There are new competitors springing up all the time. We're confident that our system delivers what it needs to deliver to cardholders and to merchants, and will continue to do so. But having said that, we'll continue to evolve it as well to make sure it does.

MR HARRIS: The most interesting thing here is this app based utilisation. It's very popular I think in Australia. You know, we are quick technology adopters and interestingly it almost seems like it's another mechanism for a party that has a card based brand to use that brand without even a card. You know, the ways that you could potentially see the system being used

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seem to be quite remarkable, and in that sense it could be quite a diversification opportunity where it's an app rather than a plastic card. The same sort of outcome though really.

MR SIOROKOS: Sure, and I think we've already got products that are non-card products. Bankwest recently released a ring that you just tap and off you go. There are payment bands. You're right, mobile phone applications, all these things are happening.

MR HARRIS: And almost everybody has to be in the game almost just in case, if you're a very large user, because there's the possibility of being disrupted by somebody else who - - -

MR SIOROKOS: Yes, the world is changing very, very quickly.

MR HARRIS: Yes. Anyway, I just thought you might have something that might have been put forward on that because we are interested in the adaptation of the system and its accessibility to all parties.

MR SIOROKOS: And again, happy to provide information on that.

MR HARRIS: Yes, we might - when we come - we might come and have a further discussion with you.

MR SIOROKOS: No, more than happy to do that.

MR HARRIS: Okay. Thank you very much for making your time today and for the offer of an information exchange and possibly some data. That would be great.

MR SIOROKOS: Again, thank you for giving me the opportunity.

DR KING: Thanks Chris.

MR HARRIS: Okay. I think people who have managed to sustain themselves through the first hour get the opportunity of a free cup of tea and a stale biscuit, or something better than that. So we're just going to suspend the hearing for 15 minutes while people take advantage of our generosity.

ADJOURNED **[11.01 am]**

RESUMED **[11.17 am]**

MR HARRIS: So we will be resuming hearings now in Sydney on the nature of competitiveness in the financial system, and I think we have the Business Council of Cooperatives and Mutuals.

MS MORRISON: That's correct, you have Commissioner.

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MR HARRIS: When you have settled yourselves appropriately could you identify yourselves on the record for the purpose of the transcript?

MS MORRISON: Yes, thank you very much. Melina Morrison, I'm the CEO of the Business Council of Cooperatives and Mutuals.

MR HUNT: And I am Peter Hunt who is a consultant working with the BCCM.

MR HARRIS: And I think we have met with you before - - -

MR HUNT: Yes.

MR HARRIS: - - - in the course of this inquiry. Do you have opening comments you would like to make?

MS MORRISON: I do have a few comments. So, thank you very much. First of all, thank you for the opportunity to provide some follow up remarks on the draft report and speak at this hearing. The context for the inquiry into competition in the Australian financial system is vital to ensure that we have a world class competitive industry that provides the best outcomes for consumers of financial services, especially genuine choice and marketplace competition, to deliver the highest quality products and services at the most affordable price. And this competition and choice issue is very close to our heart.

The Business Council of Cooperatives and Mutuals represents a vast network of enterprises, some 2,000 in number, of cooperative and mutually owned organisations operating in sectors including finance and banking, insurance, agriculture, motoring services, health services, aged care, disability, education, indigenous, housing and retail.

Cooperatives and mutuals, CMEs, cooperative and mutual enterprises, are distinguished by their ownership model. Regardless of what legal form they use, they are owned by their members and operate for member benefit. Member benefit can mean a wide range of social and non-financial benefits as distinct from the financial returns enjoyed by an investor in a publicly listed entity. Membership is tied to contributing to or making use of the cooperative or mutual, and this ensures that the CME is made up of people who share its common purpose. We know that all businesses exist to serve their owners. The difference in a CME is that the owners are the members.

The draft report of the Productivity Commission's inquiry discussed here today does recognise the competition effect of this business model. In addressing the topic of price competition in banking, the Productivity Commission writes on page 10, "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." This statement also recognises one of the key barriers to competition for mutuals, and that is access to capital which my colleague, Peter Hunt, will elaborate on.

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The BCCM represents a very important part of the Australian economy. Eight in ten Australians are members of at least one CME, with many Australians being members of multiple entities. There are 28 million memberships in total, which is more than the population. The sector provides core business support for over 174,000 SME businesses. And in some sectors, like private health insurance, automotive repair and independent liquor stores, CMEs are a bulwark against further concentration and market monopolisation by fewer and fewer entities. In retail banking, the credit unions, mutual banks and building societies represented by the peak body for customer owned banks, offer genuine marketplace choice to the consumer.

The Productivity Commission report in its draft report also examines the effect of the shareholder model on consumers, saying 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 they're motivated to keep prices high in order to deliver profits that are in line with market expectations. They're also motivated to give the appearance of a diverse market through sub-brand strategies. Mutual banks are genuinely autonomous, independent entities.

The BCCM supports diverse corporate ownership. Among policy makers a new awareness has emerged of the importance of spreading risk in economies by ensuring the presence of a plurality of business types. A vibrant economy requires businesses of all types to be able to compete, regardless of corporate form. This means that appropriate legislative frameworks are required that do not restrict particular types of firms from being able to access the finance capital they need to facilitate their growth and development. And that's why we recommend the soonest and full implementation of the recommendations of the independent inquiry into access to capital for cooperative and mutual entities, the Hammond Review.

I think I will close here and hand over to Peter for some opening remarks. I will just end by saying that the evidence of the global financial crisis is that CMEs, cooperative and mutual enterprises, have generally been more resilient than listed firms. During the financial crisis of 2008 and the following years of economic turmoil, CMEs in the financial sector have not faced the levels of difficulty encountered by the banking sector and by certain other insurers. The Australian CME sector plays an essential role in this stable and resilient economy, and including the global economy, especially in times of crisis by combining profitability with solidarity, creating high quality onshore jobs, and strengthening social, economic and regional cohesion. And that's why we recommend action to increase competition from the sector. thank you.

MR HARRIS: Peter?

MR HUNT: Thank you, Peter. So if we can concentrate on just the financial services part of the mutual sector, one of the aspects of the work that we've been doing with BCCM is to look at different countries and to see where there are interesting contrasts and interesting learnings that we can potentially apply in Australia.

The sort of headline to all of this is that in many parts of the world coops and mutuals in retail banking, for example, are very significant players. So you could choose Germany as an example, where a third of the retail banking market is in cooperatively owned banks. You can look at some anomalous situations, such as Rabo Bank which has a dominant market presence

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in The Netherlands. And you can look at the French cooperative and mutual financial services businesses which are equally dominant in their sector.

But even if you take into account that there are very special circumstances in individual countries, if you start to look across, look at the European Union, and you can see that there are probably six or seven countries where cooperative and mutual banks are more than a quarter of the total retail market. So they're significant players in those countries. I mean, we're talking about France, Germany, Denmark, Italy - I will check my notes - Netherlands, Finland, and probably one other. But in all of those situations you can't just say there's just one local factor which is the cause for this particular difference. And as you know from that list of different countries, you've got some very sophisticated and successful economies there too.

So I would try and compare and contrast with the Australian situation. And I pick out three factors really which are significant in keeping down the size of the cooperative and mutual banking sector here. So the first is the lack of understanding of business purpose. And Melina has already talked about the differences that coops and mutuals have, and the different reason for doing business which is to serve their customer members. Now, this isn't just an interesting fact about them. It's actually part of the DNA of how they operate, and it changes the way they run their business strategies. It changes the way that they operate their businesses, and have done so for many years.

So this lack of understanding of this purpose is pretty widespread. I mean, you could actually say the same thing in the UK. You know, there's a very similar lack of understanding of business purpose. And so there's almost like an expectation that the right way of doing business is to do it through listed shareholder owned businesses, and everything else is a bit odd or a bit weird.

Now, the consequences of that lack of understanding and lack of appreciation of the different business purpose of mutuals is that as a result they get forgotten when it comes to regulation and legislation. And this a really big issue, a really crucial factor when you start to look at the different regimes in operation in different countries. Because the weakness in legislation and regulation isn't antagonistic towards coops and mutuals, as far as I can tell, but it's just that they're not thought of. They're not seen as important enough. And so effectively you've ended up with a self-fulfilling situation where the lack of understanding leads to lack of notice, and legislation starts to be less useful, doesn't keep up to date and regulation can be a bit one size fits all. And I think you will hear that from other witnesses who talk about the way that coop and mutual financial institutions operate.

Of course, the third factor in all of this is demutualisation. And if you hadn't had demutualisation you'd still have a much more significant sector. But demutualisation isn't just one of those things that happens like the weather. It's something that has been brought about by positive legislative action. And so if you look across the world, the only countries that have demutualisation are countries that have legislated to permit demutualisation. And going right back to the beginning of these types of businesses, they were never established with the intention that on one day at some point in the future the members of that organisation on that day would distribute the loot among themselves. But that's exactly what has happened, and that's why you don't have any conversation about an insurance mutual sector in Australia.

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So the question is what do you do about it? The Hammond Review looked at capital raising because this is one of the, I guess, best examples of what happens when you don't get the environment right and you don't understand the purpose of the businesses. And so there are fewer options for those businesses to operate. And this capital conundrum, which has always been there and is shared around the world for coop and mutual businesses, is that if you take an external investment does that mean you're no longer a mutual? At which point does that take over the purpose of the business? And so, as a result you find that they stick with raising capital and spending the capital through retained earnings because they don't want to lose their independence.

The reason that that is a particular problem, I would say more so in the Anglo legal system countries, is that there are few options for those mutuals. And do if you follow the expected capital raising line then you demutualise, and that is seen as the natural conclusion. What you can, as an alternative, have are different capital instruments that have different features which mutuals themselves are only permitted to issue, and that's the work that's going on at the moment with Treasury which has the government's support for new legislation.

The idea is that it would do two things. So the first is that it would create a new type of capital instrument, a new type of security which only mutuals can issue. So they can safety issue it, raise investor money but they won't risk demutualising themselves by doing so. So the easiest way of describing it is it's a bit like a preference share. But it's more than that. It's actually setting the legislation as being safe to use within the mutual business without losing the mutual purpose.

Of course, the second part of that which is a corollary to it, which is that if you're going to say that only mutuals can issue this instrument you've got to define what a mutual is. And because of the lack of understanding of the business purposes, there is a big gap in the Corporations Act where there's no mention of the mutual type of business, except to describe how you can demutualise it.

So I wasn't around when the different pieces of legislation were rolled in together to create the Corporations Act, so I can only speculate on how it came about. But what it's left us with is a sub-optimal legislative system which has the consequence of keeping a very useful part of the financial services market small, of making it less able to grow, compete and to toe to toe it with the bigger institutions, and as a result you have less corporate diversity and less competition and less choice for the consumers.

MR HARRIS: So you've got a process therefore to enable or in train - it hasn't delivered yet - but that might enable you to access wider sources of capital than just effectively self-generated from the membership. Is it in some sense insufficient? Is that the proposition? Is it not going to deliver you the ability therefore for this sector to grow in a competitive fashion? Is that the proposition?

MR HUNT: Well, it hasn't happened yet so we're very keen that - - -

MR HARRIS: But I think you said it was under active consideration and blah, blah.

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MR HUNT: Well it is, yes. But the legislation hasn't been drafted. It hasn't been presented to parliament, and it hasn't got the - there isn't a sufficient regime around it yet for how it will operate with the regulators. And so it's very important to BCCM to make sure that there is a concentration on this very significant change which is being proposed to ensure that it actually happens, it isn't forgotten, and that it actually delivers in the way that it was intended to do and as Greg Hammond recommended it ought to do. You know, we are in as interesting political times as ever. A change of government could change people's priorities. You know, we're very keen that developing legislation would actually be seen through to the final day, regardless of who is in power.

MR HARRIS: Is there a press release? Being a public servant of long standing I know that the second most powerful document in the government is a press release. A cabinet decision is your best, but after that then there's the press release.

MR HUNT: There was a videoed speech, and so

MR HARRIS: Oh.

MR HUNT: No, he was actually there.

MR HARRIS: Yes, I know.

MR HUNT: So the Federal Treasurer made an announcement on 8 November that he wanted to see this legislation brought before the Federal Parliament by September 2018. It's a tall order. There's a lot of drafting to be done. We've been working with industry and with the representative bodies within the industry, because this doesn't just apply to financial services mutuals, it applies to all types of mutuals because you can't do something for one industry sector when it's actually legislation for everybody that is affected.

So we're in the process now of seeking to influence the drafting instructions that Treasury are putting forward. But there's a great gap between what industry believes is necessary, what Treasury in principle supports, and what eventually gets to Parliament. So we want to keep people's eyes on this and to keep people's interest in it, and so as many people as possible should be aware that this is actually going on because it could actually have quite significant effects in a whole range of different areas, not least your own considerations of productivity in financial services.

DR KING: The direction though you're going - because there are, at least with regards to coops, with regards to any coops, they currently have mechanisms to allow them to raise some extra capital, the most obvious being the A class, B class type of shares that we've seen. So this will be a different type of form because when I think of who's done the A class, B class shares. I also think of AWB, and that was very - Murray Goldman and - okay. So how is this reform going to be sort of different to the sort of existing opportunity that's out there, at least for the coops? I don't know about the broader mutual sector.

MR HUNT: So, it borrows experience. Are you okay for me to carry on?

MS MORRISON: Yes.

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MR HUNT: Yes. It borrows experience from legislation that has been brought forward in the United Kingdom for building societies in 2013, for mutual insurers in 2015, which has gone through the process of creating this particular new type of, let's call it - it's a security - which can only be issued by those types of businesses. Because one of the problems in all of this is that you can safeguard your firm through your constitution until your members have a problem, and you've alluded to one of the best examples of where something goes wrong and the whole thing ceases to be what it was initially intended to be.

The point of these instruments is to try to create in an Anglo legal system as close as possible to a mutual instrument that you might get in other jurisdictions. So in France, for example, it's not possible to demutualise. We're not going as far as to say it shouldn't be possible to demutualise, although there is an interesting philosophical discussion to be had about how that actually takes place and who actually ought to benefit from all of that.

But in the French legal system it's not possible to demutualise because the assets, the underlying assets, have to be transferred to either another mutual or not distributed to the individual members. So it just draws the poison out of the whole process.

We don't think it's possible in the Australian or the UK or the Canadian system to replicate that, but you can have an Anglo answer to it which is to have a different type of share which has limited rights in legislation so it's absolutely clear what people are getting for their investment, and what - - -

DR KING: Does it create - and again, sorry for my limited knowledge in this area, but it seemed a standard agricultural coop approach can create a conflict, an internal conflict, that there's a duty to the class A shareholders, who are generally farmers, but then there's also a fiduciary duty to the class B shareholders in terms of profit distribution and in at least one case we know that there were certain promises made on issuing those shares, and that's under investigation. But how do you get around that problem, that conflict of fiduciary duty?

MR HUNT: Well, you're describing what the problem is at the moment.

DR KING: Today, I know. So I'm wondering how this new instrument does it.

MR HUNT: Well, to begin with it doesn't carry those promises. So if you are looking at the institutional offer of say, for example, a large credit union wanted to issue these instruments to an institution, or a group of institutions, then the difference between that and what you've just described is that firstly, under no circumstances will the holders of any securities have more than one vote, which then - in many cases we expect they won't have any votes. They'll be non-voting entirely, to fit in with the government structure of the existing mutual. But more to the point, in terms of the offer document it will offer an indicative return. But it won't be a promise, and it would be reliant on the existing governance structure actually supporting it. So there'd need to be a vote, either through the board or through - depending on what each individual mutual wanted to do. Whether they wanted to do it through their membership every year or whether they wanted to do it through their board every year.

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I will give you an example. A nationwide building society in the United Kingdom successfully got away 500 million pounds of these types of instruments, and there is no guarantee to pay a dividend on it but there is an indicative dividend which, of course, if you don't meet it you're not going to be able to market it. But there is no guarantee in all of that. And that again borrows from examples in Canada, from Dajavan Group and in France where there are external investments made into these businesses but they don't have the same ordinary share relationship that you might have in a listed firm. So it's a different type of share.

Now, then the question is is that worldly? Is it marketable? Do people want to buy it? Well, the nationwide one was three times over-subscribed. Rabo Bank have a slightly different approach because technically the certificates that they offer to institutions and to individuals are debt instruments, but they also have an indicative return attached to them. Again, no promise. And it's the strength of the institution, the strength of the individual business, which decides whether these instruments are successful or not.

MR HARRIS: The interesting question, Peter, really though is an expansion of capital for this sector, which is what you're saying is on the cards and you'd like to see occur by this instrument that in the end holds out some indicative perhaps, but some promise of a return, is a different source of funding than traditionally used by the sector, which is generated by the members themselves. In other words, the members' willingness to take a very low rate of return on deposits is an important source of capital. Mind you, you could probably say that for a lot of the financial sector now, a very low rate of return on deposits. But never mind. And that's translated to a willingness for mutuals to offer rates for certain loan purposes, not every loan purpose but some quite important ones, that are below the prevailing market rates. And so that's why we comment on - and Melina, you have read that out. So the question is what happens with this expansion of capital?

I mean, there's - how is it that a new style investor, this new instrument, is going to accept such a relatively low rate of return that you're going to be able to maintain that somewhat desirable, I would have thought, in a competitive sense, which is why you've mentioned it, the price in the marketplace which suggests that it is possible to be a sustainable institution and offer a cheaper price than the current generally prevailing price in the marketplace from the large businesses. I mean, that's the big question. What does this instrument do to the ability to maintain what looks like an attractive competitive rate? Because this is a competition inquiry, so we're really asking about the competition effect.

MR HUNT: Well, it's an interesting question because you don't know until it's happened what the actual effect is. But one of the things to take into account is that in some circumstances it will be a retail instrument and it will be offered potentially through existing membership networks. And so, although you talk about there being a new stakeholder of investor, it could actually be the customers themselves. And if you then look at a living, breathing example of this, the German Volksbanken. They get about 20 per cent of their capital from their individual customer members. So it's not impossible to see that kind of investment taking place in Australia too.

For institutions, you already have the larger ADIs, mutual ADIs, working in the medium term debt market and those are the types of investors that would be interested, from our experience in the UK, that would be interested in this kind of instrument.

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So in many ways there's no single answer to it because it depends on the institution that's doing the issuance, it depends how much of it they're seeking to issue, and the manner in which they distribute it, whether it's wholesale or retail, or both. So if you think about what they would spend the money on, which is really the point in all of this, why do they need the money? They can sit in their niche, do a very good job, as they do at the moment, but be restricted in the way - - -

MR HARRIS: This is the question. This is the ultimate question.

MR HUNT: Yes.

MR HARRIS: So you're repeating back to me what I've said to you. So we're both sitting here thinking it's not clear whether access to this instrument will make mutuals a significant, or change significantly their ability to influence price in the market. Right now, it is a niche. It's an important niche and it's good for the members and all good as far as that goes, but we were really looking at who is an entity that could be a competitive force here, and we see the restrictions that mutuals impose upon themselves about how they access capital as being a natural and limiting factor. You're saying there might be a diversification opportunity here, and I'm really trying to work out whether it's a diversification opportunity that an inquiry like this can say hooray for because we could sustain the argument that this will translate into a wider part of the community. You know, at a price that says look, it's possible to be commercially sustainable, which these businesses are, and still be 0.4 to 0.8 below the prevailing home loan rate.

MR HUNT: Well, imagine a business that would be interested in growing through acquisition. Imagine a business that wants to invest significantly in fintech. Imagine a business that at the moment can only do that through its retained earnings or - and with the consequential effects that it has on its capital ratios. So actually what we're talking about here is an injection of new permanent capital which is about getting new stakeholders on board to go the journey with the business, and to expand the horizons of those businesses. They will only succeed if the management are up to it, and so there's no simple answer to say, "Oh well, this is a panacea", because it depends on how well it's actually executed in the individual cases.

MR HARRIS: Yes. The reason we're - I don't want to sound ultra-reluctant, but as you can tell from the rest of the report there has been quite a bit of relatively superficial advice which says lots more new entrants in banking will create lots more competition. Now, we indicate there have been quite a lot of entrants and it hasn't created a lot more competition. So we just don't want policy makers to imagine that expanding the nature of the number of competitors and the size of competitors - you know, this whole thing about ...(indistinct)... as far as the four pillars - the bigness of the competitors is actually a force for competition. It's not really. Not in the current regulated constraints that exist in this kind of unique market.

It's not undesirable, but it's not undesirable for other reasons, I think. You would like to see every business that is capable of doing more get the chance to do more. That's just sort of, just a - and your point, I think, made earlier was mutuals have been forgotten in the overall structure of corporations law reform and the role that mutuals could have played, and have played in other countries. Which makes it still desirable. It's just for us it's a question of, you know,

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how firmly we can say this is a force for competition. That's why I'm really interested in that particular question.

Anyway, you might want to think a little further on that and if you've got some things to come back to us on with this that would be worthwhile, because it's not that we're against the principle, it's just that we'd like to firm up on if there's an opportunity how we demonstrate that it is actually an opportunity.

MS MORRISON: I think we would enjoy the, welcome the opportunity to provide some more evidence about that. I mean, you asked before is there anything you're sort of bringing here, in another proposition. It's really in what is a very - you know, we welcome the report. It's a very solid report and has a very broad view on the enablers of the competition. It is silent on the impacts of legislative reform so you've talked - - -

MR HARRIS: But not because we're not looking for it, but because I'm just identifying why, because we found it hard to convince ourselves that this would necessarily be a competitive force. We would like you to tell us this is how we can, and here's the possible benefit. Anyway, it would be good to see.

MS MORRISON: Yes.

MR HARRIS: Now, we have Bank of Queensland next so unless there is anything else you guys would like to add?

MS MORRISON: No, thank you.

MR HARRIS: Thank you very much for your attendance today and for the discussions we've had today, and hopefully for the possibility to be in touch again in the future.

MS MORRISON: Thank you. Thanks for the opportunity today.

MR HUNT: Thank you.

DR KING: Thank you.

MR HARRIS: Bank of Queensland. All the way from the sunny north. Thanks, for the record could you identify yourself please?

MR ROSE: Yes, Anthony Rose. I'm the Chief Financial Officer of Bank of Queensland.

MR HARRIS: Thanks, Anthony. Do you want to make some opening comments?

MR ROSE: That would be great. Thank you, Chair, for the opportunity to speak to the Commission today following the release of your draft report. We intend to provide a second round submission that will more formally address your recommendations and findings. By way of background, BOQ was established in 1874. Today it has a network of 190 retail branches across Australia. BOQ's market share in mortgages and business lending is less than

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two per cent. Our unique franchise model network of owner managed branches form part of the two million small businesses contributing to the Australian economy.

BOQ notes the Productivity Commission's findings that the benefits of competition have been reduced in the quest for stability and promoting an unquestionably strong financial system. The objectives of stability and competition are not mutually exclusive and should co-exist. The banking regulator, APRA, has an important role to play in ensuring a competitive playing field, but we believe the ACCC as the competition regulator also has a role to play. We see the merit in the ACCC being an additional member of the Council of Financial Regulators.

The playing field is not level and, while there has been some progress, more needs to be done to deliver a truly competitive market. There are four key areas of focus for BOQ. Risk weights, funding costs, transparency in the mortgage broker space, and the impact of regulatory change.

The regulatory risk weighting framework has afforded the advanced banks a significant benefit over standardised banks. APRA's lifting of the mortgage risk weight floor to 25 per cent for advanced banks was a positive step, however the remaining gap is still too large. For example, for every $2 of capital a major bank holds against a mortgage, BOQ holds around $3.50 of capital. We welcome APRA's approach for more closely aligned risk weight calculations between advanced and standardised banks outlined in the discussion paper it recently released.

We also welcome APRA's consideration of applying the advanced bank floor to sub-portfolios rather than at an aggregate level. Our position is that the floor should be applied at each standardised risk weighting bucket to deliver a more competitive environment across the full range of customer segments. This approach would also enhance transparency and contribute to system stability, particularly in a crisis.

The cost of funding is also an area of significant competitive imbalance, which we estimate to be in the range of 15 to 25 basis points between the majors and the regional banks. The vast majority of this funding benefit is afforded through the implicit government guarantee of being seen to be too big to fail. This implicit guarantee is explicitly evident in the credit ratings positions. If we take S&P's ratings as an example, the major banks have a credit rating four notches higher than BOQ, with three of those notches solely related to the implicit guarantee.

BOQ supports the introduction of the major bank levy. While the principle of the levy is sound, the six basis points represents a small proportion of the overall funding cost benefit enjoyed by the majors. Major banks have a taxpayer provided insurance policy in the form of too big to fail, and it is appropriate that they should pay the taxpayer an insurance premium for this in the form of the levy. The current levy is clearly less than the funding benefit that the major banks receive.

We support the Productivity Commission's findings for increased transparency in the mortgage broker market around ownership structure and flow of business relative to market share. In the past brokers have played a positive role in driving competition in the mortgage broking sector, however the major banks' ownership of broker platforms has had a profound influence on the flow of business back to the majors. We fully support the Commission's draft recommendation 8.1 that ASIC should impose a clear legal duty on those mortgage aggregators owned by lenders to demonstrate they have acted in the customer's best interests.

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Finally, greater consideration needs to be given to the impacts on regional banks before any new regulation is introduced. In periods where there is a high degree of regulatory change it has a disproportionate impact on regional banks who lack the same resources as the larger players. A great recent example was the sensible pragmatism applied to the approach to defer the commencement of the banking executive accountability regime for small and medium ADIs. I am happy to elaborate on these issues as well as other findings in the draft report, and welcome questions.

MR HARRIS: Thank you very much. So risk weights, people have to read the chapters in the draft report to find the nature of some commentary we made on what appears to be a bit of a developing thematic. You mentioned the levy as well. That says it is sort of desirable to add costs to the major banks as a way of responding to their natural advantage in the marketplace, either induced by rating agencies too big to fail kind of view, or perhaps the possibility that risk weights were inadvertently too generous to big banks in the past.

But as we do comment in the draft report, that simply raising costs if nothing else changes is probably going to increase prices to a bunch of consumers, and you wouldn't necessarily say that's terribly desirable. So tell me a little more about this idea that risk weighting should still be lifted for the large banks rather than, in the alternative as we have tried to comment with our two suggestions on risk weighting, in both cases they were suggestions about how APRA might consider varying risk weightings to recognise the possibility of banks that are currently capital constrained, and you might be strongly in those circumstances, being able to lend more if those risk weightings are a little more generous.

So I guess what I'm trying to characterise is we're very interested in things that might actually reduce costs in the marketplace. Of course, if risk weightings are unutterably wrong and you're prepared to substantiate that of course they should be fixed. But isn't the greater interest to try and get that cost of capital necessarily held against risk down a little? Isn't that the greater interest for all of us?

MR ROSE: So you've captured a number of points there.

MR HARRIS: Yes, but a homily I know - but I'm just trying to get - - -

MR ROSE: No, no. I get you. They're all really valid.

MR HARRIS: If you can come back and tell me where I'm wrong that's great.

MR ROSE: So I might start with the bank levy. So at the moment the major banks benefit, and I think I mentioned there's a four notch credit rating differential between BOQ and the major banks, and three of those notches in S&P's methodology relate directly to the implicit government support.

They get a natural funding benefit because of that implicit support, which prior to the introduction of the levy they got for free. So there is a question of equity around if the taxpayer is providing a contingent, has a contingent liability in the form of a too big to fail insurance

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policy, then should it not receive a regular insurance premium for providing that? And we believe that's the merit of the structure of that.

It has a secondary benefit of yes, providing a more competitive landscape by levelling the playing field between those banks who don't have as large an attribution to implicit government support as the four majors. So that's I suppose - it's reducing, if you like, an artificial benefit that they are getting today.

As far as the risk weighted assets point is concerned, APRA and off the back of the FSI position, have a determination, if you like, to make sure Australia is unquestionably strong, and one of the elements of that is ensuring that the capital levels meet the desired targets that APRA have determined relative to global industry comparisons. And so I think our point is not about where APRA determines that position should be. Our point is that the gap between advanced and standardised measurement shouldn't be $2 and $3.50. It should be significantly converged. So ultimately we'll let the regulator determine where that hurdle should be in the interests of the balance for the community, and then - you know, but we do believe that competitive piece needs to be reduced.

The other element I would then go to in your discussion around costs of capital, we - the construct of our economy in Australia is such that we are arguably the most reliant banking system of developed economies across the globe on foreign capital for funding, and as a consequence of that we need to run settings that reflect that degree of reliance. Now, part of that goes to unquestionably strong capital that we've just covered, but there are a range of other factors.

I would argue that another factor that is critically important is unquestionably strong capital levels in and of themselves are never going to guarantee against a disaster scenario, and for the foreign investors to continue to be as long Aussie bank paper as they are, overweight Aussie bank paper, that they need a reason to suggest that that industry will always be appropriately capitalised if there was a shock event. And I think that actually by outcome means that our banking sector needs to deliver premium returns for equity investors to ensure that that capital will always be there, over and above the returns that would be expected in a banking industry that is domestically funded.

If we had a domestically funded industry we would probably be sitting in a position where the return profile of the participants would be lower. But I think there is that balance that it's in all of our interests to make sure that that funding source from offshore is not turned off. The implications of that are obviously significant, as we have seen.

MR HARRIS: I understand that up to the point when you consider a crisis. And we've had an example, possibly an extraordinary one, but you know, we've had one in 2008/09, and it wouldn't have mattered what the returns were earned by the Australian industry, banking industry from lending for domestic purposes surely. It was a freezing up. It didn't matter what the price was. I mean, we're all creatures of our own existence but I was running a very large infrastructure project at the time and so saw at first hand the utter unwillingness to lend by international parties to a project that was, whose customer was the State Government of Victoria. And for a product that was undeniably essential for the people of Victoria. And so, you know, the markets froze up in the way they did and so the question is - I sort of understand

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the theory behind what you've said, but surely we're not advocating the earning of premiums in this market in order to have confidence of foreign investors in the assumption that come a crisis, a genuine crisis, they will keep providing money to us. Because that example, which is our only real piece of evidence, is no, they won't. They'll do what happened globally. And regardless of the quality of the party, no one could be sure apparently who was of genuine quality.

So surely we can't advocate having a system that guarantees the earning of premiums simply because of foreign investors. I understand we need to have market capital, but I can't go as far as to accept that we could justify premiums simply on that basis.

MR ROSE: I would argue that if this was an industry that simply returned the levels that would be expected of a domestically funded sector, there is a question mark as to whether or not in the post-GFC environment all of the government guaranteed debt that was on issue could have been refinanced in global markets such that the world would be prepared to continue to go along. You've got to recognise that a fixed interest investor will do the credit analysis on the underlying credit that they're exposed to, but in such a situation where they are so overweight as a cohort to that investment class they've actually got to do the "what if" analysis that says what happens if another big bear fund down the road suddenly decides that they want to go market weight Aussie bank paper? What's going to happen to the refinance market for that maturity that I'm currently holding when it comes to needing to be refinanced? And therefore there is a spread volatility risk that is real, and therefore they'll charge us for it. They'll charge us for that.

So there is an argument that says an element of that excess return lowers the cost of debt, right, for the institutions and it's balancing those two elements. I don't think you can simply say the market will always be there at the degree of overweight position it is today, that - yes, at a much lower return level. So it is a balance between those two things. And I do think by having that strength you do end up with lower funding costs in the wholesale markets that ultimately do come through into improved pricing for customers.

MR HARRIS: Yes. Stephen?

DR KING: Yes, I just want to chase up a couple of the other issues that you mentioned there. I wonder if - implicitly you've sort of got the major banks paying twice for the implicit government support. So you've suggested the levy may be a way, and we discuss the levy in our report. You also mentioned unquestionably strong, and obviously the systemically important institutions, which the majors are, face and have faced increasing capital requirements, even though they're IRB banks. Isn't that also in a sense to try and pick your terms, getting them to pay for that investment, that government guarantee, protecting the government because they are unquestionably strong? So in a sense why do you need both? Why do you need to push up the risk weights to make them essentially unquestionably strong whilst also imposing that levy?

MR ROSE: I think the two points are distinctly different. One is where does Australia as an economy want to balance the degree of unquestionably strong? And I think it's broader than just capital - [part of that is capital and part of the other things that I've covered - versus the implicit guarantee is something that they benefit from because the taxpayer provides this

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contingent obligation. And it does seem just sensible and equitable that the taxpayer would receive an appropriate fair valued premium for that cost. And I think at the level that it sits at the moment - and we're agnostic to where it moves from here. I mean, obviously we can see arguments for, you know, you could probably double it and you would say you wouldn't have created any anti-competitive position for the major banks in that scenario relative to the actual underlying benefit they get from that implicit guarantee. But I think that that's the nature of the framework of that charge, and it does seem eminently sensible. It has a second order effect on obviously helping to level the playing field.

MR HARRIS: I am less concerned about - this is a radical statement so I struggle with my - I am less concerned about the levy per se and the concept of whatever its rationale was, and a number of rationales were used, about these risk weights and the driving up of risk weights. This fascination with saying there's a problem here with risk weights and the solution is that they should be, they should impose effectively a higher carrying cost of capital. It does seem to me to impact far more on competitiveness in the marketplace than the question of - well, let's accept the argument, it's an insurance policy and someone should be paying for it.

So let's accept that and say well, that's logical. If it was an unpriced insurance policy it should be priced, and park it. I'm not trying to make that argument as an acceptable one, I'm simply saying I don't think it's the bigger problem. The bigger problem is this fascination with risk weights are misaligned and the solution is that they should rise. As I said, we've tried to point out well, here's some examples where they could fall. And you would expect at least as much emphasis on that as this endless search for reasons to raise them.

It is sort of one of the things that indicates to us that this - there's no satisfaction yet that unquestionably strong is sufficiently unquestionably strong. And the person paying for that at the end of the day is the consumer, notwithstanding anybody else. There's no ACCC inquiry into stopping the passage of risk weights into the marketplace. The consumer is going to pay, and thus we see this intersection between stability and the potential impacts on competition. And I guess I'd be always more impressed if people can offer examples of how perhaps by greater willingness - you mentioned in passing, you mentioned some portfolio kind of risk weightings. This would presumably be driven towards here is a sub-class of borrower who shouldn't be subject to a bank holding a, if you like, the default level of risk capital against them because they're a better risk and so we should reduce them. That seems to be a more interesting and pro-competitive kind of thing rather than the fascination of just let's lift some risk weights because we think they're misaligned.

So is there much in that? I mean, we found what we found. We were sort of hoping to find a bit more, but do you think there's any more in that for us?

MR ROSE: Look, I think - completely would support the greater granularity of risk weighting buckets in the standardised approach. Now, APRA have started down that path and there's arguably - you know, we could take that further and we'd be very supportive.

MR HARRIS: And that would benefit you guys because presumably - - -

MR ROSE: Absolutely.

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MR HARRIS: - - - then you could run a model around the particular attractive sub-classes and demonstrate that you should qualify for that revised, more generous risk weighting and potentially offer a different price or a different willingness to lend into the marketplace as a consequence.

MR ROSE: Yes.

MR HARRIS: So surely that's going to - you know, it's almost like some people have proposed, the breaking down of the complete IRB modelling exercise into more accessible chunks. That would be desirable surely as a sort of proposition.

MR ROSE: Definitely.

MR HARRIS: And do you think that's a direction APRA is heading in?

MR ROSE: The discussion paper does suggest there's a lot more granularity than the 35 per cent bucket that was one size fits all. So I think that is definitely positive. You know, there is a shift in SME risk weights in the standardised approach that's under discussion from 100 to 85, but again that's a one size fits all for that cohort rather than a graduated approach to that, which certainly would be - we would be supportive of.

I think the other point that we've been very keen to try and make is that wherever you decide to maybe try to pick up the best of both worlds, and your comment around do we just go to a more granular standardised framework, you know, not wanting to dismiss potentially the benefits of having advanced modelling techniques around that - but we do advocate if you're going to apply a floor of an advanced model to the standardised approach, rather than applying it to an aggregate bank level if you actually applied it at each individual standardised bucket in that granular piece you've immediately got less likelihood of cohorts of customers within the portfolio that - where the standardised framework is uncompetitive with the advanced framework. And that would be something, you know, we've been strong advocates about.

We think the other additional benefit that that actually provides in a reporting sense - if you start to have advanced banks in their modelling report against each of those standardised buckets, there's transparency around the degree to which your models provide benefit below the standardised approach and you will enable external scrutiny across all the market participants which adds a degree of transparency and resilience that was actually lost during the GFC because everybody turned around and said, "We don't believe the advanced bank models. They're a black box." That would go a long way, I think, to providing stability.

DR KING: Just a clarification for my own perspective, so when you're talking about those floors, you're talking not just about the three and four per cent floors in the first APRA discussion paper, you're talking about floors on the IRB rates over a loan class?

MR ROSE: Yes.

DR KING: Okay, that's all right. Just to make sure I understood what you were getting at there. Okay.

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MR HARRIS: I haven't got anything more on this. Do you want to ask about our publication of real time pricing? Can I go to that?

DR KING: Yes. I just wanted to do a little bit on brokers as well.

MR HARRIS: Yes, okay. Well, you can do brokers. I'll do this. So yesterday we did get a proposition from I guess what you say might be from another member of the cohort of banks, where Bank of Queensland is, from Bendigo and Adelaide. They made a comment on our proposition that ASIC should be able to gather information from banks on quite a structured basis about the actual median price for a negotiated loan in a particular location for a particular kind of borrower, and ensure that the market was informed by as close as possible to real time actual prices rather than mooted potential discounts against a standard variable right, and propositions like a comparison rate and general, you know, prices that certainly aren't the actual price being paid in the market.

Now, Bendigo and Adelaide didn't like that. Yesterday they told us that this would advantage the larger banks. I guess it's an interesting proposition for us that real and actual prices, which are viewed generally in markets as being a desirable thing, and certainly occur in - you know, go to the supermarket and see it - isn't - is going to advantage a larger competitor here. What is your reaction to that recommendation?

MR ROSE: Look, the industry already has a comparison rate reporting regime. I think we'd need to do some more work to determine what are you actually achieving. I think it's quite easy for people to compare published rates on websites. We also know that there is discounting that occurs off the back of that. But we also have a broker space which also plays a part in understanding the differences in offers that exists at any particular point in time. And then you've got individual credit risk settings and portfolio appetite that each individual institution plays, which probably adds to the degree of complexity that isn't clear and apparent from those other mechanisms that I've just mentioned. Because certain customer types may be more attractive in the mix of building your portfolio than others, that you might be more interested in.

But I think the question is do we really think customers are getting a materially different outcome when they come to the market for a new loan, given the degree of new loan competition? We only have to look at the owner occupier principal and interest market at the moment where customers - it is a borrowers' market in that environment.

MR HARRIS: Yes, I think I understand all the points you made, and I could make a set of counterpoints to each of them too. But I think the in principle proposition we have is it is now quite possible in a technical sense to say what the December median price loan in a particular location for a particular kind of borrower was. That's information that traditionally would be accepted as being of value to a consumer in a marketplace, and the uncertainty that otherwise arises does encourage a consumer to go to a broker. And increasingly we've seen brokers now owned by banks.

So whilst a broker is a source of information, the question is what information and how far does it go? And yet if the consumer went to either the broker or the branch knowing that a particular bank that they're now in in December offered them at their level of income for a

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property in this particular location a median price of this, they would at least know whether they were indeed that customer that wasn't desirable for the portfolio of the bank, when the proposition they get back across the counter or from the broker is sorry, we can't offer you that price. It has to be higher. We'd just call that truth in advertising. We'd say it's just a desirable contribution to information in the marketplace.

But I'd like to add to that as well, the question is for the existing borrower who otherwise is apparently unconscious of the fact that there are better propositions out in the marketplace and would in fact be better informed by this. So we're still struggling to see in terms of the question I want to put to you is this question of how does it advantage a large bank versus a medium size or smaller bank? It's not clear how that advantage falls to them, and that's what I'm really interested in getting your response on.

MR ROSE: Yes. On that specific point, I mean I think if we separate the ownership of brokers as a separate issue for the time being.

MR HARRIS: Yes. I'm just saying there are answers to many of the points here. The core one is that.

MR ROSE: Just assume that ownership issue doesn't exist, so that it is perfect in that sense. You know, there is a risk in that environment that greater transparency does see a diminished utilisation of the broker space. That is a risk. And we have seen that the broker market has certainly been official in allowing the non-major banks to compete in the mortgage space.

MR HARRIS: I see. So the proposition really is - and we do acknowledge, and I think everyone accepts, that banks, medium and smaller size banks have been assisted by the broker revolution and have saved the need to occupy branch space in locations. Particularly I guess if you're a regional bank that is certainly true. And you're saying therefore if that pricing impact did encourage more people to, as it were, look for a branch then the entities with the biggest branch network are advantaged by that. Okay, it's worth us thinking about that.

MR ROSE: Yes.

DR KING: And on that same point, reverse your assumption now and say well, we know that a large number of the brokers are owned by the major banks. Bank of Queensland, I don't know off the top of my head the percentages of your loans that go through brokers versus branches, but I would be interested if you know off the top of your head. Do you have concerns about that level of integration, given you have a dependence on the brokers? Does that change your own strategies? Do you tend to try and push more loans through the branches rather than the brokers, even though the brokers may have better client accessibility or may even be cheaper? And do you think our recommendation on the duty of care obligation is a useful recommendation or a useful way to address those problems, if there are problems? I don't want to pre-judge. You may say no, it's fantastic. There's no problem.

MR ROSE: So to start with, I think we've only more recently as an institution moved into the broker space. So we've been in it for about the last three to four years. At the end of the day its customer behaviour and choice as to which channel they choose to interact with to obtain a mortgage. And we've seen about half of customers use that channel across the whole market.

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So it was - we saw it as important for BOQ to make sure that we had access through that channel for customers who chose to go through that way. We've only got about 25 per cent because we're early to the market of our flow through brokers.

As far as that duty of care obligation is concerned, and we do think that is important because the degree to which major banks are getting flow of business over and above their natural market share is in effect market access that would have been available to the non-big four, that is now no longer available to us, you know, for whatever reasons are driving that type of outcome and it does appear that there is quite a trend towards an over-allocation of flow back into the proprietary products of the owned businesses, which I think is addressed by putting that duty of care obligation in.

DR KING: I mean, you're on the ground in a sense so when you're saying well, it does change the flow, the ownership does change the flow of product, are you relying in a sense on the same as us, simply looking at the macro level and saying well, it doesn't seem right, or is there intel that you get back on the ground sort of saying well, yes sir, we'd love to sell more of your product through this but you've got to recognise there are other forces at play. Sure we don't know explicit statements, but we're interested in that micro level. We can see the macro, but the micro story, the story on the ground, and if you want to take that away and consider for further submission on that that's fine.

MR ROSE: We've been monitoring that ownership structure with a concern and a premise, and we raised this at the FSI directly, that we thought it was important that those that own aggregated networks should actually be required to publish the degree of flow relative to their market share for the public interest, to understand whether is there anything to see here or not, and to be honest the information that you have provided in your report is new information to us as well, but doesn't surprise us. Again, it's hard for us to access that information as well.

MR HARRIS: Nevertheless we will persist there. So I think we've reached the end of our questioning. Is there anything you would like to add in closing, which you're not obliged to do, or otherwise I want to thank you very much for making the time today and for the contribution that your input has made to the inquiry, and we may be back in touch with you at some later point for clarification if that's necessary. In the meantime, thank you very much to the Bank of Queensland.

MR ROSE: Thank you.

MR HARRIS: We are going to have an adjournment now so that people can go out and buy a sausage roll and then we're going to start again at 1.15 according to my schedule.

ADJOURNED **[12.27 pm]**

RESUMED **[1.15 pm]**

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MR HARRIS: Okay, we're going to recommence Sydney hearings for this inquiry and I think the Customer Owned Banking Association is next up. If you gentlemen would identify yourselves for the purpose of the record that would be great.

MR LAWRENCE: Okay, thank you, Michael Lawrence. I'm the CEO of the Customer Owned Banking Association and I will open up with some comments, if I may, just in terms of an opening statement.

COBA speaks for mutual banks, credit unions, building societies. It's the Customer Owned Banking institutions that provide the important competition and choice in the retail banking market and being unmatched for customer focus in that market. The success of our model is demonstrated by the sector's consistently market-leading satisfaction ratings compared with other banks and particularly listed banks.

The Customer Owned Banking is distinguished by prioritising custom benefit over profit maximisation, conservative business models and prudent risk management, and deep community engagement and strong customer loyalty.

The first point that I'd like to make is in relation to making regulators more accountable about competition. We agree with the Commission that there is a need to increase the focus on competition in the Prudential Regulatory decision-making.

Our view is that APRA does give some consideration to competition and its performance in this regard has improved since the financial system inquiry. However, there are multiple examples of where APRA may not have given enough consideration to the impact on competition. We support the use of the statements of expectations to deliver further improvement, but a more effective way forward is to change APRA's legislative mandate to introduce an exclusive secondary competition object.

APRA's mandate currently mentions competition but elevating its status as a clear secondary objective behind financial safety and stability will increase APRA's focus on competition. This secondary competition objective does not mean APRA would have to sacrifice its other objectives in pursuit of a more competitive environment, but APRA would be more accountable about its approach to competition.

APRA's peer regulator in the UK, the PRA, was given a secondary competition objective in 2014 and the outcome is a material change of gear where competition is gaining air time and traction at all levels and there are numerous instances where competition considerations influence policy outcomes.

Moving on to our second point around competition and the champion of the Council of Financial Regulators. The draft reports proposal for a competition champion on the Council of Financial Regulators is welcome, but not necessarily address all the problems that we have identified. The Council of Financial Regulators is concerned with macro-prudential policy, but many of APRA's micro-prudential decisions can, and do, affect

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compensation.. These decisions wouldn't typically be matters for consideration for the CFR.

Our proposal for a change in APRA's mandate would supplement the concept of another regulator, the ACCC or ASIC having the role of competition champion on the CFR. Our preliminary thinking is that the ACCC is more naturally suited to the role of competition champion and would therefore become the permanent new voice of the council, while ASIC would have an obligation to consider competition added to its mandate.

We agree that the lack of an advocate for competition is a mistake that should be corrected. APRA's excessively blunt macro-prudential interventions, that was brought out in the report, into the home loan market has harmed competition and unfairly affected the smaller banking institutions. One of the major issues on the agenda of the CFR that will affect competition is tackling the too big to file problem that gives major banks an unfair funding cost advantage over the smaller competitors.

The government endorsed the financial system inquirer recommendation to reduce the implicit government guarantee and perception that some banks are too big to fail. The recommendation was made in 2014, and accepted by government in 2015. APRA announced recently it expects to commence consultation later in 2018 on the proposals to implement the FSI recommendation.

Our third point around mortgage risk rates, we agree with the PC draft report recommendations for a review of mortgage risk rates to better reflect risk. APRA has recently issued a paper on proposals to revise the capital framework, including changes to mortgage risk rates

COBA and its members are examining these proposal and we note that APRA will also carry out further analysis on the impact of the proposed changes in banking institutions. We want to see further narrowing in the capital requirements for mortgages held by small banks compared to the major banks. The financial system inquiry identified this as a significant anti-competitive problem and APRA has since taken interim steps to reduce that gap.

There is still some way to go, but we are encouraged by APRA's statement that the revised risk-weight framework is likely to reduce any competitive differential in regulatory capital requirements between the large and small ADI's, improving the competitive position of the latter.

Our fourth point around cumulative regulative compliance burden. The key concern to our members, and key factor influencing the competitive capacity of smaller challenges to the major banks is the regulatory compliance burden. The fixed cost of complying with regulation falls more heavily on smaller firms. The regulatory compliance burden provides yet another advantage to the major banks because they can spread their cost over a vastly bigger revenue base.

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Regulation should be targeted, proportionate, risk-based and where possible graduated. Decisions to improve new regulations should be coordinated and cumulative impact should be assessed. Seen in isolation, a particular regulatory measure may appear relatively being, but the continual introduction of new measures can amount to death by a thousand cuts for the smaller players in the market.

Our sector, with a strong customer focus and good compliance culture, is caught up in the backlash against some of the conduct and culture that's playing out in the market at the moment, particularly through the Royal Commission. For example, all banking institutions are subject to the Banking Executive Accountability Regime, but we were pleased at the recent announcement that the smaller banks had a 12-month extension on the implementation of that. Another example where regulation could be better targeted is the government's proposed financial product issue around the design and distribution regime.

In relation to banking, basic banking products such as savings accounts and debit cards, there is no evidence that the regime will improve consumer outcomes, and there is a clear risk that it will lead to worse consumer outcomes, and finally, a proposal on the ban of interchange freeze, I'll make some brief comments about the draft report recommendations to ban the interchange fees.

We do oppose this recommendation. Interchange fees are a mechanism to enable sharing of costs on certain benefits and card issuers provide to merchants. These benefits include processing transactions, preventing fraud and authorising transactions. Merchants should bear at least some of the cost of benefits provided to them by the card issuers.

Banning interchange fees would affect competition by having a disproportionately greater impact on smaller card issuers that do not participate in the merchant acquiring market. Major banks dominate both the card-issuing and merchant acquiring sites of the payment card market.

The loss of competition for costs sustained by the card issuing side of their business could be balanced by not having to pay interchange fees for the merchant acquiring side of their business. I note that the payment system board carry out a comprehensive review of the card payment interchange fees in 2015 and 16, and the new benchmarks commenced only a year later.

So thank you for the opportunity here, and sorry it was remiss of me to introduce my colleague, Luke Lawler, who's the Director of Policy at COBA.

MR HARRIS: Sure.

MR LAWRENCE: Thank you.

MR HARRIS: All right. Do you want to go in reverse order and do interchange fees- - -

DR KING: Yes.

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MR HARRIS: - - - and disproportionate impacts? So can you explain to me how it's disproportionate impact, the interchange fees? Why would it be a disproportionate impact on smaller institutions?

DR LAWRENCE: Because a lot of the small institutions don't participate on the merchant side, so they're only on the card issuing side, and so, you know, if you are - it's that balancing act in terms of removing that interchange fee where you pick it up on one side and lose it on the other. If it's removed and you're only a card issuer, then obviously there's a disproportionate cost because you can't - you're not going to offset it.

DR KING: So, I mean, the interchange fees have dropped substantially more - if you move from current level to zero, they've dropped more than that since the RBA started regulating them, so are you using fewer credit cards today than you were back in 2003 when the original regulations came in?

MR LAWRENCE: No, I wouldn't say that there's less being issued. You know, the decisions that are made as a business you've got to deal with, doesn't necessarily mean you exit the market. You need to absorb it, but the point is you become less competitive because, you know, the costs burden is great.

DR KING: So fewer reward points on your cards, has that been a consequence? So you're not paying customers as much or - - -

MR LAWRENCE: Look, you know, I can't talk about the specific arrangements across 75 of our members. They are different, but we can certainly look to provide some of that detail in terms of where some of those benefits might sit.

DR KING: That would be very helpful if you can do that, yes.

MR HARRIS: I still don't quite see the quid pro quo that you're identifying here. The fact you're not on the acquiring side, and the fees are abolished, so what's - what stops you still, if as a card issuer, ensuring that the price you charge for access to that card includes whatever costs that you residually still incur after the interchange fees are abolished. What stops you doing that?

MR LAWRENCE: There's nothing stops you from doing that, and - and obviously you can and you would need to pass those costs on, but if you're a larger organisation where you're getting the benefit of the others on the other side you may not be in a position where you need to pass those cost on because then - - -

MR HARRIS: So you're saying your card issue might have to have some kind of higher charge structure inside versus a larger institution?

MR LAWRENCE: Potentially.

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MR HARRIS: Yes, good. Well, we've got them next. We'll ask them.

DR KING: You're getting a request, by the way, from the absent Commissioner to speak up.

MR HARRIS: Sorry, I'm leaning back too far. Yes, okay, well, we'll ask them their view on that as well, so that's - that's interesting. I hadn't imagined that the cost was, you know, of that nature that it was likely to be reflected in, so, actual competitive advantage for - between different card issues. Anyway, we can ask them their view too. All right, that's interchange.

What do you want to do next? Because you made some observations - because you're generally supportive of the idea of a competition champion, but you want to add the secondary competition objective that the UK has put in place as well. That secondary competition objective is - was imposed on the Bank of England in the - by its Prudential Authority in 2014, I think, or something like that, so you want both a regulatory shift which deals with micro-prudential as well as the competition champion at a micro-prudential level?

MR LAWRENCE: Yes, that's correct.

MR HARRIS: So that's pretty clear-cut. Can I just pursue - you seem to suggest that was fairly successful. I mean, and it's been put to us that the way that's been interpreted by the prudential authority in the UK is, well, any, you know, competition is all making sure the right people are paying for everything and stability is all about making sure that you've got the right people paying for anything, therefore anything that's good for stability is good for competition, so therefore it's been put to us at least that they don't pay any more than lip service about secondary objectives. I would be interested in, if you've got a different view I'd be very interested in it.

MR LAWRENCE: I mean, I don't - I don't believe that the comment is correct in terms of if it's good for stability it's good for competition. I mean, you take the macro-prudential policies that are in place and, you know, the one that we keep bringing up, which is an obvious one, is the 10 per cent cap on investment lending.

Now, if you've got a balance sheet of $500 million, 10 per cent relative to 10 per cent on a $500 billion book it is significantly different. So if you're a smaller player it doesn't take much for you to hit your cap earlier because you're talking, you know, smaller numbers.

Added to that, generally speaking our sector, investment lending only represents about 20 per cent of the book relative to the majors at 40 per cent. So again you've got another disproportionate impact on 10 per cent of 20 per cent versus 10 per cent of 40 per cent, we could do the maths on that. It's fairly simple in terms of two and four.

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So there's that - there's an additional impact, so if you've got just a small level to play with, then you're going to hit the caps pretty quickly, and therefore you're going to have to exit the market around investment lending, and when you're - our members are, a lot of them are region-based, and if they stop the investment loan, we were seeing evidence of them seeing their owner occupier lending as well because they'll go across to the major, the customer, who has greater capacity to accommodate them on that investment loan that'll be done on the basis of, yes, but bringing across your owner occupied as well.

So I mean, there's an example of understanding where, you know, I understand the nature of the policy and stability perspective that it's disproportionate when you break it down.

MR HARRIS: It wasn't so much what I was claiming about stability and competition or aligned. It's just something that has been put to us that that's how it's being interpreted in the UK.

MR LAWRENCE: Oh, right.

MR HARRIS: And you seem to have a very different view. You seem to view the secondary objective as being effective in the UK.

MR LAWRENCE: Well, I mean, APRA, as I said, we're already seeing that from APRA now in terms of any of the papers that they put out there is always a discussion upfront around competition, but the question is, is it going into the level of detail that we think is necessary, and arguably it's not. So you know, it's - by making it exclusive around an objective, we just think that there would be a heightened level of focus on it.

MR LAWLER: And if I can add, it certainly increases accountability because the reporting on that, the explicit reporting requirement on the secondary competition objective is that there's just a much higher level of accountability than there was before when there was criticism, even though there was a requirement for the regulatory to have regard to competition. They did only, you know, effectively pay lip service to that, whereas independent evaluations of the executive competition objective to date have been fairly positive.

MR HARRIS: Yes, all right. And you say the cumulative regulatory compliance burden is another advantage to major banks because they can spread it across a larger base. I guess the principle of that is pretty evident. Have you got examples of the sort of practice that we, you know, is there - has there been a recent change that would create a good example to run in this?

MR LAWRENCE: Yes, I think one that comes to mind, it's still to play out because it hasn't been implemented, but that's the BEAR, the Banking Executive Accountability Regime where the smaller banks are being given an extra 12 months. We cannot underestimate the amount of work that is required on that front, and, you know, there obviously is going to be a lot of toing and froing between the regulator and the banking

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institutions as a work towards an acceptable position on what the BEAR might look like within organisations.

We don't have to be putting resources in that initial phase, and it's probably not the best term, but you know, riding off the coat tails of the heavy lifting that the majors will do on that front when we come in in 12 months' time, and that's not to say that we shouldn't be doing work from day one, but we can certainly pick up a lot of those learnings and apply them. So that's an example of where that will - just that 12 month delay alone will reduce the cost burden for the smaller players.

MR HARRIS: All right. I think I see that, and you're supporting more finely calibrated risk-weighting which we talked quite a lot about today so this is your general view in support of that?

DR KING: Sorry, can I - a couple of things. Firstly, the APRA discussion paper is obviously, it only came out, I think, last week in that respect, but it was focussing on residential mortgages or mortgages backed by residential property. Any thoughts on the SME space in terms of those risk works?

MR LAWRENCE: Yes, look, we've had discussions with APRA on that, and there is acknowledgement that there is really no differential in that paper around, you know, secured versus unsecured SME lending, so you know, we will continue to have those dialogues with the regulator, that that is acknowledged as there is an ending differentiation on secured versus unsecured on personal loans, which moving from 100 per cent to 125 per cent, and then you can have the debate, well, you know, 125 per cent risk-weighting on a personal loan versus a credit card, and you look at the risk of a credit card default versus a personal loan default, you know, why would a personal loan be 125, where again, generally speaking across our member base, most of the personal loans are for car purposes, and there is an asset.

So all these things - it is a discussion paper, and APRA are obviously receptive and they're looking for the feedback. We need to unpack it in terms of all of the risk-weightings that have be proposed. You know, there's - under the Basel framework it talks about reliance on the cash flow from that property and what does that mean. You know, again, that's problematic because that information hasn't been captured to date, so - and again, the regulator is aware of that and so, you know, there's still a lot more to play out on that.

You know, non-standard loans, for example, non-standard loans is, you know, if you're outside of your lending policy, because that means banks loosen their policies so they don't - - -

MR HARRIS: They're not going outside - - -

MR LAWRENCE: It's not the behaviour that anyone is looking for, but, you know, potential unintended consequences of some of that, but as I said, these are the conversations

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and the regulator is certainly listening to these and everyone has the opportunity to feedback.

MR HARRIS: You mentioned the too-big-to fail premium, and I'd like your opinion on, sort of, you know, there's a range of arguments that have been put to us with regards to risk-weights and the difference between the IRB and standard risk-weight, so in no particular order, the IRB banks made large fixed investments in getting their internal risk models up and running. Of course you would expect them to have significantly lower risk-weights because it made that investment.

The pay-off from that investment is that they made a cost lowering investment that they're able to at least, in terms of the regulator weighting and from APRA they're able to show a benefit there, so if you like, that's the first one.

The second one is that, you know, there's some sort of too-big-to-fail premium that's hidden in there and somehow that raising the risk-weights, I'm never quite sure how I see that, but raising the risk-weights is somehow a compensation for this too-big-to-fail premium, and obviously also for levy which I put to one side has also been suggested, but that, I think is really a different issue.

The third one is that while the risk-weights, the IRB risk-weights have to be pushed up for stability reasons, and the fourth one is that this is just an attempt at protectionism by the small banks, the smaller non-IRB banks just want to be protected from the fact that the bigger banks invested in cost-reducing technology. They don't like the fact that they now can't compete as well against the big banks so they want the big banks' rates pushed up. They want that cost advantage reduced.

So your view on those four different arguments, because they've all been put to us quite passionately.

MR LAWRENCE: Yes.

MR HARRIS: I would be interested to know what you feel.

MR LAWRENCE: Look, I would acknowledge the level of investment that the majors have made. You know, the question comes down to, we're not saying that the risk-weights should be the same, but the debate is, should they be as wide as what they are.

And you don't have to go back too far where, you know, if you had my house as security with a major versus my house as security with one of our smaller members, the asset's the same, but the differential, as I said, not that long ago was 17 versus upwards of 45. Does that level of investment to get to IRB status justify that magnitude of the differential, bearing in mind that the capital ratios of the majors are generally lower than at the smaller players who are required to hold more capital in the first instance. So, you know, there's different issues at play there.

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So, you know, the argument is more, from my perspective I don't think the level of investment justifies the difference that we set out, and particularly when you've got recommendations from the Basel Committee and, you know, we are at the very top end of that from a risk-weighting on residential mortgages. So there's that aspect.

The too-big-to-fail, well, that's effectively implicit guarantee. I mean, we can get into the debate about charging a levy, start doing that, makes it quite explicit in terms of a guarantee, but as has been said already today, it does have an impact in terms of your cost of funds.

MR HARRIS: But to the degree that that's relevant for risk-weights or - is it at all relevant to the risk weights? Is that something that's just simply a separate part of the discussion?

MR LAWRENCE: No, I don't think you can isolate it because again, what the regulator is looking at is stability, and if you can ratchet up the amount of capital, then potentially the reliance on that guarantee down the track is going to be less. So I don't think you can isolate it. You know, they're looking at those risk-weightings, and you know, the unquestionably strong, yes, the regulator came out and said there's an extra 150 basis points on majors and extra 50 basis points on the smaller.

What the regulator is actually endeavouring to do with this capital framework paper is to look at that in terms of, well, you know, could it possibly, with the changes and the lowering of the less risky assets, become a net-net situation where it's actually no change.

MR HARRIS: Okay, and what would you say to the final figure that I mentioned which has been put to us that the attempt to even the risk-weights, at least raise the IRB risk-weights closer to the standardised rates is just, you know, what you'd expert in terms of protection for the smaller banks that's anti-competitive?

MR LAWRENCE: No, so lower the - lower the risk weighting for the smaller banks. I mean, you'd look at it different ways, and that would then definitely be passed on to the consumer, but again, you know, we have to be mindful that the regulators, and certainly APRA, their primary objective is stability, so for us it comes back to that differential, and our view is that it is just too wide.

DR KING: But you've seen from our report that certainly in some areas there are reasonable examples of how risk-weights could be brought down, and I ask you, I think you were here earlier when I, I guess one of the most interesting aspects of our report is, for us anyway, was the limited number of people who were actually arguing for reduced risk weights.

Almost everybody had an opinion, and dating back to the Murray Inquiry, in favour of higher risk-weights regardless of the supposed effectiveness of this very large investment in modelling, and as you've just noted there are two choices, I guess, but the inclination appears almost by default to be if the gap is, in judgment terms too wide, we'll just lift less expensive risk-weight closer to the more expensive one, and as I noted in the end that means

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the customer pays, leaving aside the levy and its claim as to whether the customer will ever pay for that. It's a limited risk-weight shift the customer's going to pay because - unless you expect shareholders to take it and generally speaking, as you can see from the theme of report we'd say, no, shareholders appear to have it over customers most of the time.

MR LAWRENCE: Yes, look, we would certainly advocate for lower risk-weightings, and it goes back to the point I made around where the Basel Committee sits in terms of range, and we are at the top end of that range, so you know, the regulator could potentially look at, well, do we move more back towards the mid, which is effectively a lowering of the risk-weights.

MR HARRIS: Yes. Anyway, we would be interested in more contributions on this question about where else could risk-weights shift besides the two that we've indicated in different loan evaluation ratios for, I think for owner-occupying housing or for some versions of housing, but anyway, different loan evaluation ratios, so some differentiation there, and some change to small to medium enterprise lending and the nature of the assets placed at risk by that business owner in support that lending.

Both those areas look like they're prospective by comparison with overseas experience. If there is more, we'd be interested in knowing towards that end because, you know, it can only be a positive contribution if it gives people competing, even if it's fairly weak competition, nevertheless competing in a market a chance to differentiate their product and appeal a little bit more to a class of consumer.

MR LAWRENCE: Yes, and we potentially will be able to feed more back into the Commission on that front as we and our members individually look at the impacts of the capital framework paper, and obviously we're out there seeking feedback from our members as to what that specifically means to them because I mean, not all our members, for example, do SME lending.

MR HARRIS: No.

MR LAWRENCE: But there are quite a number who do and they will have views on that, and as we obtain that information we'll be able to consolidate and bring something back to you.

MR HARRIS: Okay, that will be worth doing. Do you have anything more yet?

DR KING: Just one tiny thing. You haven't raised it so far, but obviously your members, with, I would assume, a substantial number of your members would be reliant on brokers as a channel to the market. Any comments to make on the degree of aggregation there, the fact that we have seen a large amount of integration, not by your members but by the major banks into the broking space which must have an effect on your members' ability to access the market. Any thoughts on that?

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MR LAWRENCE: Look, we, as an association, have spent a lot of time on that. I mean, clearly some of - a number of our members do use brokers. You know, I think that what the Commission's paper is showing around greater levels of disclosure I think is a very important thing, because at the end of the day it then comes back to, you know, the consumer and them being able to make decisions, eyes wide open, with all the information and the facts in front of them, and, you know, some of this information around where the aggregators, where the ownership sits, I think they should be disclosed.

MR LAWLER: We've participated in the combined industry for lenders and the broking industry to respond to the ASIC report which looked at issues like that, and we certainly have supported the decisions to increase transparency so consumers know who owns who, and who we're dealing with.

MR HARRIS: Okay. Yes, done? Other final comments that you guys would like to make or - - -

MR LAWRENCE: No, all good, and appreciate the opportunity.

DR KING: Thank you.

MR HARRIS: Thank you for your contribution to this inquiry and to - are you going to put in a subsequent submission or is this - - -

MR LAWRENCE: Yes, we will.'

MR HARRIS: Okay, and I've asked them for that too. Okay, now, we're running a little early which is always desirable in these things.

DR KING: I don't know if the next people are here.

MR HARRIS: Commonwealth Bank present? Excellent, they're ready to go. All right, we'll do the swap. There's obviously organising going on here logistically.

So I'll stick with our normal process and just ask, once you gentlemen have settled, if you could identify yourselves for the record.

MR JESUDASON: My name's Rob Jesudason. I'm the Chief Financial Officer of Commonwealth Bank, and this is Angus Sullivan, the EGM responsible for retail banking.

MR HARRIS: Do you want to make some opening remarks of some kind?

MR JESUDASON: If I could, absolutely.

Well, firstly, thank you for the opportunity to discuss your report and share our views. We recognise that any point in the economic cycle, there will be opportunity for regulatory

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change, and we support balanced regulatory change that increases competition and encourages innovation.

We are supportive of many of the recommendations of the financial system inquiry which led to many reforms, and we look forward to seeing how these improvements play out. We also support the majority of the Productivity Communication's draft recommendations.

We believe a highly competitive banking system that balances system stability, prudential supervision and customer protection through the cycle is good for customers. We are fortunate in Australia that we are one of the most stable banking systems in the world. It is also highly innovative and competitive and customers have high degrees of choice. They also receive high degrees of service. You can see this in the fact that customer satisfaction has improved over 80 per cent for the major banks and also there's a decreasing trend of dissatisfaction which sits at roughly 5 per cent today.

Our primary goal as an organisation is to secure and enhance he financial wellbeing of people, businesses and communities. This guides us to be highly customer-centric. However, it's important that we get the balance right between delivering a highly competitive value proposition to customers, and ensure fiscal responsible management of Australia's largest financial institution.

In the last five years we've invested over $6 billion in improving the Commonwealth Bank franchise. Our scale and profitability enables that investment. We believe that Australia's regulatory framework is superior to most mature markets. We supported the clear division of accountability between the Reserve Bank, APRA and ASIC. It ensures a system that's stable, good with strong prudential supervision and also strong customer protection.

We also support the role of the Council of Financial Regulators to balance these objectives. It ensures Australia's economic prosperity and the financial wellbeing of customers. This system has worked. It has contributed greatly to the prosperity of the country and it's also been recognised externally.

In November the CEO of Standard and Poor's said that the regulations governing Australia's banks are amongst the strongest in the world. Therefore, it's important that a discussion around competition must not lose sight of two fundamental characteristics of the market. Firstly, the nation's economic prosperity relies on access to global funding markets. This has been achieved through stable banks with sufficient scale to fund the economy.

We saw through the global financial crisis that funding markets can be highly volatile. The strength of our system enabled the major banks during this period to continue to extend credit, both to individuals and businesses. This is an important consideration for Australia because the concentration of the banks to facilitating private sector growth is much higher in this economy than other mature markets.

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To put this into perspective, the major banks alone raised almost $100 billion of long-term, wholesale funding and offshore markets last year. During this period, CBA raised $27 billion in long-term offshore wholesale funding. We also renewed $32 billion of offshore wholesale funding in terms of short-term debt. This was renewed very month. The ability to access offshore markets to scale was critical to enable CBA to provide $135 billion of new lending to Australian customers.

The second consideration is that Australia has enjoyed over 26 years of uninterrupted economic growth. This is globally unprecedented. Given the pro-cyclical nature of banking it has naturally led to strong performance of Australian banks. It should not be ignored that the profits of major banks have in turn benefitted the wider community. Approximately 75 to 80 per cent of profits are returned to shareholders as dividends and the major banks are amongst the nation's largest taxpayers.

However, at some point in the future Australia will experience a recession. When this happens Australia's regulatory settings must ensure that the financial system has the strength and the stability to absorb losses. The global financial crisis gave us clear evidence of how banking systems with regulatory settings not attuned to macro-economic downturns can ultimately fail to protect customers.

Governments in the UK, US and Europe were required to bail out major banks, or in some cases let them fail. This is in contrast to Australia. Our major banks were not only able to help the economy, but also to continue to extend credit to consumers and businesses. There were also no bank failures.

On this basis, we support most of the Commission's recommendations. However, we encourage caution with regard to three matters. Firstly, the proposal to abolish interchange fees. The payment system is critical infrastructure for the country. Investment is necessary to provide security, stability and continuous innovation. There have been successive reforms that have aimed to optimise interchange. Australia's interchange fees are low by global standards. In our opinion, there should be no further changes in these regulations until the RBA has had the opportunity to evaluate the effects of the most recent reforms introduced last year.

Secondly, the proposal for APRA to develop an on-line tool to report median interest rates on housing loans. Our concern is that this is likely to have a number of significant, unintended consequences. Mortgage pricing is determined by a number of factors. These include a risk assessment of individual customers and external factors such as wholesale funding costs. Publishing historical median interest rates without the relevant personal context could mislead customers.

Lastly, the proposal related to mortgage aggregators and brokers. We support any recommendation that aims to protect customer and put their interests first. Our objection is the recommendation as currently expressed would only apply to aggregators owned by lenders. We support equal treatment of all brokers and aggregators. We look forward to

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discussing these topics further today. We will also respond in greater detail to all recommendations and findings in our written submission.

As I said, we are broadly supportive of the draft recommendations, subject to thoughtful consideration as to how they will be implemented. We look forward to working constructively with the Commission, the Government and our regulators to address important design considerations and improve competition and help maintain the strength of the Australian financial system.

Thank you.

MR HARRIS: Thanks, Rob. Okay. Just on the broader question, the way you presented the essential nature of having a system, a banking system in Australia that sources of offshore finance have a high level of confidence to ensure that we get access to money in Australia. I don't think anybody has tried to dispute that. In fact, the core issue for us is not whether we have maintained such a system. I think the general perspective is that we have and different parties have different claims to credit for this and the Government itself thinks the only party that didn't actually get a mention in your presentation. It probably would say it did something as well.

So I'd say, yes, everybody managed the circumstances quite well, but I don't know whether you had a chance to look at yesterday's transcripts, but we had a little bit of a debate yesterday at one point as to whether, or why it is that the UK, which certainly had a worse global financial crisis than we did, nevertheless has recognised some three years ago now that it had gone too far in generating a sole focus on stability and introduced a secondary competition objective for its prudential supervision entity within the Bank of England.

Now, we haven't done that, although we did get a proposition today that literally we should adopt that secondary objective, we haven't gone that far in our draft report, but I'm going to ask you to go on the record here and say whether or why it is, as I was trying to ask, I think it was Westpac yesterday, but it might have been somebody else, what it is then that UK, which has a worse GFC than we did, and with general levels of congratulation all round about how conservative we were before the GFC as a big contributor to this and we've seen former Governors of the Reserve Bank say just that, we've nevertheless really, really gone in hard on this unquestionably strong issue.

So why have the UK decided to do some rebalancing back in favour of competition and not us?

MR JESUDASON: So I'll make two or three points. I think firstly before I get to the UK, if I make a couple of comments about their system, in 2007 the Commonwealth Bank had an equity tier ratio of 4.5 per cent, and the banking system did perform well during the global financial crisis, but today we sit at 10.4, 10.5 per cent, and there's no doubt that the system today is stronger than it was even before the GFC.

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What Australia didn't experience during the GFC is actually a recession in the country, so we saw the impact of volatility in global funding markets which did impact all banks but was particularly acute to smaller institutions that didn't have scale, and so we're very supportive of some of the changes that APRA and the RBA have made over the last ten years because for all countries, all regulators and all financial institutions, there were some big lessons to learn from 2008/2009.

Moving to UK, I had the fortune, or misfortune to have worked in the UK banking system, particularly in the late 90s, and actually some of the changes that you have mentioned might be emerging now were actually implemented then, and the UK moved very much away from a four-pillar banking system to very strong competition, and many of those institutions that drove that competition were smaller banks, Northern Bradford & Bingley, HBOS was a stand-alone bank, and what happened is, in the short-term credit was extended, and credit became cheaper, but over the medium term many of those institutions failed and the solution was either larger banks to rescue them or the government in many cases to rescue those institutions.

And that, you know, I don't think there's much debate that that has placed a huge burden on the national finances, and on consumers, and one of the big issues that came out post even the rescuing of the banking industry is when you've got unprofitable banks with broken business models, even after the Government bails them out, their extension of credit decreases, right? And you would have seen lots of debates in the UK around why aren't banks lending, particularly to the SME sector. So that becomes a real issue, and this dynamic of strong countries and strong financial systems, and banks with scale, I think, is a really critical dynamic in a successful functioning economy.

Part of that, as it relates to wholesale funding, is particularly when you fund significant parts of the banking system offshore, one of the things that offshore investors look at is, are these businesses economically viable? Are they profitable? Do they have sufficient returns to make this an attractive investment? Because at the end of the day when I, in my current role as CFO, travel around the world and meet investors, including debt investors, they are benchmarking buying our debt or any Australian bank's debt, against a range of other global opportunities, and so profitability scale and the regulatory environment are the ingredients that go into their decision-making.

MR HARRIS: Yes, no, I think we are all on utterly common ground there, but in summary it says the UK have a shocker, we didn't, but they post the GFC have gone, "Gee, even though we've had a shocker, we really have to lift our standards towards", I'll just use our terminology, unquestionably strong, "Ah, but then now we might have gone slightly too far and now we're going to have a secondary objective for the Prudential Supervision Regulator in favour of competition which was, in their own terms, a review of the same kind of functionality that APRA is asked to do; that is, have regard to competition was replaced by a secondary objective is competition.

So we actually have that same terminology, "have regard to", so I'm still left with this question, why are we like this, and the only halfway decent answer is, we're more

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dependent than they are on foreign parties, but as you pointed out yourself, SMP is out there, you know, saying, "We are fantastically strong here", so for us it just contributes to this overall impression of other parties appear to be doing some rebalancing that might be, you know, reasonable parallels for us.

Shouldn't we be at least considering competition more than we are, and we then say, and we have some evidence that shows that, you know, pricing, we agree with you on services, but pricing has moved in a direction which says, for example, you know, that the gap between official cash rates and market rates has roughly doubled since the GFC in some key products, and you say, well, that's a notable move, and perhaps competition isn't as strong as it ought to be.

So we ask the question, and we're asking it more of the regulatory structure because our view is, it substantially drives the ability to be competitive in the marketplace which we've been discussing most of this inquiry, risk-weightings, things like that..

MR JESUDASON: So maybe I could respond.

MR HARRIS: Still interested in this direction question?

MR JESUDASON: Well, the first point I would make, and I should have made it in my previous answer, this is a highly competitive market, and I'll give you a couple of examples of this.

Firstly, if you look at the major banks across some of the key products, including Commonwealth Bank, we have been losing share, so as you think about, if you take home lending, demand by consumers for housing, and therefore home loans, has been extremely strong, to the point that APRA had to bring in some speed bumps which we were very supportive of, and you're quite right, price was adjusted. Price was adjusted as a mechanism of meeting a regulatory hurdle to match supply and demand.

But as a result of matching and manage the objective we needed to reach, which is to be below 30 per cent of interest only mortgages on flow, we lost share, so the market is efficient because you're quite right, price is one of the factors in the marketplace and every organisation takes a view on where they price, but that has a direct correlation to your market share performance.

The second point I'd say is, if you look at the broader banking environment, the gap between the ROEs of the big banks and the small banks have narrowed. It was 9 per cent and today it's 3 per cent, and again, you can see a dynamic over the last 12 months where the major banks lost share in home lending. The regional banks grew and the non-banks grew even faster.

So actually, rather than fewer and fewer competitors, the number of competitors is increasing, and you see that not just in that product, but in credit cards in a number of products, in payments across the financial system, and the point we would make quite

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strongly is, competition is alive and kicking. What we want to balance, and we come into the market every day having invested in the franchise to meet that competition, our organisational response is to invest in technology, is to invest in the customer experience.

And you can see that translate into high satisfaction levels, but this is an industry where the solution to the competition has been high degrees of investment by the banks, and the customer experience benchmarks extremely well in Australia versus global, you know, global - other offerings around the world, yes. Yes.

MR HARRIS: We have a comment on a draft report but I'll be diverting to go into it so I won't go into that.

DR KING: Well, I wanted to actually follow up to some - on that, yes. Where is the nexus of competition? If you take - you've got the Big Four and I want to come to four pillars in a second. You've got the Big Four, and you then have five through to whatever, and you add them all up and they don't come anywhere near the Commonwealth Bank in terms of size. So it's essentially fallen, you know, so are you saying that it's just, you know, effectively is competition just between the four?

MR JESUDASON: I'm not saying that. I might hand to Angus who can - who, you know, leads our branch distribution business and he can give you a few examples of how competition plays out in retail products.

MR SULLIVAN: Thanks, Rob. Yes, maybe to build on Rob's remarks, I think even as recent as early this week in their financial review, there was material coverage of the pricing behaviour of second and smaller tier players in the interest only segment of the market quite aggressively pricing that, and it's having a material impact on our business at the moment.

So it's certainly not the case that we operate in an environment where we singularly focus on the other three large banks in the credit card market which has been the subject of a lot of discussion is in excess of 30 providers of credit cards in the market. There are some very successful second tier players. Qantas are making a big push into that space as well at the moment with their own proprietorially branded offer now that they've decided to go with on their own.

So I think, you know, from our perspective this is a market with a number of examples of competition at the manufacturing level. In addition at the distribution level, obviously the existence of mortgage brokers gives a range of additional competitive pressures in the provision of mortgage products to customers, and as you mention in part of your recommendations as well, there are a range of on-line provides for all types of different products, savings products - on-line comparison sites for savings products, credit cards, mortgage rates. They're prevalent, Mozo, iSelect, RateCity, Canstar, are all providing opportunities for price discovery and comparison.

DR KING: And then we can get into more particulars, I think brokers were raised here, but just on that - - -

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MR HARRIS: And whether comparison websites are an ideal tool - - -

DR KING: - - - as we said in the draft report, we're not saying competition doesn't exist or is neutered everywhere, and there are some competitive areas and you mentioned the credit card issue which I think is one of the areas we say in the draft report is at currently derived by competition, but when you start getting into the core business which is the lending business, in particular the residential lending business, we don't see the effects of this competition from outside the Big Four.

We don't see that reflected in market share. We don't see it reflected in your return on equity. We don't see it reflected in your interest margin. It's all very well to say that, "Well, we're doing stuff", but that's fine, they don't actually seem to have an effect on the Big Four banks, and in what sense is that useful competition?

MR JESUDASON: I think we've got to take a step back and - market share does not necessarily, or translate to a lack of competition because I the retail bank we have a business with 12,000 people, 11 and a half thousand people who come into work to try and run that business successfully for the long-term benefit of customers, and run a good, growing business, and we, you know, as I mentioned, we invest billions of dollars in the customer experience, not just in technology, but we've added more lenders.

And so even with all of that, you would see in the last 12 months we've lost a bit of share and we've lost a bit of share because it's really competitive. But these are businesses that don't stand still, and to actually compete in the marketplace, which is very competitive, you've got to invest and you need good people at the top of their game, but even with that it's - you've got a lot of people trying to take share.

MR SULLIVAN: I might, if I may, can I forward on to your question on the core products? From my perspective, both our deposits and the home lending portfolios are critically core to the operations of the group. I noted in watching last night the representative of Westpac making a similar point around deposit margins at the moment and their relative - their relativity of pricing to a cash rate, which over the past eight years has moved substantially from below to quite materially above the cash rate, which I think is evidence of very aggressive competition.

DR KING: Remember that APRA post-GFC put a great deal of emphasis on the banks moving to domestic funding between deposits and you'll see the spike in deposit rates, so I mean, the suggestion that that's due to competition rather than regulatory intervention, I think, is a disputable proposition, if I can put it that way.

MR SULLIVAN: Possibly, but the end result of the intervention from regulators was that there was significant competition in the marketplace over the last, I think the data here, seven or eight years which meant that margins in that particular part of the portfolio and across the industry came under pressure. Similarly on the mortgage side, as Rob said, there

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are a range of factors that have contributed to the recent margin, which I know is an observation in your draft report as well.

Our strong impression is, when looking across the range of different competitors in the marketplace, the range of products, the range of different providers, and the proportion of business that's originated through broker channels in particular, there's many indicators that it's a highly competitive marketplace.

MR HARRIS: Yes, I guess our proposition's a little less. I mean, Rob, you've mentioned the last 12 months and shifts in market share, you know, and periods even going back to eight years ago, which is squarely in the GFC period and therefore, whereas you notice in the report we did a 20-year analysis and we definitely tried to characterise what had happened, and we can see competitiveness show up in those two key metrics, the difference between the official cash rate and the home lending rate and the difference between official cash rates and the deposits, the rate available to depositors.

And on those kind of trends we can see the periods of serious competition and then long periods with limit apparent movement in that, and we added to it the overall conclusion which said, and notwithstanding that the larger banks, even with two very large shocks, first the freezing up of markets in the GFC, and then secondly, the unpredictably rapid fall in the official cash rates, still managed to maintain what are called quite a stable business that I'm sure it was the duck on the surface, you know, paddling like crazy underneath to keep it, but our proposition therefore isn't, you know, year to year or even back a couple of years.

Our proposition is, are we seeing, particularly today a highly competitive marketplace. We would say there are challenges for everybody running businesses without a doubt, but it does not look highly competitive, and so those - the ability to maintain relatively advantageous positions, or at least stable, that's when market share comes in, at least relatively market shares, suggest that we're having - we're in a circumstance of less competition, but our proposition hasn't been and isn't it dreadful you're running profits, which we debated yesterday was Westpac and have to look at that again, but it wasn't at our volition, it hasn't been that at all. It has been what can be done to encourage greater levels of competitiveness.

And to that extent we look at the activity that's created by regulatory intervention because the capacity to compete is substantially influenced by that, not an evil thing either, just is what it is, and the question is, what more can we do about it?

So I'm still interested in the fact, this was done twice now, I'm just going to mention it for the third time, I mean, here's the UK's benchmark. They had a shocker, we didn't, and yet they've decided that they need more competitiveness and we haven't go there yet, apparently. Anyway, we'll see. We'll see.

I did want to ask you about this caution that you expressly needed to do about our on-line median rates and the possibility of consumers being misled, and it's an interesting

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proposition where it says, I can tell you what everybody around the country paid in the market you're interested in who had your income last month, and get misled.

Now, I can see people perhaps foolishly convincing themselves that they were in a particular category and they weren't in that category and therefore making life difficult for a broker or a branch loans officer educating them that they weren't but I can't see how anybody can be misled by a simple statement of reality. So can you expand it more on the deception that comes from actually knowing the real price last month?

MR SULLIVAN: Yes, happy to. Maybe by way of introduction, you know, I think we're of a similar mind that we support the provision of quality information to customers. We see that as an important ingredient in ensuring that there's a competitive market where customers understand well the products that they're buying.

Maybe a couple of thoughts around why we get to the conclusion that there's a risk of untended consequences by the way that I've described them. Firstly, this is a very, very crowded and complex marketplace. I did have a quick search last night and came up with no fewer than ten on-line rate comparison websites. So it's certainly not a marketplace where customers are devoice of, let's call it data as opposed to genuine insider information as opposed to insight.

Hundreds of products, probably thousands, and the pattern of behaviour that we tend to observe is that 99 per cent plus of Australians decide that they want to go and see a person to help them make sense of that barrage of information, quite overwhelming at times, I think especially when you put yourself in the shoes of a first home buyer, someone who's never been through this before. Being supported with guidance through that process is very, very helpful to them.

Specifically with regard to it and I'll come to where I think their opportunity is in the marketplace, with the provision of the median price there are two concerns from our perspective. One is obviously the price-setting process in mortgages is deeply connected to risk, and there will be an incentive undoubtedly for lenders within any sub-category of products to risk select away from the poorest risks towards the best risks within any box of the matrix so their price presentation appears more favourable to customers, despite the fact that once they get into the fullness of a process and all the particulars of their circumstances are considered that may not be an appropriate or accurate price for them.

Back to my consideration beforehand of the reality that 99 per cent plus of people end up seeing another person, the range of comparison sites that exists today, they present by and large the best or lowest rate that a customer could expect to receive. So if you go into these sites the rates, there is not the median.

MR HARRIS: No.

MR SULLIVAN: It's much closer to the best possible rate available, and so I put it that the motivator for customers to compare where they are today, relative to that information,

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is already materially greater than the motivator that would exist if one was comparing one's rate today with the median because inevitably mathematically you're going to end up with half of the people look at that rate and say, "Well, that's higher than my rate. There's no need for me to have a discussion with anyone", when perhaps there may well be some segments of that people of customers who would benefit from a discussion and would reveal a lower rate at the end of it.

I think finally maybe just, you know, I think our lenders, many of whom work for me and do a great job, and the brokers that serve our customers, they do a great job of providing customers with that transparency today. Once they get into the detail that's required to properly understand the right product for them, that process of understanding price comparison is one that I would suggest all of the brokers, and I know for us all of our lenders, have that discussion front of mind with customers to ensure that they can talk to the customer and describe to them why the rate that they're getting is a great rate for them.

MR HARRIS: Sure. Sure, can I go back to the second-last point though.

MR SULLIVAN: Sure.

MR HARRIS: So in fact it sounds to me like you've just offered us some support for the idea because you're saying that comparison websites were offering people like an unnaturally rosy view of their capacity by being the very best, whereas the median won't do that. The median will be the median. It will be last month's median, your income for a house in the western suburbs of Sydney. You know? So aren't we actually helping those people not have an unnaturally rosy perspective, you know, versus our comparison website, and we've written on comparison websites more than once before, so we have some, you know, experience in this area. We did it in data last year as well as the inquiry so - - -

DR KING: I think the position would be that, given the range of data, information that's available today which provides more than ample opportunity for customers to provide a point of comparison that motivates the next step, so given that range of data that motivates the next step, and given the 16,000-odd brokers that exist in the marketplace and the 5,000-odd proprietary lenders who are delighted to help a customer understand the best rate available for them, I think our view is that, given the risks of potential misrepresentation with the median, the risk selection issues that could become apparent from it and the unintended consequence around lender behaviour, I think there's relatively modest upside from that additional set of information into that quite complex landscape that exists today.

MR HARRIS: Okay, just one other question before I let Stephen loose on brokers. A number of the smaller banking institutions have said to us, you know, they're not very comfortable with this idea as well, but they characterise it as an advantage to you, and clearly you don't see it as an advantage otherwise you would be in here today saying you actually love this idea and it's of advantage to us, and I'm a little intrigued as to your - well, can you give me your reaction to that?

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I don't want to over-interpret the reasons why it might be in the smaller institutes an advantage to you, but I think possibly the best simple argument I could put forward is, you've got more branches than they do. If this is an encouragement to consumers to bypass brokers because they now feel well informed and go into branches, you'll be an unnatural beneficiary of this. Now, I'm not sure that - delete the word "unnatural". You'll be a beneficiary of this. So what's your reaction to that?

MR SULLIVAN: As simple as I think at the end of all that discussion it's going to be the consumer making a choice about how they want to interact with the e-Bank, history over the past 20 years has indicated an increasing trend and moderation recently towards customers seeking out brokers, I'd be surprised if the provision of any single tool on-line materially shifted customers' behaviours between brokers and proprietary channels.

MR HARRIS: I tended to that view, I did a speech on Monday and there's a half a page effectively on just that, and I don't think it was our expectation that simply by having a more accurate view of what last month's price and profile was in the area that they were interested in, people would avoid going to a broker because of this complexity that is associated necessarily with something like that alone, but nevertheless we plan to consider this further because it's a point we made earlier, but anyway, I'm going to drop off that and ask Stephen does he want to ask anything about brokers.

DR KING: Yes, so thank you for your support, although you feel we haven't gone far enough.

MR HARRIS: Your cautious recommendation.

DR KING: We applied any recommendation about an obligation to the customer to be brokers and aggregators associated with a lender for the simple reason that that's where the obvious conflict arises, so CBA, as I understand with Aussie, for example, and explicitly or implicitly, and I won't ask about that, but the numbers show that CBA product are over-represented compared to the market in Aussie product. I think it's something like 37 per cent versus 21 per cent of mortgages in the data that we had available.

More general, just common sense says that if you're a broker or an aggregator working for a Commonwealth Bank owned body, you're going to feel some obligation, loyalty or perhaps explicit pressure to write more Commonwealth Bank product. So that's why we focussed in on those aggregators. I would be interested in your response to that, and also, depending on that, why you feel that the non-owned aggregator, non-lender owned aggregators should have an additional duty.

MR SULLIVAN: Sure, happy to. So maybe I'll turn first to the question of Aussie specifically for you and our relationship with them and I could come back to the core issue of applicability across the marketplace. Our acquisition of Aussie was motivated by the opportunity to acquire a high quality franchise, one that was very highly regarded by Australians and one that spoke to a segment of customers to whom the Commonwealth Bank brand doesn't. Candidly, we saw it as additive to us.

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Our business through Aussie, I think it's very important to separate into two quite materially different categories of loans that originated through the Aussie platform. There are loans that are branded CBA or Bankwest, for example, what an average consumer would think of as a CBA group branded product.

Over the past number of years I think introduced about three or four years ago, Aussie launched their own Aussie-branded mortgage product. Funnily enough that was actually how Aussie started out for, sort of, remember the days way back when - - -

DR KING: When they were securitised.

MR SULLIVAN: Exactly, when John Simmonds started it and - - -

MR HARRIS: I remember the ad. I remember nothing else, but yes, it's still in my - - -

MR SULLIVAN: So you know, John was very keen to rebuild that part of the business. I think he had a great affinity for it after the business starting that way, and so we provided to them effectively, think of it like a wholesale facility that provides the funding for an Aussie-branded product. If you look at just the CBA - - -

DR KING: But just to clarify - - -

MR SULLIVAN: Sure.

DR KING: - - - for my own point of view, those mortgages now aren't securitised. They remain on CBA books, don't they?

MR SULLIVAN: Correct, yes.

MR JESUDASON: Yes.

DR KING: So that's a significant difference from the original model.

MR SULLIVAN: Correct, and happy to talk to the position of the Aussie-branded product as well because it's a - so the CBA-branded products are our share, so CBA and Bankwest together runs at roughly 16 per cent, just slightly below the average share that we received from the top ten hit groups.

So there is - I accept there's the potential for the perception of a conflict of interest, but we've run that business very deliberately quite independently from the CBA Group to ensure that the brand and the trust that customers place in the Aussie franchise is maintained through our ownership of it. We saw that as absolutely critical to the value of the franchise, and we've been obviously delighted to be able to work with Jai and the team at Aussie to provide their support their aspirations to grow the business in a slightly different way.

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So I understand, exactly to your question, I understand the potential to see it that way. In fact, it is not that way. That isn't how we've run the Aussie business and it's not how we've run the Aussie business and it's not how we've overseen and governed it.

Back to the broader issue of our interests around why apply this standard across the entire industry, yes, I think that's as simple as, we're enormous supports of, as we've down with the recent changes around accreditation of broker space, we're supporters of growing the standards of the industry as a whole, and for the broker segment in particular, and the best interest duty that you outlined. We see that as a positive development. If it was applied consistently across the industry, I think it would be peculiar for consumers to have one standard with one set of brokers where they could be assured that the broker is acting in their best interests and they'd go to another broker around the corner and there would be a different standard applied. I think that would be highly counter-intuitive to your average consumer.

DR KING: A couple of follow-ups on that. The first one, do you think most Aussie home loan, they talk about three directions …(indistinct)…, cut me off, do you think most Aussie home loan in customers who are buying the Aussie home loan product would know that that is actually a CBA product? It is a rebranded CBA product?

MR SULLIVAN: I'm not sure candidly. What I do for a fact is our ownership of Aussie is fully disclosed on the website and in the materials.

DR KING: You'd be happy, though, for the customers to know the - - -

MR SULLIVAN: This is agnostic. You know, we're very proud of our affiliation with Aussie, but we also see the importance of maintaining that as an independent brand. The - - -

MR HARRIS: The marketing people would be very unhappy with you subsuming one brand inside another when they've paid quite a lot for the brand, I assume. I assume.

DR KING: Second direction, given your investment in Aussie, and I'm not sure if this is something that is relevant, but I'm interested. One of our other main directions that we're exploring from the draft report on brokers is, having wealth advisers able to more readily offer credit advice, and operate more in that space, I'd be interested to know your feedback on that. I know Commonwealth has its wealth advice area as well as its broking, but I'd be very interested to know by the way how many of your wealth advisers also have a credit licence because that's something that - - -

MR HARRIS: It seems to be very hard for us to get numbers on, but your view on that. Do you feel that's appropriate?

DR KING: So happy to, if we can, we'll take on notice the exact number and try and come back to you with something that would be helpful.

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MR SULLIVAN: Maybe two thoughts on the planners into the credit space. If I recollect correctly from the discussion I watched yesterday, I think some of that was pointed at, might there be more forward-looking commission-based or, you know, fee for service type of models that the financial planning industry could bring to the table by being involved in the distribution of mortgages.

So, two comments. One, you know, with 16,000 brokers out in the marketplace, certainly not in a position where I think we need more people to serve Australians well and meeting their mortgage needs in terms of broker comparison.

So for me it's certainly not a quantity issue. I don't think that the industry is short brokers and I don't think a move to bring planners into the credit space, given the important role that they play and their special set of skills, I think that's not necessary. More directly to your observations or thoughts from yesterday, I guess, on the might there be more forward-looking models, obviously the ASIC and ADA work under Sedgwick have outlined the serious recommendations around what forward-looking models might look like for the brokerage industry.

I think we've come out quite explicitly saying that we've supported both of those reviews and we'd be supportive of the industry moving forward if there's a better model that we could support in a prudent and proper way executed over time.

MR HARRIS: So other businesses, of course, in Australia have got out of paying trailing commissions substantially, insurance, for example, and overseas, we know that brokers do exist. This doesn't. This particular proposition. WE have that from - ING told us a bit about how broking works in continental Europe and others have told us how it works in the UK, and Rob, you've obviously been there, so - and I say, this is uniquely Australian, but it doesn't suggest that the world will collapse if this proposition isn't there and the question is, what incentive structures would be preferable to this kind of incentive structure from our perspective.

We haven't got a recommendation on this, but it's an area where we're interested in finding out a bit more, and there's a reason why we haven't. We just don't think we had enough to have an opinion absolutely on it, which is sort of why we're running the argument as publicly as we can now. Let's get some more response on this. It's not something that we would expect necessarily occurs to everybody, but this transparency of the whole commission structure equally deserves a little bit more exposure, but it's the incentives that we're primarily interested in, I think, by way of public comment.

DR KING: I just want to pick up on one thing there.

MR SULLIVAN: Yes.

DR KING: On that separation, so, yes, I don't think there is a shortage of mortgage brokers, but from the customer perspective, you know, isn't it a bit odd when you go and see a wealth adviser that that wealth adviser in a sense isn't able to offer advice about -

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effective advice and loan advice, credit advice about what, for most Australians, is their biggest asset, and it does seem to me, and maybe this is naivety on my part, it just seems to me to be bizarre that we don't have those two key elements, you know, wealth for most Australians is housing.

MR SULLIVAN: Look, very practically, and I can comment obviously in more detail and with regards to CBA and I think across the industry there might be others who have a deeper view than I do. You know, in our branch network, our planners and our lenders, our mortgage lenders sit side-by-side in offices in the same building, in the same branch, so the distinction between the two roles, you know, it's a - you know, I sit here, Rob sits there. I'm the planner, he's the lender. We work very closely together because customers often have the need for that type of financial planning advice concurrently with when they're taking out a home loan. They might want to think about protection or a time of planning down the path.

You know, one of the other reasons that I think it bears real consideration, I just know very practically and in my experience running the branch network, there's a real limitation given specially the complexity of process and regulation for our people of how much you can get across any one person, and as you all appreciate, the financial planning landscape in terms of regulations, vote for reforms, et cetera and the obligations upon planners are very - they're heavy, and they're complex, and the obligations upon our lenders are also quite complex. It would be quite hard, in my practical experience, to find an individual who would be able to easily get across both of those domains.

MR HARRIS: But people, surely in a competitive market where choice rules, should be allow to try. That's - we see this is a competition initiative. I mean, it's competition in the service provider space, and because we've asked the regulators and no one is yet to come up with a good reason why it is as it is. It just has been as it is, although we're still going to investigate that further, but as competition initiative perhaps it will be complex and difficult and not too many people will try, but the fact that we're proposing to put professionally trained wealth manager into a sphere where professional training is less emphasised, or professional qualifications as we heard from FINSIA earlier, is less emphasised, suggests to me that we're certainly not adding to risk here for the consumer. We might be offering them something better.

MR SULLIVAN: I don't have a particularly strong view one way or the other. I suggest that if the Commission's concern is around the quality of the brokers, there are probably more direct ways to go at the quality of brokers. We've obviously made a big investment in that accreditation in ensuring that all of the brokers we work with meet the right professional standards, and - - -

MR HARRIS: yes, well, there's price as well, just before we leave this, not just professional standards. You might have noticed in the report, but we find it hard to get information, so I would really appreciate if you've got any better information on this but it appears that a wealth adviser for about - placing about the same amount of money as the average mortgage, and we know that the average mortgage is a nationwide number, so in

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Sydney it sounds like a meaninglessly low amount, but not elsewhere, or not in many places elsewhere, but for the $300,000-odd that the average mortgage is, it appears that you can get wealth management advice for a factor significantly lower than the upfront charge by a broker to place a borrower in a home loan. So we'd say perhaps there's a capacity for price competition here because the wealth adviser is obviously used to getting paid somewhat less for placing $300,000.

Now, again, I don't know whether that's literally true, but I'd appreciate any data that the Commonwealth Bank might be able to offer on just that kind of price comparison, but we saw it as being - here's another way of just looking at competition. Anyway, we've probably pushed that tremendously hard. Did you want to run any other issues?

DR KING: There's a couple of quick ones that I do want to - - -

MR HARRIS: Well, you mentioned one that I'd rather you didn't.

DR KING: A couple of quick ones. We're running out of time.

MR HARRIS: No, we're not quite out of time which is a pity because - - -

DR KING: Now, you don't - if I - I hope I've got it right, you don't have an internal LMI operation? You work through the externals?

MR SULLIVAN: Both arrangements.

DR KING: You've got both. So you do have them internal. Do you mind just clarifying for me how that goes with the customer - so this is - I'm still a bit in the dark or unsure about exactly how that relationship goes, so a customer has, let's say, an LVR of 90, you know, and I've picked a figure above 80, so right, you need a - you need LMI. A customer, you have to pay for it. What choice is available to the customer at that stage? So do you say, well, we've got Genworth over here and this is how much they'll be, and we've got QBE, I think off the top of my head is the other one, over there, and the internal Commonwealth LMI and you can choose between them and, you know, do you have competition, or is it simply that the person writing the loan at that stage says, "Well, here's what LMI's going to cost you"?

MR SULLIVAN: So two introductory thoughts for you. I mean, first and foremost I would have said the choice that is available to customers and a small, or a number of them take it if they take more time to save the deposit to buy the house and not buy the LMI - - -

DR KING: I understand that it's an alternative but - - -

MR SULLIVAN: That is something that's available to customers.

DR KING: But let's assume they're going to take LMI.

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MR SULLIVAN: So we have a one LMI rate for us, for our customers, plus there's obviously available to - they can go to a competitive bank or they can go to a broker and cover their different range of offers available for them, but for simplicity, we have one rate that we put to customers in terms of LMI.

DR KING: Okay.

MR HARRIS: I mean, given that the customer again pays that, I mean it's just a transfer through to the customer, I mean, on what basis does Commonwealth have the incentive to make sure that the customer's getting the best possible deal?

MR SULLIVAN: Customers would still pay much attention to the rate that they're paying in addition to the LMI premiums for - - -

DR KING: I'm sure, but LMI, I mean, on a 90 months and LVR, the LMI premium, as I understand it, is pretty substantial. I think you could be looking at about $10,000, I suspect, on a standard home loan for the 90 per cent LVR, so that's - that's non-trivial from the customer's perspective. You just give them a rate, so where's the competition? There's alternative LMI providers, but it doesn't seem like the person whose interests in the competition gets any say in that.

MR SULLIVAN: So, you know, obviously this is a segment of the population which is high risk in terms of assets, gentlemen, and obviously we use the LMI insurance as a way of being able to lend to customers who we may otherwise not be able to lend to, and often that's of enormous value to those customers, to be able to get into their home a year or two earlier than they might otherwise be able to do that.

As we've noted beforehand, in the mortgage market there's a range of different providers and broker and lenders who can help customers uncover and compare the rates for a 90 plus zone, a 95 loan, an 85 loan. That information is available and clearly disclosed to customers for comparison if they so wish to do.

DR KING: I just find it odd that, I mean, I find it odd that the Commonwealth wouldn't want, you know, a more competitive rate and, you know, and want their custom - the customer's more likely to take out a Commonwealth Bank loan if you say to them, "Look, here are the alternatives. We can get you a great LMI rate to help you". I mean, otherwise, you know, it just strikes me as a bit odd when you're saying, "Well, the customer can go elsewhere", and the Commonwealth can lose the loan.

Are there any other reasons, any other incentives we should know about with regards to LMI? Does the Commonwealth receive rebates, for example, if it relates more to Genworth or QBE contracts? I mean, I just seem to be missing something here because it seems like a no brainer that the Commonwealth would help customers on this and you're telling me, no, they can go away to somebody else.

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MR SULLIVAN: On the contrary, we feel like it's a - it's an offer that we're very proud of and obviously we put a lot of work into making sure that that's competitive with the marketplace so that the LMI price, and the rate as I mentioned beforehand, obviously that's front of mind for customers as they go through that origination process, and so we've put a lot of time and energy into making sure that that LMI rate and the offering of those with it and the mortgage rate are competitive to the marketplace, so it's certainly not in any case the instance that we want a customer not to take their product with us. I'm simply saying that there's a range of obviously competitive offers in the marketplace.

For reasons of simplicity, we put one rate, in terms of LMI, to our customers and we work with them to ensure that's appropriate for their needs.

DR KING: Is Commonwealth able to use its buying power with one of the insurance companies? I mean, again, I would have thought in your position you would gone to one of the insurers and said, "Well, I'll tell you what. You make sure that you're providing this great rate, and we'll, you know, perhaps with volume discounts and some rebates back to the Commonwealth, so that we get a better deal for our customers", and you know, does the Commonwealth do that? is that the sort of thing that I'm missing here?

MR SULLIVAN: Certainly not in any way primarily in the decision that we make around the offering to our customer. I mean, that's guided us, as I mentioned beforehand, a very competitive market. We look across the marketplace at the - our competitors, LMI or, you know, loan insurance offers and premiums, and we make sure that we're highly competitive with those rates for customers.

MR HARRIS: The claim rate struck me as being quite, well, as a product, if I understand rightly, claims against LMI are quite low. Premiums are quite big, and I think I can recall something suggesting that the claim rate's about 50 cents in the premium dollar. It might be even lower than that. Does that sound right to you?

MR SULLIVAN: I'd need to take it on notice. I wouldn't want to estimate it.

MR HARRIS: Yes. If it was of that ilk, it sounds like a premium price might be a bit higher, doesn't it, because we've got this ASIC data on other insurance products where claims are in the 85 to 90 per cent category versus premium, so you know, a 10 per cent, I don't want to say profit because it's not, but I'll say some margin of some kind, but you know, a generalistic kind of term here, but - and that seemed to be considered to be acceptable. Maybe not great, but acceptable.

MR SULLIVAN: I think to Rob's opening remarks, you know, that rate or the claim rate obviously in strong economic times will represent something that's not reflective of a through the cycle claim rate and the experience obviously when customers which we obviously work very hard with and to avoid them going into a position where they lose their home and need to claim on that insurance, but that rate would be reflective today of a very different point in the cycle than the claim for - and the magnitude of losses that both we and our reinsurers would experience in a stressed scenario which would be material.

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MR HARRIS: Right, and we might try, if we go down this, we might try to get some better data. As you say, it'd be a more sort of through the cycle proposition, and maybe see if we can find a comparable benchmark, kind of, so whether that's a, you know, reasonable sort of risk, and then - because there is a risk obviously.

DR KING: I have one question to start with.

MR HARRIS: Yes, go for it.

DR KING: General advice.

MR HARRIS: Ask.

DR KING: Unfortunately one of our Commissioners is unable to be here because of - - -

MR HARRIS: Yes, but anyway, go on.

DR KING: But you did want to get your views on general advice, and the Commission has obviously recommended changes in that area with regards to both, you know, what is potentially a misleading name for advice, just general advice rather than personal advice. Your views on that whether that change would be desirable, and if so, how - can you aid us in getting to a recommendation implementation rather than our recommendation or draft recommendation which is to say something needs to be done, but - - -

MR SULLIVAN: Yes, I'm happy to offer one thought. It's a very practical and quite tactical thought, given the majority of the time that I spend in our branch network.

I would just suggest there's been an incredibly large amount of time and effort that's gone in to build the current level of awareness, albeit if your assessment of it is that's insufficient, it's your view perhaps.

To educate customers around what general advice is today and what personal advice is today has been an enormous effort for the industry. You know, those words don't have what I would describe as an immediately intuitive common sense interpretation for Australians, but we have worked very hard to help them understand what those mean so that they're getting the products and services that meet their needs.

The only thought that I would offer in regards to that is, anything that we started, the naming convention would restart a process of very material education again, and one would just need to give due consideration to the relative upside of any new name, vis-à-vis the cost and effort that would be required in helping Australians understand what that practically meant.

MR HARRIS: This morning, I asked one of the participants, though, another option is not to rename general advice, and another option is to abandon it because it was singularly

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failed to convey what it was intended to convey which is, this is not tailored to your particular circumstances, which I know is in the script immediately afterwards, but it doesn't seem to - I think a number of participants have said to us, it's a fairly common view that this hasn't worked very well, regardless of - I'm not questioning the effort at all.

The question is, were the words themselves an adequate foundation for all the effort that has subsequently gone in. Whether we might not be better over-emphasising something as professional advice, or it's just things that you heard, in other words, to abandon the - anyway, it's a question. If you were to have a view on that we'd interested in that by way of a further submission.

MR SULLIVAN: Okay.

MR HARRIS: So do you have anything else?

DR KING: I think that probably does me.

MR HARRIS: Excellent. Managed to avoid at least once - - -

MR SULLIVAN: We all thought we'd go for more than an hour.

MR HARRIS: No, no, you guys probably - thank you, anyway for making the effort to come along. Thank you for your cooperation - - -

DR KING: Thank you very much.

MR HARRIS: - - - and help so far in the course of inquiry and we'll look forward possibly to asking you some more database questions when we frame our next round of requests. Thank you very much.

MR SULLIVAN: Thank you.

MR HARRIS: Okay, I think just to continue the pressure upon us to comment at the highest possible level, I think we have the National Australia Bank. Thanks, Rob.

When you're settled, if you'd like to identify yourselves for the purpose of the recording, thank you.

MR CAHILL: Antony Cahill, Chief Operating Officer, National Australia Bank.

MR DOOLEY: Shaun Dooley, Group Treasurer, National Australia Bank.

MR HARRIS: And do you have a statement or something that you'd like to read?

MR CAHILL: Yes, I do, Chairman, thank you.

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Good morning, and thank you, Chairman and Members of the Commission for having us here today. Today I am joined by Shaun Dooley, NAB's Group Treasurer. We welcome this opportunity to speak with the Commission on the competitiveness of the financial system in Australia and assisting with this important inquiry.

I have worked within the financial services industry for 20 years and belief Australians have access to world-class financial products and services designed to meet their needs and circumstances within a competitive market environment.

We note you define competition as being where customers benefit from high quality products at low prices. While we agree with this point, we also believe the market must have the characteristics of being both secure and sustainable, in addition to being capable of functioning efficiently throughout the entire credit cycle.

Stability and competition, however, are not mutually exclusive. A competitive, resilient and well-regulated financial industry is critical to Australia's ongoing economic stability and the growth of the broader economy. We believe Australia's financial system is both efficient and well-regulated, and in the vast majority of cases deliveries positive outcomes for both consumers and businesses.

In 2018 the level of competition in the market is truly intense. In addition to the established competition from 148 ADIs and other non-ADI lenders in the market, we are now seeing the emergence and rapid growth of new competitors such as fin techs and tech giants.

Last year KPMG reported Australia had seen a more than five-fold increase in the number of fin tech companies from less than 100 in 2014 to 579 companies at the end of 2017. While we do look for opportunities to work with start-ups, fin techs and emerging technologies where there are opportunities to create new experience for our customers, we are acutely aware the majority of these new players will likely act as direct competitors.

We are now also seeing the global tech giants such as Apple and Facebook continuing to move into financial services, particularly in the payments environments through services such as Apple Cash and Facebook Messenger. These tech giants are truly global businesses. They're many times larger than any Australian bank, and have multi-billion dollar budgets which dwarf the investment capacity of any Australian company.

Customers, however, are the net beneficiaries of this situation. Overall borrowing rates are now approaching the lowest levels on record. Many fees and charges have been reduced or removed while services such as digital payments and mobile banking are widely considered to be amongst the best in the world.

Most importantly, this is delivering high levels of customer satisfaction with industry satisfaction rates moving from 58 per cent in 2001 to 80 per cent today. Competition is clearly reflected by key performance indicators, and that interest margin has halved over

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the past two decades and ROE has dropped by 740 basis points or 40 per cent over the past 15 years.

While margins are under pressure, it is important to note that price is not the only factor consumers take into account when selecting a product or service. We work hard to understand what our customers want, and our research consistently tells us that customer advocacy is driven by multiple factors with customers often valuing the overall experience and outstanding service as being equal to, or more important than, price.

It is for these changing market conditions that we know we must respond. We are doubling our investment in our innovation hand-up brief, NAB labs, and in 2018 we will invest more than 200 million in our customer journeys program as we seek to complete the re-engineering of our key customer experiences. It is also while we place a key focus on improving the net promote to school in our priority segments. We already have the number one score of the four majors in our priority segments. However, we recognise it won't be sufficient to win in the long term and we have set goals that will place us amongst the best in the world.

We have also recently announced a multi transformation program designed to improve customer experience, increase agility, whilst also removing more than $1 billion in annual operating costs from our company, in part to respond to the growing pressure generated from strong competition. This competitive dynamic has been created within an environment that has also delivered long-term stability. It's widely acknowledged that Australia's regulatory framework for financial services was the envy of the world during the turmoil of the global financial crisis, and today we continue to be viewed as a well-regulated and stable industry.

As a nation, Australia is a net borrower of funds, and as stability plays an important role in enabling us to borrow money at competitive rates in offshore money centres to on win to customers to buy a home or grow a business. I firmly believe this situation needs to continue and any changes designed to increase competition must take into account the overall impact on stability as we need the system to deliver for customers through all stages of the economic cycle.

From a global perspective, the stability has not stifled competition or innovation. On key metrics relevance competition across the globe, such as ROE and net interest margin, the Australian financial system is not an outlier. For example, the ROE of Australia's banks is comparable to Canada where the banking system is similar in structure and also void of significant losses in the GFC, and broadly comparable with banks in Sweden and Denmark.

In 2017, the RBA observed that Australia's major bank NIM is in the range of large banks in other countries and close to that of Canada. Since 2008, there have been more than 50 Government or regulatory policy inquiries or reviews, 12 of which are ongoing. One of the key inquiries, the Financial System Inquiry, or FSI, made the point that competition in the financial system is generally adequate at present, but we do note a call for this to be monitored over time.

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Following the publication of the FSI, numerous industry changes have been introduced that are designed to improve customer outcomes such as a new code of banking practice; changes to remuneration following Sedgwick; the upcoming establishment of the Australian Financial Complaints Authority; and reforms to credit cards. A number of significant changes are still to be implemented. These include the introduction of comprehensive credit reporting and the open banking regime. At NAB, we've taken leadership positions on CCR and its introduction since 2015.

On Monday 19 February this year we became the first major bank, ahead of legislative mandate, to participate in CCR for personal loans, credit cards and overdrafts and we look forward to this being rolled out more broadly. We do believe it's good for competition and it will mean better outcomes for customers.

Building on the work of this Commission's inquiry, open banking will introduce new opportunities for customers given them control of their data and improving the way data can be shared, introducing an open banking regime will place Australia at the cutting edge of competition regulation alongside the European Union which is in the process of introducing a regime known as PFD2.

Last month also saw the launch of the new payments platform, NPP, in Australia. NAB is one of 13 institutions working together to develop the NPP at a significant cost to the industry to make payments faster, easier and more convenient for customers. Importantly, NPP also enables customers to set up a pay ID, an identity such as a mobile phone number or an email address which will make it far easier for customers when they seek to change financial institutions.

From an innovation perspective, Australia is viewed as a leading market in terms of innovation. As it stands today, Australia has one of the highest penetration rates for contact less payments in the world, and the uptake of mobile banking is also equally high.

In 2017, as Australia's largest business bank, we saw an opportunity to create an unsecured digital lending product for small businesses for up to $100,000 with a fully digital application process. This allows small businesses to apply on-line for a quick process, have approval in minutes and cash in accounts within 24 hours. We've also partnered with realestate.com.au to provide a seamless search and finance experience for home buyers and we're working closely with Xero to provide market leading experience for Australia's small business customers. These three examples represent real innovation and they have delivered world-class experiences for our customers.

So in conclusion, given the breadth and scope of this review in the limited time we have available today, there are three areas that we feel best placed to provide further context on in line with some of the observations I've made today, namely the competitive landscape and market dynamics; ensuring a balance between stability and competition; and thirdly, the extent to which customers can exert competitive pressure. We feel these topics are the cornerstones of the competitive landscape.

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In closing, we do support the work the Commission is undertaking to ensure our system remains a highly competitive one. We hope our comments today and our written submission, which will follow, helps to inform your views and understanding of the competitive financial services landscape in Australia.

We welcome your questions, and thank you.

MR HARRIS: Thanks, Antony. I think we can stick with the three, sort of, general topics that you have proposed, although we undoubtedly here will dive into others, and you will, as best you can, respond, but this general question, I don't know whether you have observed some of the other participants here, or whether you were present for the discussion earlier.

This general question of the competitive landscape, I don't think we're going to have much to differ over about the, if you like, the quality of services that are attempted to be offered to customers in Australia and the rapid adoption of technology and the equivalent, but this question of price, although I do note you emphasised that your survey works suggests consumers value quality as much as price, it may well be true, but price competition, as you can see from the report, is the area we think weaknesses are reasonably evident for pretty substantial periods.

And certainly since the global financial crisis and the emphasis on it are unquestionably strong, it appears to be the case that price competition, even though as we acknowledge at any point in time firms are under pressure from other firms, but price competition itself hasn't resulted in any kind of substantial shift in favour of consumers, and to the extent you use different benchmarks you can find different numbers, but it does not appear to be the case that that's - we have a strongly price competitive market from our perspective.

Anyway, we're interested in the debate and discussion that that undoubtedly generates. Yesterday we were encouraged to think about different measures of profitability. We're not that bothered, we've been trying to say continuously, about profitability per se. We're interested in the nature of competition and its measurable effect, particularly in pricing, so to the extent obviously that you feel a need to talk about profitability that's fine, but our focus is really on those measures which tend to show as far as we can tell that consumers aren't necessarily benefitting a great deal in the pricing space, and we've used, for example, the increase in the gap between the official cash rate and the rate paid by consumers, or in the case of deposits, the rate received by consumers, just as a kind of benchmarking exercise.

So do you have an opinion or a judgment on those?

MR CAHILL: I think the, and I'll ask Shaun to touch on it, but that's certainly a vision we're taking a look at in terms of what are the returns that it would generate compared to the cost of capital within the business, and I think that's a particularly important measure to look at, but from a competition perspective, if we look at mortgages for example, at the moment, absolutely in the last six to 12 months mortgages now, and it's near the lowest

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rates on record. In terms of competition for flow, the January stats were published yesterday, for example. All four of the majors grew below the system, and the second tier banks or the smaller banks are growing well above system. So the smaller banks are absolutely winning market share at this point in time.

We are competing fiercely in the marketplace to win new mortgage customers, and you're seeing very significant discounting playing out at the moment and really all the majors and the smaller banks are all competing very hard for those customers to effectively join the banks, so I think this discussion around is our price competitive? Absolutely, and you would have seen that play out at the moment in terms of the rates that are available to borrowers, and secondly where the growth is actually occurring, that the four banks traditionally have been seen as the largest players in the mortgage market, but that absolutely the other players are winning market share and growing faster than the rest of the market.

MR HARRIS: The fact that rates are historically exceptionally low for borrowing is one thing, but official cash rates are also at, depending on which nice historical parallel you like to read, 200 or 500 year lows, so of course we've only been around for 200 years so - but in Europe 500 year lows, so I mean, we are in a really unusual circumstance and the gap is our, sort of, one of our more substantive indicators of the gap between official cash rates and rates paid by borrowers is just an indicator. It's not a perfect judgment one way or another, but it's an indicator, and it's definitely grown since the global financial crisis.

So we say to ourselves, it's most likely that there are many contributors to that, but one factor that suggests this is, you must have market power in place if no party is prepared to jump outside, as it were, the pricing paradigm, and force that down towards the official cash rate, while still maintaining a reasonably healthy margin.

MR CAHILL: And then I'll hand to you, Shaun, but probably just make two points. The new in the business has halved over the last 20 years, so the net interest margin that is generated across the company has halved and we think that absolutely demonstrates there is strong competition.

Secondly, the bank has to generate its cost to capital, and our statutory ROE last year was effectively equal to the bank's cost of capital. Secondly, if we don't generate returns above our costs of capital, we can't continue to grow our lending to our customers because clearly we have to have capital, tier one capital to on lend to customers. So when you look at NIM and then you look at how that relates to ROE, I think that very clearly demonstrates very strong competition, but Shaun, you may wish to add to that.

MR DOOLEY: Thanks, Antony. What I was going to add to that is the comment around the cash rate and the relevance of the cash rate. What I would say is we don't fund ourselves as a bank around at the cash rate. Our funding profile is - it comes from many sources, both in terms of mix, but also tenor, and there's been a lot of change in the way bank balance sheets have been funded over the past few years, so really since the GFC.

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Some of that really are decisions made by management teams of the banks to continue to strengthen their overall balance sheets to ensure that we're able to withstand a series of shock scenarios so - and we've very much run our bank about - around scenarios that could play out, but also responding to regulation, and so regulators around the world have sought to strengthen the system by ensuring that certain liquidity and funding ratios are met which will change the mix of both our funding profile and therefore the cost of funds, so we will be borrowing in two markets, so for instance, last year we raised about $36 billion of wholesale term funding that occurred across a number of markets.

About 75 per cent of that came from outside of Australia and New Zealand, and that was from a range of tenets, everything from sort of three year through to ten year, and we need to continue to manage the funding profile of the bank to ensure that it's stable, and the costs associated with that are not directly linked to the cash rate. The cash rate does have an influence, but we don't fund ourselves with the cash rate.

MR HARRIS: No, no, I think we understand that. We just chose it because it's a benchmark that everybody can understand; everybody meaning everyone who's familiar enough with it will know the weaknesses and strengths or otherwise, but in terms of your own off-shore cost of funds, which as you said is a big contributor to that, so off-shore costs of funds appear to have been, you know, incredibly low themselves during this period, not so they aren't, you know, I mean, they're positive.

They're not negative as for temporary periods people were happy to accept from the official sources in Europe, and in Japan, but they're low as well. So it appears, although we don't have the data and I guess maybe you could help us with some data which shows just on that - there's a nice graph in our draft report which does show the difference between official cash rates and market borrowing rates, and how they have increased notably, or near doubling since the GFC, how has that occurred as a consequence of off-shore borrowing? We'd be very interested in trying to sort of break it down for that.

Our overall commentary on the NIM, for what it's worth, has been, we agree, 20 years ago. Just as brokers came in, there's a very significant reduction in margins and it's again a benchmark in our report, but going on the data throughout the shocks of the GFC and the way it's falling, the NIM is very stable.

I mean, admittedly slightly down as a group for the larger banks, but pretty stable for a period of, you know, absolute, once in a couple of generations kind of thing, which does suggest to us again an ability to maintain a margin, you know, I'm sure a great deal of investment, but nevertheless an ability to maintain it suggests that it's not a strongly competitive market. We would have expected to see more shocks in the NIM line for you, pretty much like some of the smaller banks, but perhaps not as bad, but you are very good at maintaining, you know, probably because you were very well rated, maintaining your healthy position in the marketplace.

And so that's not a criticism. That's an observation which leads you to a conclusion that we're not in a circumstance of ruthless competition. We're in a circumstance of wealth

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of stability and calm, and so we're - everyone's in favour of stability and so are we, but we're looking therefore at what we can do to alter the competitive paradigm.

MR CAHILL: I think my one response, my key response, though, is that interest margin, the ultimate returns of it generated. Bloomberg estimated, or estimates our costs of capital for external estimate is around about 11 per cent. Last year our ROE was 10.9 per cent. So as an institution now, if NIMs and returns go any lower, we're not actually covering our costs of capital.

So as a bank, as I'm sure many other institutions are, this is why we're spending hundreds of millions of dollars and seeking to ensure we provide customers with additional value-add products and services, given the best possible experience they're looking for because we have to be able to generate a return that covers our costs of capital, and so when we undertake our net promotor score surveys, and when we talk to customers around what are the key drivers of their choice, yes, price factors into it, but there are other factors that they use being just as important, if not more important, and really that's how we're seeking to manage this, Chairman, in terms of ensuring that we can generate a return that covers our costs of capital, and therefore how do we have a conversation with customers that isn't just purely about price? What are the other areas that they do value? Why would they choose to come to NAB as opposed to another institution?

MR DOOLEY: As Antony said before, in order to continue to support lending in the marketplace, we need to be able to generate core capital. That's in order to enable us to continue to grow a balance sheet. I think it's worth pointing out that the environment within Australia over the last couple of years, the economic performance of the country has been very stable, as we all know. As a consequence we're seeing the incidence of bad debts across the Australian banking sector really of long-term lows, so when we think about our bank and forecasting of our capital position, we need to look through the cycle, and you would expect in time that obviously the cycle of the economy will change, and we might see bad debts vary from what we're seeing today.

And so we need to prepare ourselves, and we do run our bank, as I said before, with the ability to withstand a downturn which requires us to manage not only a strong balance sheet, but continue to generate capital as an institution.

In terms of the NIM, the NIM, obviously there's the cost of funds and then there's the interest revenue that we generate from our customers. So I'll talk about cost of funds. We have seen a fair bit of volatility in spot cost of funds, and I want to make the distinction between average cost of funds and spot cost of funds. Spot costs of funds is the price that we pay when we go into the market today for a transaction, but given that the, I guess the tenor of our funding book is about five years on average, so 20 per cent of the funding book is maturing in any one year and we're having to go back and replace that and so on, so it takes a while for spot costs to move into average costs in the …(indistinct)… hence why the slow change, and that's appropriate. You don't want volatility in those key financial measures because that would imply that you're running a very volatile balance sheet and

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that's clearly - that's not what we want to do as a bank, and that's the sort of thing, what our regulator or our counterparts or our investors would like see as well.

But really since the GFC, and it's important, I think, with the - to the state of the GFC, it was more of a financial crisis in liquidity and asset markets that were largely outside of Australia. It had an impact on Australia because we participated in global markets. We rely on global markets for our funding, and so we saw credit spreads move out a lot through that period. We also saw a number of markets completely seize up through that period, and the most notable one was the securitisation market in Australia in 2008/2009 largely disappear with the exception of the intervention from the Government through the Australian Office of Financial Management.

We have seen a significant return to health of the securitisation market over the last couple of years. 2017 was one of the strongest markets that we've had for some time, and we, as a bank, are very proud of our leadership role in the securitisation market, and really to facilitate access to funding of smaller banks and none-bank KDIs, who rely on the securitisation of the market to fund their businesses.

All participants need sustainable funding models, and the securitisation market and our role within that is key to that. We were involved in most of the transactions in the market last year. We are the leader, in our view, of arranging transactions for other players, and we were pleased to see a return to health of the securitisation market last year after some quite difficult years.

But since the GFC we've also seen volatility and credit spreads come things like the Europe crisis, and we saw a lot of event risk occur through 2015 which saw a lot of volatility and credit spread, so when we think about the cost of funds, there's the base cost. As you observed, the official cash rates in many countries are at historic lows, but credit spreads move around, and the other factor that we have to consider is the cost of bringing that currency back into Australia.

So there's cross currency costs because we bring everything back to Australian dollars and we manage the risk here, and so there are a number of drivers that go into the land of costed funds that are not solely linked to what's happening in official cash rates, so it's breaking up those components.

And then what we're also seeing is the influence in different markets. So we raise money in Japan, in the US, in Europe, in Taiwan, in a number of markets in a number of formats, all of which different drivers in terms of the funding costs, and they vary over time.

MR HARRIS: Yes, that's why we're interested in that cost of funds line which is - in our - we don't have that data, and so we just have official rates and market rates because they're both, relatively speaking, publicly available, but they do show that shift and that's one of the key foundation stones of our report.

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I think we're interested in securitisation, but we probably don't want to narrow it down just yet, or do you want to ask - - -

DR KING: No, I would like to come back to securitisation later.

MR HARRIS: Later, yes.

DR KING: Yes, but just on the - I want to flip the competition story here instead. You said that the smaller institutions are gaining market share. It's still a long way behind obviously. I think if you get to the size of the NAB you'd have to take home loans and assets and take everybody from Macquarie on down outside the Big Four and add them all up and I think you'd just about get to an ANZ or NAB in terms of assets, so we've obviously got a long way to go.

When we talk to the smaller groups, and their response to some of our recommendations, there's been, well, the systems biased against the smaller banks, smaller ADIs at the moment for several risk weights. They appear to favour APRA basing the risk weights on the IRB banks. Further, I note that the SSI suggested that and that's been carried out. The RBA says there's still an advantage, a too-big-to fail advantage. There's still an advantage to the big banks. What is your response to that?

MR CAHILL: So there's probably two parts to the question. So part one in terms of competition in the market today, when you talk about mortgages it's very important to look at the stock market so that the existing mortgages are seen on balance sheets and flow. When you look at flow in the marketplace today, the non-majors are absolutely picking up the market share and for the last few months they've been growing between 1.5 and to two times the system, double the rest of the market.

All four of the major banks are currently losing market share, so the competition and intensity of price competition at the moment in the market today is particularly intense. When we - we've just recently gone through all of the pricing requests that we had in the last quarter in relation to mortgages, and we saw more pricing requests from one of the regional banks than we did from one of the- against one of the Big Four competitors. So they are absolutely competing very aggressively to win their customers. They're putting very sharp prices into the market, and so customers are absolutely seeing a very competitive market when they look at going to different providers for mortgages.

Part two, then, I think you're picking at the point in relation to risk weights, and the majors and those that are operating under advanced status have an advantage. Sure, we can talk in depth about that, but our belief, we strongly belief actually that there is very little to no advantage now that is in play given not only the risk weights that are held for mortgages, but the adjustments that are made for banks operating under advance status. We believe there is very little competitive difference in relation to those overall risk weights, but Shaun, you may want to go deeper on that.

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MR DOOLEY: Yes, thanks Antony. As you noted, the emphasis on inquiry report highlighted the gap between the standardised and the advanced methodology for all the IRB methodologies we'd describe for risk weights. There's been actions taken since the publication of that report. APRA made some changes to the amount of capital that the advance banks hold against the mortgage portfolios back in 2015 with some changes that brought the average risk weights for advance banks for about, on average, about 16 per cent up to about 25 per cent was the change that they made in mid-2015.

Subsequent to that, there's been a lot of work done globally through the Basel Committee, and more recently APRA have published a number of papers, including a paper about three weeks ago, two to three weeks ago on proposed revisions to the capital framework. Those proposed revisions are directional at this point. It's quite hard to quantify exactly what the impacts will be until there's further work and consultation and impact studies, but suffice to say is that it's continuing to narrow the perceived gap between advanced methodology and the standardised methodology. In fact, there is a floor that is being applied globally, and APRA has a regulator that seeks to deploy the Basel standards where appropriate within Australia and we'll consider that in those consultations.

As Antony said, the perceived difference between the two is not as great as we think people believe it to be. The other factors that need to be considered, because there'll be the headline numbers between the advanced and the standardised, but the advance banks have to carry higher capital in terms of the surcharge for domestically strategic important banks, so that's a surcharge of more capital we have to carry. We need to carry more capital for other types of risks that are not picked up in the standardised model, so the interest rate risk that emerges out of the banking book is one piece.

We have a different way of calculating risk weights which take into account overdrawn balances. There's actually a significant ongoing investment that's required to maintain accreditation involving a considerable number of people and systems to maintain the data and the quality of the modelling that is expected by APRA, and the portfolio diversification that we actually have as a major bank, we tend to have more diversified portfolios as well, and all of these factors, including types of lending that are done by a bank such as ours, so they're not done by all competitors, are projected and structured finance, but particularly infrastructure finance is a case in point where the risk weights and the methodology calculating those risk weights are evident in the major banks, but they're not always coming through in smaller banks that are more concentrated in mortgage lending.

MR CAHILL: We will be putting more information in our full response in two weeks' time as I think that would be very helpful because, if we can lay that out I think maybe that may even mean a subsequent conversation beyond that.

MR DOOLEY: The other point I'd make is, the IRB banks, there's a - the risk weights will move much more substantially in a downturn scenario than under a standardised model too, so we get a fair bit more volatility in both risk weights and also capital. That's an outcome of the IRB approach.

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DR KING: Which is the right approach. So the IRB investment was substantial by the banks. I'm trying to think of a polite way to put this. The polite way is, would NAB now look back and sort of say, yes, we did that and we've done our dough. I guess the polite way of doing it is, if you didn't have the IRB system in place today and you were thinking of it as an investment for the bank, would it be the sort of investment that would - to meet your hurdle requirements or is essentially you've done your dough.

MR DOOLEY: No, I don't think we've done our dough. I think one of the core principles around advanced accreditation, it's the usual experience of your own data and understanding your customer base in a much more granular, sophisticated way than under a standardised approach.

So the knowledge that the systems and the models give us around performance of our client base, the ability to stress our portfolio to a range of different scenarios is all really an outcome of the investment that we made. So the investment is really stronger risk management. So that's the payback for us, and we have a, I think, and I can't speak for other banks on their experience, but what I can speak for our bank is that it's given us a much more sophisticated view of our portfolio, and the potential performance of our portfolio in a number of scenarios, and advanced accreditation assists for that.

DR KING: The trouble I have with that is that you better understand the risks of your customers, and yet that's not being reflected, as I understand it, from your position, it's not being reflected sufficiently enough in the risk, the individual risk weights that you face or your able to have compared to the standardised rates that don't depend on any of that information.

MR DOOLEY: So within IRB Bank you'll have a range of risk weights. So a standardised bank is prescribed a risk weight for a set type. So I talk about averages of 25 per cent. We always have some assets, some of our exposures will have risk weights in the teens and some will be above 40 per cent because what we're actually doing is applying our granular risk weight to each, effectively each customer which is a product of their potential for risk.

And so what the advanced approach allows us to do is to drill down into literally arrangement by arrangement to look at the probability of default in each case, you know. The exposure that might be, and - - -

MR CAHILL: So on a mortgage, for example, just to give some context, a high risk loan that you may take on to the books, you would be required to hold 40 times the amount of capital compared to a low risk loan, so from my perspective, it's absolutely giving us critical information as we think about going forwards. How do we compete? Where do we compete? What's the risk that's coming on to the book? How should we price the product and I think, as you start to move into more and more personalised pricing for individuals, and we're starting to see that, we actually see that now in mortgages. We're starting to look at far more factors when we price what is the actual end rate for the customer having this modelling place, understanding what's the true risk associated with the loan and the capital that you hold. I think there is - it's been a worthwhile investment.

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And what we haven't yet seen in the marketplace, and I think this will start to happen over the next three to five years, and we've had this conversation with a number of the regulators in prior - in previous months is, you will start to see far more individualised pricing, be it on loans personal loans, credit cards, home loans over the next three to five years, as we start to see more use of data analytics, and this an important contributor to that.

MR DOOLEY: And we see that in lending to businesses, for instance. You know, they're a price risk across the business portfolio reflecting our assessment of the individual risk characteristics of those borrowers including their potential for default, but also what happens in this case.

MR HARRIS: So you thought Murray was right then, lifting your risk weights? You agree you were getting a really good that you shouldn't have got and you put your hands up and go along with the regulator? Is that the idea?

MR DOOLEY: No, look, I'm not saying that Murray was wrong. What I would say is, we've adjusted our capital and our business to reflect the requirements that a regulator has on how much capital we should hold for certain asset classes. I'm just going to add to that, that there's regulatory capital and there's also our internal view of risk, which would be an economic capital number, and you will get quite significant differences between the two. Economic capital is an internal tool that all banks will use to assess their own view of risk versus a regulatory view of risk, and they will vary depending on where**,** you know, we see the environment and underlying assumptions. We're holding the capital that we're asked to hold against the mortgage book, but our internal models would suggest a different number.

MR HARRIS: So is the other way of looking at, "We got the risk weight relativities wrong when we first established IRB standards", which, you know, appears to be the logic for the change back in 2014 or thereabouts, is, "Well, we should perhaps lower the risk weights for the smaller banks". In other words, perhaps we - and we have - well, there are some. We have put two examples into ours with SME lending where it looks like we have a single line standard and we perhaps should have had a, you know, standard that certainly other countries appear to have been able to differentiate in some aspects of SME lending to have more than a simple understanding.

MR CAHILL: So I don't think, and Shaun you should reflect, but I think the original question was, have we done our dough in putting this methodology in place.

MR HARRIS: I'm not so worried about that, although my wife's a shareholder and she is worried about it.

MR CAHILL: Our view is, we haven't done our dough because having their information more inside, truly understanding the credit risk within the business, what's the risk profile represented by certain types of lending and customers can only be a good thing, and so

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therefore we believe this methodology and undertaking this work was the appropriate thing to do.

As Shaun has said, we have internal views on economic capital versus regulatory capital. I think we've now moved to a second question which is actually are the risk weights right or wrong which is slightly different to this. This was a view that the regulator gave. Shaun, you might respond to that.

MR HARRIS: That is true, Antony but my interest is primarily from the point of view of what this inquiry is all about.

MR CAHILL: Yes.

MR HARRIS: Which is, have we gone too far in favour of stability. Now, I did note you had a very good line in there which someone has written in your presentation about the fact that - - -

MR CAHILL: I wrote that last night.

MR HARRIS: Even better. Big tick to you for - that the competition must always take into account stability, which is the inverse of everything else that we've been doing here. It would be good for stability to occasionally take into account competition. So I think there's a gold star coming from that line alone, but see, that - the reason I ask the question that I did of Shaun was, there are two ways of resolving the fact that the risk weighting differentials on one is to say, "Perhaps we have been too strenuous in our single line standardised approach".

Now, I don't know. It just seems odd that the preference is always towards increasing the risk weights, and in the end this is an area where customers must pay. If banks are retained, you argue that you have to be able to finance the bank and you have to be able to justify your balance sheet expansion, and so in the end, all other factors being equal, that says high price for customers, or some customers are going to miss out. You will fund it instead by simply saying, "These are now too risky for us and we're going to ditch some of them.".

MR DOOLEY: So on the second point about high price for customers, I think as we've said a number of times that, you know, that NIM and ROE has been coming down all the time, and mortgage costs as the key indicators have been coming down all the time.

In terms of the risk weights themselves, I think APRA's paper a couple of weeks ago that I referred to is really starting to address a number of the points that you've made and that's taking the lead from some of the Basel Committee changes, and we're looking at the proposals for risk weights for small business over time, and also mortgages, and I think what the Basel Committee have been attempting to do is to reduce some of the variability that exists across the financial sector around report of capital numbers for, and differences in capital numbers for portfolios that should ultimately produce a similar outcome.

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So I think we're also looking at how capital should be calculated for a sector such as the one you describe, so it's probably a live debate at the moment, and something that we'll be consulting with APRA as will many of the other market participants will be consulting with APRA over the course of really the remainder of this year.

So I don't have an answer for that yet, other than I think APRA also recognised that, so - - -

MR HARRIS: It's an unfair question in a sense from me because I'm asking you to criticise risk weights in a circumstance where clearly everybody wants to be regulator compliant.

It's just that the sentiment, such as it's put in front of this inquiry, is continuously towards if - if there is a fault with a differential between IRBs and standards, the solution is a higher risk weight, not the solution is a lower one, and that's what inquiries like ours do. We zero everything. We go, well, why is it so, and this is a very hard one to get an answer from because of course, and so I'm not being critical here, it just is very hard to get an answer on because nobody wants to step out of line on a question of risk weight.

MR HARRIS: But we're actively engaged with the regulator on this topic, and absolutely from our perspective we want to hold the appropriate amount of capital against the appropriate lending through the cycle, and we'll continue to have the ongoing dialogue.

MR DOOLEY: That's right, and I think one of the points too is, capital is there to protect yourself against unexpected loss. So there's expected loss and unexpected loss. Capital is your unexpected loss and we set our capital positions thinking through the circle, and as I said before we're actually at a low point of the credit cycle in terms of the cost of risk to financial institutions in Australia is at very low levels compared to where it's been historically, but we can't sort of manage our capital to today's environment. We have to manage it for a variety of cycles, and I think that looking through the cycle and what the long-run expectation will be for the cost of risk and ensuring that our capital is able to withstand those shocks, including severe but plausible shocks which is how we do our stress testing, that that speaks somewhat to this issue of should risk weights come up or down or stay the same, and I think again that's a broader discussion with the regulator around how we position for the future.

MR HARRIS: Yes. Yes. No, really, it's more a question asked in frustration than anything else because it's very hard to nail this down. It appears to be - - -

MR CAHILL: A default preference which goes to this whole question of stability versus competition.

MR HARRIS: Now, I'm going to get off it because one last - my last comment is that, you know, the problem that we face is the risk weights going up for the IRB banks reflecting stability or the risk weights going up to the IRB banks reflecting protectionism for the small

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banks. Because if it's the latter then it's clearly anti-competitive, but if it's the former then there's clearly a relevant reason and we need to get to the bottom of that to the extent that we can, he says, being less of an optimist.

Okay, we do want to talk about securitisation so I want to leave a little bit of time for that.

MR CAHILL: Okay.

MR HARRIS: Transparency of pricing. So we have a proposition to publish what we call real time pricing, real time actual prices in a set of markets for a particular kind of borrower. We have had presentations from both the smaller lenders and the larger lenders for different reasons saying this is a bad idea. So can you give me a perspective on not so much the practicality of this because we think it's practical. If you think it's impractical we're interested in that, but the question of why it would do no good for consumers to know better when they go into a transaction what last month the equivalent consumer guide by way of negotiated price, why would it be no good?

MR CAHILL: So I think from my perspective, and I think we're probably talking about mortgages predominantly, is the product's in question.

MR HARRIS: It's easier to think about.

MR CAHILL: So we are seeing more granularity in the pricing that is made available to customers today, and the two main factors that I use when customers are seeking to understand what is the price available today is typically the loan size. Secondly, what's the LVR on the security because again that may have a different price point, and then whether it's for an owner-occupier investor. This is for a variable rate product.

And so we have our standard variable rate and that is used and that is adjusted from time to time depending on what happens to our input cost of funds for both new business and for our existing, and we have to be able to do that to manage against the changing cost of funds.

That published SVR on those criteria is the maximum a customer will pay when they come to the bank and say, "I'm interested in taking out a loan with you". Going back to that conversation we've just had in terms of risk weights, then the conversation starts and we begin to understand far more about the borrower themselves, and what is the actual, or how many borrowers are applying for example.

Depending on how many borrowers applying, that actually impacts the amount of capital you hold against the mortgage. What type of income are they earning; how stable is that. Where is the security, for example. So we are more prepared to negotiate on a price in a security that we believe is far more attractive, is likely to see capital growth in an area where there's a high risk associated with it where the actual security value may go down.

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So that published price is the starting point, and I think customers now are seeing more of that in terms of loan size LVR; what's the actual purpose. Then the conversation starts, and I think the question that you have is, it is very difficult to give the precise price that a customer will pay because there are so many nodes now that are being developed.

So when a customer comes to NAB today or they go to see a broker, we have an instance pricing tool deployed in our front line. Our staff can put those - the criteria into the instant pricing tool and that will give a recommended price to the customer. At that point, then, the customer can choose to accept that or not, and even then the customer may say, "Is there any more room to move?", and there will be that competitive tension playing out about whether we're prepared to go any further or not below our lending floors to secure that loan.

So it's impractical to be able to publish a list of all the pricing nodes that are available at any one single point in time, but - so it's the starting point that the customers see and there are, sort of, those - we're starting to see those zones emerge now in terms of what's the loan size; what's the purpose type; is it above 80 per cent, less than 80 per cent; and then the further negotiation begins.

MR HARRIS: Well, think of it this. If your child was going in to negotiate their first loan, you're a banking executive, you know the nature of the market. Surely you're going to say, 'I know - I know that although the standard variable rate is like this, the kind of order of magnitude of price for some of your income that we've negotiated last month is X". You're going to try and give them detailed information just so they've got a mental reference point. Even if they do then go to a broker, at least they know what a broker has said has some either ring of truth or perhaps there is more to be found.

And you know, one of the biggest tools you've got for increasing competition in the marketplace is better information to consumers. We've heard - just about everybody has agreed with us so far that there's an awful lot of data out there which is somewhere between meaningless and misleading, and that includes comparison websites which do provide people with rather optimistic perspective of what they might be capable of getting.

Whereas the median is the median is the median, and you know, it's last month's median, therefore, you know, once it's published every month, we'll have an ongoing series of medians, but we'll see gradually how the market is moving and we just can't really conceive of a case why it's harmful for consumers to be better informed now that digital data does enable us to do this.

The best argument we've had against it so far is that it might advantage larger banks versus the smaller banks. This is an argument which says that people believe - now know the price from a publication of the median. They won't bother going to a broker. They'll go into the branch and, gee, you've got more branches than the smaller banks and therefore you're going to be naturally advantaged. I am interested in your perspective on that if you want to offer one, but I'm not sure it completely makes the case against doing this. It does give

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us reason to think a bit further about it, but it doesn't make a case necessarily against us doing it.

But I am very interested in why this is, you know, not just a pretty simple idea now that we have the data capabilities we didn't have five or ten years ago.

MR CAHILL: So as I said at the starting point, we're now very clear around, this is the SVR rate regardless of loan size. As you start to step up in loan size, these are the rates that you can expect to see, so a person already starts to get an idea of what the purpose type is; an owner-occupier investor, what the loan size is; what is the rate they're going to - they're likely to pay.

And then there are those other factors that we simply can't - we couldn't publish 50, 60 - - -

MR HARRIS: No, I don't think we actually, it wasn't going to every factor. In fact, the reverse. It would be - anyway, I'm sorry.

MR DOOLEY: I think the proposition that you raised before is the right one. People are better off with more information. The question, as you highlighted, is making sure the information is genuinely …(indistinct)… and it can be dealt with. So I think as a proposition - - -

MR CAHILL: I mean, I think one of the things would be, from our perspective, we do think there is a proliferation of products in the marketplace, so within NAB we set a goal over the next four years of actually halving the number of products we have on sale across the whole company. Now, there are two reasons for that. One is, we think that will give more clarity to customers, and I think over time, we look over the last 20 years, there have been plenty of different products coming through with different features and service levels, but actually when you really look at this maybe you could have a smaller number of products and that will remove some of the confusion that's in the marketplace.

Secondly, from our perspective, we believe there's great efficiencies that can offer us through the company in terms of decommissioning systems that have been there for many years. How do we start to enable ourselves to be more agile, more efficient, and more streamlined. So the end goal for customers, we believe, by hopefully achieving that halving of the total product set will be to remove some of the - I think it can be quite a confusing landscape.

So that's sort of where we're heading and we're sort of trying to understand. Absolutely we're seeking to put more information on to our websites and to our digital tools and we will continue to do that and we always say to any of our mortgage customers, both new or even existing customers, if you want to have a discussion about your home loan, then talk to us, and one of the things we are doing now is, we phone all - we contact all of our customers now after 12 months to see are they happy with their home loan; are there any issues; and if they're existing customers, if they would like to talk about my rate.

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That's where there is an opportunity to do that. So we're seeking to have that conversation with customers.

MR HARRIS: That's an interesting innovation. Do you want to do securitisation? We're getting on to five to four so.

DR KING: Yes probably. I intended to follow up on brokers and just trading commission given that they're reading back after 12 months.

MR HARRIS: All right. Do brokers.

DR KING: All right, very quickly, you've got three aggregators. You're aware of our recommendation. Happy to shout about that. But the other path that we were looking at is the way that brokers are currently paid. You've mentioned that you're planning to ring them back after 12 months to check on whether they're happy with product or what else you can do for them.

MR CAHILL: Yes.

DR KING: If we ask brokers and their representatives why they need to receive trail commissions, they claim that it's necessary for ongoing engagement with the customer, but quite frankly that doesn't seem to make a great deal of logical sense that you're guaranteed a payment whether you contact the customer or not, and in fact there's an incentive there not to contact the customer for a marginally better product because, you know, if you turn the customer to a marginally better product, yes, you gain a new - it's a different lender. You gain a new upfront fee, but of course you're losing the trail commission on the existing product.

So your views on the way that brokers, and particularly in your situation, the way that brokers are remunerated, if you think they should be remunerated.

MR CAHILL: So this is a complex question with many variables and I've spent a long time working in and around the broking industry. So I think firstly, just in relation to now, we have three aggregators which is quite different from some of the franchise models in the marketplace, so none of the brokers who aggregate under our three brands are employed by National Australia Bank, so quite a different model to the - - -

DR KING: The main type of model.

MR CAHILL: No, or quite different, for example, for mortgage choice or Aussie home loans. So we have the three aggregation businesses. The question in terms of best interest, for example, which I know has - is one of your recommendations, we would always say brokers need to act in the interests of customers first. I think in relation to the question of best interest, one of the - the question that I have is, how would you actually validate what constitutes best interest? Is it price, is it other factors and how would you work that through?

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So I think the idea of requiring brokers to put their customers' interests first is appropriate, and I think the vast majority of brokers within Australia would absolutely argue that they do put their customers first. I know the industry is having a number of discussions about this in terms of how can they raise the bar from where they are today and how can they continue to ensure that customers benefit and that brokers are putting those customers' interests first.

In relation to the remuneration, I think this is the question - one of those questions around upfront commission versus trail. If there was an upfront commission only then you may say, to your point, is, would there be an economic driver for a broker to put the customer into a new product to receive the new commission. If there was a trail only, you may say the broker would win the customer and then they'd just go and try and win another new customer to build their ongoing trail book. So that's the pure economic argument, but the fact is, we, within NAB, absolutely expect brokers in relation to receiving a trail commission to have an ongoing relationship with their customers, and they should be talking to those customers on a regular basis throughout the time that they're receiving a trail commission, and Anthony Waldron, who runs our broking business, he's an absolute - he's absolutely working through how can we ensure that is taking place; what are the conversations that need to happen; and how might we think about the relationship with brokers.

But personally, I think brokers within Australia, they are a force for good. I think they, to your point earlier, they - when they came into the marketplace you actually saw - absolutely saw a concentration of NIM. I think they do offer a wide variety of product and they do allow smaller lenders who don't necessarily have large physical established networks to be able to distribute their product.

One of the things I would say is, if you look around the world today, and in Australia, the vast majority of mortgages are still sold on a face-to-face basis. There is still a conversation and a face-to-face conversation with a customer. The digital origination of mortgages is still very immature compared to what you might consider to be a simple product such as a transaction account, personal loan, credit card. That may well change over time and you may see more of that product being originated through digital channels, but physical channels at the moment in terms of the ability for a customer to sit down and have a conversation with somebody is still the predominant way that that product is distributed around the world, not just Australia. So I do think brokers play an important role in the marketplace.

DR KING: The hardest thing for us to accept at face value, the statement that the vast majority of brokers persist despite pay - well, despite the payment of trailing commissions to act in a customer's best interests is the statement the brokers themselves make or their leadership make that says this payment is to stop churn and yet churn is the competitive opportunity potentially for a customer. So I mean, it's almost like confessing the conflict, and no way when you're dealing with it, absent some duty of care, and it almost seems impossible to resist. In fact most of the presenters that have come along have said to us in

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one form or another they're sort of pretty happy with the idea of a duty of care generally speaking as long as it applies to not just bank-owned or controlled broker - - -

MR CAHILL: Yes, I absolutely see that, and I think to your point, personally I'd be happy to see a more structured agreement requirement put in place. I think how that would play out, how it would be structured, how it would be implemented, how it would be tested, that's the area I would like to have a greater understanding of.

DR KING: Yes. No, I would think, as we said in the draft - it's only a paragraph, but it was a deliberately written paragraph inside the draft report, you know, this could have been done probably by a contract originally and might have been a better way - because you can design a contract, you see, to balance the competition. What occurs in someone's head between, you know, even if I am employed, directly employed by the bank, but I have to act in the customer's interests.

On the one hand, you know, we have these different incentive payment structures and then if I'm not, if I'm an independent broker but I'm still trying to build up my business and the trailing commission is a bit part of my ongoing value of my business, you know, these things are possibly, or all of those are possibly better managed by a contractual arrangement, but as we say, we're not in the business - can't recommend somebody on how they run their business. So we look at the regulated option because it's the most evident thing from the point of view of the public policy.

But it is a very interesting area and one that I think is going to be addressed regardless of whether it's done through our report or through other mechanisms. It looks pretty much like it's going to be addressed. We should ask about securitisation.

MR HARRIS: Yes, I notice the time actually. So do you want to ask or do you want to - - -

DR KING: Well, you know, because you're anticipating - although we have a big interest in this and you've volunteered it in this area. You are a leader in this area, so we sort of reserve this almost for you because we thought we'd get the best answers from you. So to what degree - so we had funding dried up post GFC. The securitisation market obviously effectively collapsed at that stage except for the Government intervention as you noted.

It has come back to some degree although at least from our outside view it doesn't seem to be a competitive force but it certainly was when, you know, Aussie and RAMS first started up in the 90s. We would be very interested in your views in where is securitisation going and your role in dividing the warehouse funding if needed of the securitisation. How difficult is that now under the current stability regime, the regulatory regime that you face? Could that be improved? Could there be more incentives provided, or could it be easier for you to provide warehouse funding to be able to help that sector to - - -

MR CAHILL: Shaun can talk about this for three hours on just - - -

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DR KING: Yes, yes, yes.

MR HARRIS: We thought you would be it, so we're up for advice on this, and we're not going to presume that this is, you know, a business where the larger banks control this channel in order to manage non-banks. We're not going to presume that because they don't presume that. We've discussed it - - -

MR CAHILL: This is actually an important part of our bank. It's an area where we are very successful. Shaun can talk about the total issue and facilities and health of the market, so Shaun, why don't you touch on some of those?

MR DOOLEY: Yes, so as I said before, so all participants need viable funding models and the RMBS is important, market is an important part of ensuring that we have viable funding models.

2017 was a record year for securitisation, the most securitisation that we've seen since 2007, pre-GFC, 35.7 billion. Now, to put that into context in 2008 there was about 7 billion done and most of that was really by the Big Four. In 2013 it was about 25 billion, so we're seeing a significant ramp up of that. NAB is a leader in arranging deals. We were the leader range from 17 out of the 23 transactions done in 2017 and we were a joint leading manager on 23 of the 25 transactions, so we see ourselves as the leader.

And we arrange transactions for many counterparts. Some are smaller banks, some are non-bank ADIs. Some of those, in many cases, are direct competitors to parts of our business, and so we can talk about that in some detail, but it's important that we continue to provide credit in the form of warehousing, structuring, credit, due diligence, but out of that is increased liquidity and depth in bond markets which is important to all of us in terms of funding but it's also important to provide product to investors, so we have investors on the other side, institutional investors who are looking to take exposure to credit, and high quality credit and that's where the securitisation market falls in there. It's intermediating between the needs of the ADIs who need the funding to provide to their customers, and the investment requirements of large funds, and bank balance sheets. We also buy paper as well, as part of our investment requirements ourselves.

The market has changed a lot, so the pre-GFC/post-GFC, the number of participants and the character of the participants has changed a lot, and what I mean by that is, we saw a lot of buyers in the pre-GFC securitisation market that were the ones that were probably caught up the most in the turmoil in the northern hemisphere, so they would be what we call conduits or construction investment vehicles, and so were actually providing liquidity into the market at that time. They faced their own liquidity crisis, and therefore stopped buying in the marketplace. So people that were buying in those days are very different from the participants that are buying these days. So they're very different markets.

The other issue is that you had a number of international banks that were active in providing warehouse facilities. Pre-GFC they'd actually left Australia and they left Australia for

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reasons not connected to Australia, but really they were retreating back to their home bases, and so we saw the providers of credit and buyers of credit disappear, and that led to effectively that shut down in the marketplace.

We saw a number of months through 2008 where there was virtually no activity at all. We did see some action taken by the Government through the AOFM to provide some liquidity into that market. They still own some of those assets and they're still selling some of those assets today. We see that our role is to continue, as I say, to provide credit in the form of warehouses and distribution of structuring.

The fact that last year was a record year I think indicates that conditions have certainly improved and you need the whole end-to-end process to be working effectively for those strong market conditions to prevail. There have been changes to the regulatory rules around securitisation, and they've had different impacts on different parts of the market depending on whether you're an issuer yourself, and so we're both an issuer and an arranger, and it changes the cost, particularly for the provision of warehouse facilities.

So I think there is an opportunity for a discussion about what do we really want to achieve out of the securitisation market in Australia, and what are the things that we can do to continue to promote liquidity and participation in the marketplace, and again that's probably a discussion with the APRA around their attempt, but it's an important market for us. It's one we take pride in our leadership and we'll continue to support that market.

MR CAHILL: I think one area that you might be interested in, so we often talk about, how do we generate greater depth within Australia, so when you think about the size of superannuation savings pool now, superannuation savings pool is predominantly weighted towards equities. So we believe there can be a far greater depth in the domestic market in terms of those pools taking out debt that's issued within Australia. So that is an area where we the ink you get potentially more competitive funding. There is a huge form of liquidity there. How do we start to bring very significant, very substantial savings pool to bear where that marketing funding can take place, and ultimately that can lead to greater market depth and therefore better pricing.

MR HARRIS: Yes, we seem to have a very thin corporate bond market - - -

MR CAHILL: Yes.

MR HARRIS: - - - in Australia by comparison with other countries.

MR CAHILL: Yes.

MR HARRIS: And we've asked this - it came up on our infrastructure inquiry.

MR CAHILL: Yes.

MR HARRIS: It came up in superannuation funds and their investment approach.

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MR CAHILL: Very similar.

MR HARRIS: And the same deal. Well, we couldn't get a straight answer from the Treasury as to why this was.

MR CAHILL: No.

MR HARRIS: No one seemed to have a good - - -

MR CAHILL: We think there's absolutely an opportunity there for all participants in the market and there can be greater efficiencies generated if we can actually work through, how do we access that; how do we ensure that the assets are seen as attractive by those buyers.

MR HARRIS: And so it becomes quite important potentially not to kill this securitisation development off again by seeing it just as a, you know, a non-bank threat to the stability of the banking system, but to recognise that it's more than that. It's a nascent development of a set of buyers who then might be convinced to go and buy other kinds of corporate debt.

MR CAHILL: It's an important part of our funding profile as well.

MR DOOLEY: And we would encourage the continued development of that market. We think it's important for us in many ways, but also, you know, the depth of liquidity in the marketplace here will help funding for all players, including ourselves.

I think the - there is definitely a structural challenge around where super funds invest their money and where we like to see that over time. It's probably more into fixed income than it is today, but that's - - -

MR HARRIS: But that's what they were asking.

MR DOOLEY: Yes.

MR HARRIS: - - - and they were saying, otherwise, no, we've got to go offshore and take the exchange rate with us.

MR DOOLEY: Yes, and we're happy to talk to them.

MR HARRIS: That's right, but then I think - yes, so effectively what this is - - -

MR DOOLEY: And that's why this matters.

MR HARRIS: It comes back through the way the banks, so I think it's also looking at how super funds are measured, how they're measured and how they measure their own performance and how the consultants measure the performance of the super funds. There are a number of aspects there that we could look to - - -

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MR DOOLEY: And emphasis on the need for liquidity.

MR HARRIS: Yes. Anyway in the exchanges - - -

MR DOOLEY: And more interest in the market to build more liquidity.

MR HARRIS: In the exchanges that have probably occurred between you and the regulator, more than they will occur with us, this seems to be tremendously important. It's not just about the interaction of the non-ADI sector with the ADI sector. It's got to be influence and it's an overall question of, do we have a, you know, what I might call differentiated forms of corporate borrowing in as.

MR CAHILL: Our view is there are multiple participants that need to come together to work this through, but it is absolutely an opportunity for the overall economy. There's a huge depth of liquidity available and how do we ensure that we present the assets in an appropriate form where they can take those on.

MR DOOLEY: But it's definitely heading in the right direction, I mean, last year being a record year as we said, but we'd like to see it continue to develop more rapidly.

MR HARRIS: We may write this up a little bit more, although again it's entirely tangential to the competition report, but sometimes when you find something is tangentially important we'll still - - -

MR DOOLEY: But we think it's key because in order to be competitive you have to have a ...(indistinct)... anyway.

MR HARRIS: No, no. Yes, quite, it's just that the thematic of running it on beyond the nature of the focus on non-ADI competition, it does go further than that.

Anyway, I would like to thank you guys very much for taking the time and trouble to come along here today for your continued participation and inquiry and for the possibility that we might have a bit of a further exchange with you on some of that data, rather than the discussion we had earlier about the actual cost of funds and what might we be able to further add to our report.

Anyway, otherwise, thank you very much for your time.

MR CAHILL: No, thank you.

MR DOOLEY: Thanks very much.

DR KING: Thanks a lot.

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MR HARRIS: For the hardened souls who managed to make it entirely through the two days, I want to congratulate you. I can see at least one face that was here - - -

DR KING: A couple.

MR HARRIS: - - - 100 per cent of the time. Well, the secretariat's - - -

DR KING: Cut down by a couple of people.

MR HARRIS: I know.

DR KING: Headed off.

MR HARRIS: Running for the planes even though this chairman's banging on up here. So I will now formally close this hearing in Sydney and just advise anybody who's really a sucker for punishment that we're back doing this in Melbourne next week. Thank you very much.

ADJOURNED AT 4.10 PM UNTIL
MONDAY, 5 MARCH 2018 10.00 AM

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Australian Government
Productivity Commission

PRODUCTIVITY COMMISSION

INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

MR P HARRIS, Presiding Commissioner
DR S KING, Commissioner
MS J ABRAMSON, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT 530 COLLINS STREET, MELBOURNE
ON MONDAY, 5 MARCH 2018 AT 10.47 AM

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INDEX

	Page
SUNCORP GROUP MR DAVID CARTER	**181-200**
LATERAL ECONOMICS MR NICHOLAS GRUEN	**200-214**
CONSUMER ACTION LAW CENTRE MR GERARD BRODY	**214-229**
FINANCE BROKERS ASSOCIATION AUSTRALIA MR PETER WHITE	**229-250**
MS MARIA RIGONI	**250-262**

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MR HARRIS: So I think I'm going to first check that we have sound and it's going okay. Sound's happy. And we have vision and everyone's happy on vision. So I'm going to open the Melbourne hearings for this inquiry of the Australian Financial System or Competition in the Australian Financial System. As people will know, we released a draft report on this in early February and we're due to offer the government a final report by 1 July. I should acknowledge we meet today on the traditional lands of the Wurundjeri people of the Kulin nation and I pay my respect to their elders past and present.

I'm Peter Harris, I'm the presiding commissioner and chairman of the Productivity Commission and I have with me Julie Abramson and Stephen King who are the other commissioners of the inquiry. Finance is so big we need three of us. So the purpose of the hearings today will be to cover off comments received from submitters and from other registered parties registered today on our draft report. Today's hearings follow hearings we had in Sydney last week. We conduct these hearings in a reasonably informal manner, but I want to remind participants first that a transcript is being taken, so, second, try not to be defamatory; we will interrupt you if you're getting towards the point of defamation. We surprisingly had that happen once or twice before, or getting close to it.

And also I should remind participants that although they're not on oath that Productivity Commission legislation does require participants in hearings to be truthful in their remarks. As I said a little earlier, we are livestreaming so there will be people taking down comments outside. We don't prevent anyone from in the room from participating via various social media arrangements, but we do not allow photography other than by prior permission or indeed TV broadcasting by prior permission but today we don't seem to have that, so I don't think it'll probably matter terribly much. There will be a transcript provided on our website in a week or so of these remarks for people who are looking for it in hardcopy.

And then finally I have to tell you, under OH&S arrangements, if there is, an alarm system, you'll be able to observe us following the alarm system and proceeding via the green exit signs and taking advice of wardens and assembling supposedly in Enterprise Park down the road there, but I'm sure half of you will go for coffee somewhere else more easily. Now, let's hope that the alarm system doesn't sound. And our first person this morning I think is Suncorp. Could you identify yourself, please, for the court?

MR CARTER: Yes, thank you, David Carter, the CEO of banking and wealth at Suncorp Group.

MR HARRIS: David, do you have some opening remarks to make?

MR CARTER: If I may, thank you. Firstly, I'd like to thank the commissioners for the opportunity to appear at today's hearing. Suncorp strongly supports the Productivity Commission's work in relation to competition as we see the enquiry's an important opportunity to initiate reforms which will ultimately drive better our customers. In our view, one of the better ways to deliver this is by improving the ability of all banking institutions to compete on a level playing field. The Commission's draft report is a

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comprehensive document which identifies a large number of potential issues and possible improvements.

Many of the impediments to competition that we raised through our initial submission have been addressed in the draft report. We are therefore largely supportive of the Productivity Commission's proposals and welcome the opportunity to consult further on this important topic. Before turning to some key issues for smaller banks, like Suncorp, I would also like to take a moment to acknowledge the strengths of Australia's financial system. While we see opportunities for improvement, our financial system is far from dysfunctional and has largely operated well in serving the interests of all Australians. Australia's regulators have ensured that financial stability has been maintained and this focus undoubtedly positioned the country solidly through the global financial crisis.

Customers have been safe in the knowledge that their hard-earned money is protected by responsible banks operating within a well-functioning prudential framework. While the major banks do hold a dominant position in the market, having four strong and globally recognised banks operating in Australia is also a strength for our system and one that in many regards has benefited our economy. As a net capital importer, access to international funding markets is essential, and the scale and profile of our major banks improves their ability to gain access to these markets while simultaneously freeing up access to domestic markets for smaller banks.

In many regards, this equation strikes a good balance for all parties, and we should be weary of imposing any significant changes on these market structures given the risk of unintended consequences. It's a symbiotic relationship that may very well help to insulate Australia from future shocks and disruptions in the global economy. However, there are several areas where we continue to believe the prudential and regulatory settings could be adjusted to enable smaller banks to compete more fairly against the major banks. In particular, we continue to hold concerns about funding costs, risk weights, macroprudential interventions and the disproportionate burden of regulations on small institutions.

We seek reforms in these areas as we believe positive changes will allow smaller banks to more effectively bring tension to the sector which will inevitable spur greater innovation, choice and deliver better outcomes for all customers. APRA's recent paper on implementing Basel contains some encouraging proposals around risk weights including potential reductions for some low-risk residential mortgages held by standardised ADIs. However, uncertainty remains around final calibrations, particularly for some IRB or internal ratings-based settlements. Suncorp has already made a significant investment in developing the risk models needed to achieve IRB accreditation and we would not want to be penalised for being a regional bank leader in this area.

Risk weights have an impact on decisions that banks make about lending products, and it is important the settings are calibrated in a way that does not undermine consumer outcomes. Macroprudential caps on investor and interest-only lending continue to distort competitive tensions in lending markets and have allowed those with the largest investor and interest-only portfolios to use their pricing power in these areas to offset particularly

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sharp pricing on lower risk owner-occupied principal-and-interest loans. We welcome the Productivity Commission's findings in the draft report that banks' ability to compete on price have been constrained significantly by macroprudential interventions. While we maintain concerns about the caps, we have been encouraged by APRA's recent comment that the investor cap was potentially becoming redundant.

The investor cap has already had a significant impact on aggregate lending levels across the industry and the other measures introduced by APRA and ASIC have addressed regulator concerns around lending standards. As such, we believe the investor cap is no longer needed and that its removal will once again allow banks to compete for this type of lending. We continue to observe the non-ADI sector has benefited from macroprudential caps and has been able to fill some of the gap created by the reduction in credit to investor/ interest-only, and we continue to observe that that sector is subject to much lower capital and regulatory requirements and has enjoyed significant growth and commensurate return.

Further, the major banks continue to hold significant funding cost advantage cost advantage over their smaller rivals. While their size and scale will always give them a price advantage in funding markets, we believe that the three notch credit uprating upgrade they received due to the perception of government support provides them with an additional unfair advantage on top of this. It does beg the question as to how that can be good for customers. Smaller banks' ability to compete on price ultimately is driven by their ability to source capital to support growth in both the retail mortgage and small business lending markets, which is typically the focus of those banks.

The owners of capital require suitable return or return on equity. The return is influenced by funding costs on the revenue side and by the costs of running the business on the expense side. The equity is influenced by the risk weights used to determine capital requirements. Large banks have scale advantage and this is a natural economic outcome, however this has been compounded by increased regulatory activity and the cost associated which is likely disproportionate for smaller banks. Post-GFC, ROEs in smaller banks have averaged closer to half those in the large banks.

In order to witness greater price competition it would seem necessary to first deliver a return on equity that can attract incremental capital to the smaller banks. Finally I would like to emphasise that competition in the banking sector is about far more than price competition. While price will always be an important consideration for many customers, other important factors such as product features, customer service and the reputation of the institution itself are often highly relevant. What is important is that customers are empowered to choose a product or service that provides them with a combination of price and other factors that best meet their needs.

In this regard we believe that the broker sector continues to play an important and valuable role providing customers with additional choice and service which is often more than just about simply identifying the cheapest product. Thank you again for the opportunity to be here today and I welcome your questions.

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MR HARRIS: Thanks. So can I start with return on equity? You may have observed last week in Sydney a number of the larger banks persisted in arguing that because return on equity had fallen in recent times, somehow that was an indicator that competitiveness was increasing, that seemed to be the implication. And we had some doubts about that and we had observed - or I observed at one point that we did start out with the banking analysts themselves to ask, "What are the preferred logical measures here of profitability and other performance in markets?"

So let me just ask you this in terms of return on equity: equity's been increased by regulators post the GFC; if there's been, roughly speaking - not true in the case of smaller banks but large banks it is roughly true - no real change to net interest margins nor any other alternative big increase in costs, return on equity falls simply because of the action of the regulator, not actually because of anything that's happened in a competitive sense in the marketplace. Would that be correct or have I sort of broadly misunderstood something here?

MR CARTER: No. I think in the absence of the R changing much then if E goes up, ROE must fall. I guess the key question is whether capital remains attracted to a lower return on equity, and one would argue in the current low-yield environment double-digit ROEs or mid-teen ROEs are a relatively attractive return for what is a relatively safe industry.

MR HARRIS: Yes, yes, so - I mean, it's not - we wouldn't dispute that ROE is of relevance, it's more a question of it wouldn't be necessarily a primary way of judging competitiveness in a market. Certainly - anyway, that's the perception I hold currently. I'd be happy if anyone else who also is going to contribute submissions - he says talking with a broadcast - who wants to dispute this, I'd be very interested in getting some better information on that as well. Stephen, do you want to ask any - - -

DR KING: Yes, can I - I just wanted to clarify, David, you mentioned the IRB approach and you were partly down that route. It wasn't quite clear to me, are you concerned - what are your concerns in changing or in - just on Basel recommendations or the direction that in APRA's discussion papers the risk weights are going?

MR CARTER: Yes, I see a clear intention from the regulator in APRA to try and move the risk weights closer together. It's very clear in the proposals what the implications for standardised banks are, in respect of small business, a slight improvement in risk weights which should be positive for returns in that segment and/or competition. In the housing side I see in a standardised - some movement to try and improve the competitiveness for highest quality mortgages with a new minimum, if you like, of 20 per cent. Large banks can still write the best quality mortgages at a much smaller number, potentially half the capital, so the marginal deployment of your funds is potentially still more lucrative as an advanced bank.

What I also see is the proposal for investor and interest-only lending: a 50 per cent loading designed to recognise that those loans over time show high-risk characteristics, which is probably true, they probably do show high-risk characteristics. However, in the ratings-

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based approach I see a correlation factor change which equates to something in the order of 22 per cent loading for doing investor and interest-only, which again would seem to recreate a little bit of an imbalance and make it relatively more attractive, all things being equal for the advanced banks, being the four large banks, to write investor and interest-only lending.

So what we need to now see is some of the detail, which in fairness to APRA they have said they need to work through in order to recalibrate their unquestionably strong outcomes by asset class. The challenge for us all will be the residential mortgage and small business lending segments which is where, you know, one would hope most of the small banks are focusing their effort, being relatively lower risk, easier, less complex lending.

The challenge will be if that is - if in recalibrating somehow that recreates, you know, mismatching the playing field again. So, for example, APRA could choose to calibrate in the corporate end of the market, which will not have much impact in terms of the smaller players.

If I may then, just as Suncorp, we and probably at least one other have spent several years now building the models and taking a path towards advanced accreditation, and whilst we find our dialogue with APRA very constructive, I would say that significant changes to the basis for models and/or the models themselves tends to cause us to have to re-spend an amount of time and money. Existing advanced banks do not lose their accreditation whilst they recalibrate, but a bank who has not achieved it may find that they have to re-serve some time where their models are stable before they can achieve accreditation.

DR KING: Yes. Just to follow up on that: so internally, when you make that decision whether to continue to pursue accreditation ...(indistinct)... bank or not, it's a significant investment. Presumably the greater the difference in risk weights, particularly on that residential and SME sector, the bigger the difference in the rates the more incentive Suncorp has to - - -

MR CARTER: Yes.

DR KING: - - - make that investment, because it will see a return on that investment.

MR CARTER: Yes.

DR KING: So I get worried when people say, "You've got to read" - and it's been suggested by previous enquiries the rates be brought closer together for competition reasons when there's an investment behind those ...(indistinct)...

MR CARTER: So we believe there should be an incentive to be an advanced bank and we as a bank would certainly argue that we have benefited from the investment and better understand the risks in the portfolio and has led us to make better decisions which will, you know, contribute to the stability of the system.

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The advantage of advanced in our — from where we sit at the moment — is in your future origination which should enable you to grow and therefore compete more assertively in the market. There is a one-off — as far as we can see at the moment — a one-off impact when you convert, if that makes sense, and therefore a rational investor, a rational board would want to see what the payback period looks like if one had to, for example, increase capital levels initially.

Now, we don't perceive there is a reduction in capital on conversion to come, and that is partly a reflection of lots of change in requirements over time and unquestionably strong, but whether there is a significant or small increase on conversion will depend somewhat on the finalisation of the paper that issues in February from APRA.

MR HARRIS: So just sticking with risk weights then - you're about to head off?

UNIDENTIFIED SPEAKER: Yes.

MR HARRIS: - - - that attitude on risk weights that we tried to express in the draft report was to search for areas where risk-weighting could be varied in a way that might actually reduce costs rather than increase them, and there seems to have been for, you know, I'm sure quite rational reasons, but nevertheless that the pressure prior to us putting in a draft report always seemingly being towards - if there was a problem with risk weights then we'd want to raise them because that would make us even safer. And it doesn't seem to be a - you know, an approach that recognises sufficiently the impact on competition that can come from raising prices; I mean, at the margin the potential borrower is dissuaded and activity is reduced, and so you've got less demand in a marketplace and consequently it is less demanding.

MR CARTER: Yes.

MR HARRIS: Less competitive pressure from the consumer side, anyway. So it did seem a little imbalanced. So we had two risk weighting propositions in our draft report: one, to propose gradations in the case of homebuyers, and therefore, you know, its variability in that area, and the other in relation to small business lending. Do you have a comment at all on either of those?

MR CARTER: Yes, maybe I will and then maybe just to start at a high level. I think the purpose of the risk weights was to encourage banks to focus their risk taking on the lower risk activity, and it has been so effective in this country that everyone has focused on what was the lowest-risk activity, which was residential housing, but unfortunately at a system level that has moved a lot of capital into residential housing and created some - arguably some imbalances, and whether that manifests in house prices or in expansion and debt levels in households or whatever is for others who are more trained in economics than me to opine on, but - now, risk weights can therefore be being used for two purposes.

One is to accurately measure the risk to the system and ensure capital levels are appropriate to protect the depositors in the institutions, which at the end of the day is the primary

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purpose of the prudential regulator; the other is they can be also used to influence where the marginal dollar of capital is deployed and potentially help support taking heat out of housing markets and certain cities. So I think at a macro level one has to be clear on what the purpose of the risk weights and adjustments is going to be for. We see the proposals in the paper that APRA issued recently for small business as being positive for small business lending and reduction broadly from 100 per cent risk weights to 85 per cent, all things being equal reduces the amount of the E in the ROE equation so that should enable slightly greater competition in terms of pricing and margin.

On the residential side, again, I think there's a dilemma in managing the systemic risk of having too much capital targeting one particular asset class and discouraging over-exuberance in perhaps that asset class because the returns are too attractive. So that's an interesting tension for people to have to try and manage particularly compounded at the moment by very, very low interest rates; and history shows when interest rates are very low and creditors freely available, such as would be encouraged by low capital ratios, asset prices tend to increase rapidly, and one could argue we have seen that particularly in Sydney and Melbourne over the last 36 months.

MR HARRIS: Yes. I guess the reason we're interested in this though is this tension that APRA has to manage between system stability objectives of risk weighting and supposedly impact on competition. The question is, we spend our time trying to look for these opportunities that might be less evident, perhaps, to a regulator that has such a clear-eyed focus on stability and unquestionably strong.

There seem to be opportunities there, and they also seem to be opportunities that might allow these risk-weighting gradations to occur, as I said, that - differences in loan to valuation ratio could potentially be expressed in slightly different risk weightings without, I would have thought - as long as you're calculating it reasonably wisely without damaging the system stability because they're well-judged based around additional information, consumer credit is now going to be improved substantially by sharing information across a financial system in a way it hasn't been before, artificial intelligence enables people now to more accurately focus on different classes - - -

MR CARTER: Yes.

MR HARRIS: - - - of borrowers. The small to medium enterprise, a shift we proposed does actually in part logically have a foundation in utilisation of those sorts of techniques, greater knowledge of different classes of borrower rather than just treating a borrower as a small enterprise and therefore for all small enterprises it's the same, the only question is: do they have a house or not? In which case they get one kind of loan if they get a house, another kind of loan or maybe no loan at all if they haven't got a house.

This ability to wisely judge information that is available in a financial system, at least in those areas that we concentrated on did not seem to be well-reflected in the risk weights. Now, is that ever going to come out in these APRA papers, do you think?

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MR CARTER: I think the IRB model does enable one to do that and discriminate risk at a much more granular level. I think that's as applicable in small business as it is in residential mortgages. I think loan-to-value ratios, which is what APRA is sort of moving to propose now, are a useful tool, they are a bit crude, they do not go to the credit - underlying credit quality of the borrower, merely the equity they have in the property which - and look, there is a correlation between equity and credit worthiness, but it is a bit imperfect.

Comprehensive credit reporting which will - and more open data and more sharing of people's credit histories will generally be a positive in terms of discriminating risk; having said that, there is a valid concern, I think, about vulnerable people and the disadvantaged - financially disadvantaged people in the community about comprehensive credit reporting potentially disadvantaging them further and making it harder for them to access mainstream credit which is something, as a society, I think it would be important for us to mitigate, much like we use social welfare to mitigate people who suffer disability and other things in the country.

MS ABRAMSON: Peter, can I just - David can I just follow up on the SME lending, and I apologise if I haven't got this quite straight, but if with the change in the weight it frees up more capital to be lent to SMEs, from what I understood you to be saying though, you would still be assessing each risk differently, so it may not necessarily change the need to have the house on the line because it's an individual credit decision. Did I understand you correctly?

MR CARTER: Yes. I think - we're starting to touch on an area which is challenging because we have multiple, potentially conflicting at some times, regulators and others in operation here, so as you've seen there's a significant political and public motivation to increase the level of protection for borrowers in a small business, and you know, my view, make that more consistent with consumer credit. If we - "responsible lending practices" means that if we - you know, we only looked at people's security on offer we would get ourselves into a lot of trouble with at least one regulator.

And so we need to make sure we're not blind to the underlying credit quality of the borrower. I think that small business credit will continue to open up for borrowers, and in our case we have spent a lot of time trying to understand historical risk selection and what makes - what are the characteristics of good borrowers? The last thing we ever want to do is realise someone's house or commercial property or any other security. For that matter it's - there are a whole host of reasons why we don't want to do that, and I think the availability of data, the technology which produces the cost to serve at scale as much as anything will enable that to evolve.

We've also seen new competition enter the market in some of the fintechs, and whilst they are tending to operate at the - not in the mainstream market, they are bringing technology and other solutions to customers and a customer experience there that forces the incumbents to act and respond.

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MS ABRAMSON: Thank you.

MR CARTER: Yes.

DR KING: One final one from me before - - -

MR HARRIS: No, you - and then you move on, yes.

DR KING: Yes. You mentioned the IRB model and the high level of sophisticated ability to have more nuanced understanding of the risks associated with, say, a residential mortgage. At the same time, regulation has moved to, in a sense, blunt that by putting floors on, increasing the floors and so on.

MR CARTER: Yes.

DR KING: How should we think about that what seems to be - you know, invest in a model that allows you to come up with - use more information and then regulation which says, "Well, whilst you've done all of that, now ignore that because there's a floor in there." How should we think about that?

MR CARTER: It goes back to my earlier point, I think. Risk weights can be used for a couple of purposes potentially, and maybe APRA's better placed to answer than me which purpose it's being used for, but in fairness people have asked APRA to try and level the playing field, and I think the use of floors, for example, is one way that is assisting the standardised banks to try and lift the average risk weighting on the mortgage portfolios of the IRB banks rather than perhaps where they were.

I think also to make it relatively less attractive to deploy so much capital into the residential housing market may be another objective in raising some floors, and then I'm sure there'll be another argument that says, "Actually, it's - prevention's better than cure, and because we're nervous that people haven't quite got this right, we're worried about a shock to the system and so we'll put capital in ahead of that potentially occurring: (a) to take some heat out; and (b) to make sure there's protection there."

DR KING: Do you see there's - I mean, you know, the extra capital has a cost, the cost has to be paid by someone - - -

MR CARTER: Yes.

DR KING: - - - do you see that as being ...(indistinct)... by the customers? I mean, are customers made worse off by these floors?

MR CARTER: I certainly think - there's only really - well, there's three stakeholders who are going to wear the cost of more capital: one is the shareholder in terms of return, and we have properly seen ROEs start to reduce in this country; two is the customer through paying high rates, and we've seen relatively higher rates on interest earning and investor

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lending, which as it turns out is where we've seen APRA target particularly with the changes, and the third is with your people, and that is we see less people working in banks going forward as people look to get cost out to try and offset the need for the return on the capital. So we are seeing that burden - if that's the right language - being shared as opposed to being directly worn by any one of those stakeholder groups.

DR KING: Just on mortgage brokers, just to change direction a bit - sorry I don't have the numbers off the top of my head - what's the sort of - the split in terms of finding home products through Suncorp in terms of brokers versus branches?

MR CARTER: Yes, we would say, you know, medium-term average is over 70, perhaps 75 per cent, and that is driven by a couple of factors: one is that we have the predominance of our physical presence is in Queensland, which is about 18 per cent of the mortgage market.

Two thirds of the mortgage market is in New South Wales and Victoria, and so if one wants to participate in that market for various reasons, i.e. to grow or to diversify risk, the mortgage broking channel offers us a relatively lower-cost entry into the market. We apply exactly the same lending standards to the assessment of that and our history suggests that the default risk on broker mortgages is roughly the same as mortgages we source ourselves, so we satisfied ourselves on that.

There is a marginally higher operating risk for information that we are given to assess on, we have to run the risk of a little bit - and maybe we need to test it a bit more so - but generally we have a very good relationship with the broker channel and we think it brings us more opportunity rather than less, particularly in places where we don't have a big physical presence.

DR KING: Okay. So, I mean, Suncorp as an institution that's growing, you face the decisions, do you open branches?

MR CARTER: Yes.

DR KING: Do you rely just on brokers in the particular area? Internally, how do you make that decision? How do you decide when - you know, is it the case that you tend to use brokers to build up a critical market mass in an area and then decide to open a branch, or are brokers just cheaper and a better way of running mortgages than branches or vice versa, are the branch - - -

MR CARTER: Yes. We don't sort of trade one off for the other in terms of that channel selection, I guess. We start with looking at what the customer's preferences are and what the opportunities are in market, so most of the activity in branches - well, certainly (a) is in decline and (b) has typically been on the deposit gathering and transaction banking side rather than home lending and small business lending by volume of the activity. By value of activity, obviously lending activity individually as a transaction's a more valuable

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activity to an organisation such as ours than a single transaction to put a hundred dollars in or take a hundred dollars out.

We see increasingly customers are time poor and have - you know, there is no stereotypical customer anymore who works Monday to Friday 9 to 4.30 and can take time off to come and see the bank during business hours, so we see a greater demand for virtual lending services, so people have an increasing propensity to do it on ...(indistinct)... on Skype with one of our staff sitting remotely. They like to do things over the phone from time to time, they like to visit brokers. Our ...(indistinct)... are starting to see - although not really in home loans too much yet, the emergence of people willing to do it online, and we think all of those channels are important.

So our decision in terms of broker or branch is really more a decision about a broader range of channels. Do we invest in a digital online origination capability ahead of a branch or further investment in broker? Broker is very scalable very quickly. We have controls in place to make sure we are comfortable with the brokers we're accrediting, but other than that we can achieve the scale quickly through their aggregated groups and others and potentially only write one line a month in a particular area, which would never sustain a physical point of presence but enables us to diversify our risk. More than half our new loans are written outside of Queensland, and that has been the case for several years now.

MR CARTER: Yes, okay. So there isn't any sort of internal model where building up a market share in a particular part of Sydney then opening a branch, or something like that?

MR CARTER: We have used that in the past. Having said that again, customer behaviour continues to evolve and change, and so if I went back a decade, certainly two decades that was exactly how you would choose it, you'd identify a market you thought was attractive for whatever reason and you would set up a physical presence there. Customers don't always require a physical presence, some do, some segments do, some don't.

DR KING: On the reverse side, does that mean you're closing branches?

MR CARTER: We have reduced a number of stores, yes, and again, that is driven by changes in customer behaviour as much as - that's the primary driver full stop, actually. And the format of stores is changing as well.

DR KING: Okay. Just one more from me before passing back: your heavy reliance on mortgage brokers outside Queensland, brokers who are often owned - or the aggregators are often owned by your competitors - - -

MR CARTER: Yes.

DR KING: - - - sounds like a potentially dangerous business model where you're reliant on your competitors and in many ways on their good will to have those brokers write your mortgages. Do you see a risk? A risk seems obvious to me, very obvious.

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MR CARTER: Yes, it is, it's very - look, it is very obvious, it is very - - -

DR KING: And what can you do about it?

MR CARTER: - - - very obvious to me, I think nine of the 10 largest broker groups we deal with have at least some level of shareholding from one of our competitors if not complete ownership. We support greater transparency of ownership, both ownership of the underlying group or aggregator and also more disclosure on the provider of white label mortgage products, so mortgage loans that are branded to the aggregator which may be being funded by the owner of the aggregator, and so we think that would be important.

We do support the broker channel. I think the vast, vast majority of brokers are honest, ethical people who are running nice businesses who really care about their clients. There is always a risk of a small number of people who need to be moved out of that industry and dealt with as in any industry. But we think a little bit more transparency around the ownership structures, more transparency on who is providing the underlying white-label mortgages enabling consumers to be in a position to make an informed decision before they make that choice is key.

MR HARRIS: But how does ethics make you as a broker choose wisely between two competing loans of the same price, the same term? Surely in that circumstance the default is going to be to the owner.

MR CARTER: I can't speak for the brokers. I would say the other considerations would go to the underwriting, so some banks have more appetite or less appetite for certain things, whether it is investor lending, two-bedroom units, one-bedroom units, five-bedroom houses, whatever people are looking to do in terms of managing their risks. So, you know, sometimes the same price, same term but different underwriting will lead to one choice being far more obvious to the broker and the client.

Where I worry in where we have that potential conflict is where soft-dollar incentives or even hard-dollar incentives are in play, so either things like the fee for being part of the group being waived on white label or manufacturer's-own loans, that is clearly an incentive where the remuneration to the broker will be higher as a result, the net remuneration will be higher, the gross may be the same, or where there are other things: points, prizes, trips, whatever, involved - that is a risk in that environment. Now, that said, again I would say we are very dependent on that market, we work closely with the aggregators, and the people we work with generally are pretty good at managing that conflict from what we've seen.

MS ABRAMSON: David, can I ask you a question on best interest? You'll see in the report that - - -

MR CARTER: Yes.

MS ABRAMSON: - - - was in the case of aggregators ...(indistinct)... best-interest duty, but wouldn't it be - if there was a best-interest duty, wouldn't that mean that your products

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could have more likelihood of being before the client because it is ...(indistinct)... because you might actually have the product that is in the best interest, and it's not not unsuitable, which is a different test. So I'm interested in your views on that.

MR CARTER: Yes. Again, a number of the aggregators we deal with have a very broad menu, for what of a better word, on the approved list, maybe up to 27-28 different providers' loans. We find - and I would say this, I've worked in life insurance, the wealth management and the banking world and we have a general business as well and commercial - - -

MS ABRAMSON: About to ask you about some of your ...(indistinct)... insurance.

MR CARTER: - - - and, generally, my experience with intermediaries and brokers and advisors is the things that really shape their thinking are around the reputation and integrity of the supplier, the consistency of the underwriting approach, so I know - I'm pretty confident I know that my client is going to get dealt with a certain way and I won't waste my time over there with that - you know, those - that criteria. And the third one then is the service and the relationship I have. Price and the product itself tend to be close behind that, four or five, and they tend to become the most important things that the first three are missing.

You may say that sounds a bit - like it's not really in the best interest, but I think it is because, you know, the broker is trying to give their client the best possible experience and outcome as a professional, they don't want the client's time wasted, they want to make sure that they're not going to be surprised that they can - they're not going to be treated poorly, and then that the product is going to work for what the client is trying to achieve. So I think that can work.

MR HARRIS: It sort of sounds though a bit like that total observation that our report came out with at the start, that there is competition in quality of service but not so much in price.

MR CARTER: I would say today in the trenches it's pretty intense, particularly in owner-occupied P&I mortgages, and from time to time investor interest-only, depending on who has got capacity in their caps. And what we have seen is volatility or variability in appetite, particularly from a couple of the very large players, and when they come into market in investor/interest-only, it's very obvious, and when they go out of market for a period on those two, it's very obvious. But new - you know, pricing on owner-occupied home loans is very competitive at the moment, and generally speaking we cannot afford to be far away from the lowest price in market with the broker channel in order to achieve the outcomes we're trying to achieve from a business point of view.

MR HARRIS: In a point in time I don't dispute that, and you reference what's happening with investor home loans, and again I don't think we dispute point in time; there is always some highly competitive price activity.

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The question is, from our perspective, much more a structural one: what motivates the likelihood of competition in the sustainable fashion over a reasonable period, and your description of broker-preferences does - when you listed your hierarchy, my first reaction was that's pretty much a description of not just broking activity but generically what we tend to find in the markets that we've been examining which is, as I said, quite a lot of competitive activity and attempts at product differentiation around quality of service and technology and factors like that but far less emphasis around price, and the best argument we can find for that appears to be the implication that just as the broker apparently is judging, consumers are less interested in price than they are in quality of service. But there's no evidence for that, there's just the proposition that that's the way it goes in this market.

MR CARTER: I don't know what the basis for customers not chasing the last three or four basis points is, but I would agree that, in my experience, customers want - or consumers/customers want to be dealt with fairly. Their view on what is fair is not just shaped purely by price, and I think brokers are no different, and I think there are many industries that are the same, and, you know, to use an analogy that's got nothing to do with anything that's politically sensitive at the moment, a Toyota and a BMW both have four wheels and engines and seats, and they're probably both pretty safe motor vehicles, but some people are prepared to pay - - -

MS ABRAMSON: You made me think of the airbags thing.

MR CARTER: - - - two or three times - some people pay two or three times the price for a BMW over a Toyota, now that's their perception of value, whatever reason is motivating that behaviour I don't know, but that is a perception. It doesn't mean that one car is three times better than the other necessarily.

MR HARRIS: Yes. You mentioned this three-notch difference which comes up quite a lot in terms of a rating agency's differentiation. It's hard to imagine though a rating agency not looking at the scale and simply not offering an advantage because of that, in other words there is surely a limit to how far regulators are able to encourage - ratings agencies have a different view of "too big to fail". I mean, there is a logic which says - and it has been put to us by other participants in the course of the inquiry that says, "But surely the government or, you know - fill in the blank, whoever it is — the regulator is going to allow — fill in the blank - this particular regionally important financial institution to fail."

And therefore, you know - I guess the thing is, "We're all too big to fail therefore we should all have the same ratings coverage," but from a ratings agency perspective, surely they have every incentive to find a differentiation factor otherwise who wants advice from ratings agencies if every Australian bank is treated, you know, as too big to fail then there's no real business case for a ratings agency to be paid to do their job either. So surely they're going to find this, and it's a bit of a fool's errand for public policy to keep trying to alter that differentiation. Or am I being too harsh again?

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MR CARTER: No, we accept that there should be a reward for scale and quality, and we in fact received that ourselves. We issue at A+ even though our standalone bank rating is lower, and we issue at A+ because of the strength of the group, which is a bigger group housing a small bank. And that undoubtedly gives us access to markets, particularly offshore, that some of my regional peers have much less access to. It doesn't give me the same price though as the majors who without the too big to fail guarantee would be at a similar rating or lower.

Now, they probably would still get a better price because they issue more frequently, their issuances are far more liquid in the secondary market, so people can trade in and out, and people understand them more than they understand us, so that is the advantage they have and we accept that. We think, as others have suggested, either the whole system is too big to fail, and I think for the depositor in certain ...(indistinct)... bank here, they don't want to have the stress of thinking that their bank isn't going to survive and, you know, depositors haven't lost money in the Australian banking system for well over a century so - in the regulated sector, so I think that is a very strong track record and I doubt, if push came to shove, that would be allowed to happen.

And I note your comments that, you know, increasing the cost of funding to major banks by moving too big to fail wouldn't be good for the customer, normalising or equalising that would presumably be better. There is a second vehicle that is available, and that is through the covered bonds facility, so APRA and the RBA had provision for a covered bond which allows people to issue with the backing of the sovereign. We use it, not everyone has that vehicle in place. The majors have just a similar access to us, even though they already have the ability to access all other funding markets with too big to fail sitting behind them.

One could rebalance the allocation of the same amount of covered bond capacity in the system and give some more capacity to the smaller banks and that would enable some of them to access some of the advantages of the sovereign rating whilst recognising that the majors have more capacity, so I think too big to fail is not just about the price one pays, it is also about the accessibility. It's taken us five to six years to achieve the current pricing we have in the US markets and with Asian and indeed domestic investors; now, part of that will be idiosyncratic to us, part of that is the price of building a relationship and becoming an issuer who can then fill in all of the terms to enable the pricing curve to be accurately established by the market.

Too big to fail gives one a fairly quick - a much shorter path to the same curve which has an advantage. We are now getting pricing that if we had three years ago the funding that we took our for five years three years ago would have a better impact on our funding cost as at today. So they're the advantages I see. In fairness to our regulators, I don't think they committed the too big to fail idea to the ratings agencies, I think the ratings agencies chose to do that and - - -

MR HARRIS: That was really what I was trying to suggest.

MR CARTER: Yes, yes.

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MR HARRIS: In other words it's inevitable that they're going to find this differentiation for themselves despite any effort by regulators or another party to dispute it.

MR CARTER: I agree there'll always be a difference, it's just whether the quantum of the difference is reasonable or not. As I say, we have no concerns that we would pay a premium to a CBA or a Westpac for the same funding for the same term issued on the same day; the question is: what is a fair premium when you're issuing at A+?

MS ABRAMSON: Can I ask - - -

MR HARRIS: Yes, go.

MS ABRAMSON: Could I ask you, David, a bit about your insurance business? We've got a couple of recommendations that actually go to that. Maybe around transparency and prices. I'm happy if you want to respond in writing to that, but if you had something to say today that would be quite helpful.

MR CARTER: I may just have a general comment and then I would like the opportunity to respond in writing. It's not somewhere where I spend a lot of my time, to be honest.

MS ABRAMSON: No, I appreciate that.

MR CARTER: But we support greater transparency and consumers being able to make an informed choice, an informed decision about what they're doing, so the question then becomes: how do you achieve that in a way that is meaningful for customers that they can actually take advantage of that transparency? One of the challenges we have in this country, whether it's insurance, banking, superannuation, whatever, is financial literacy levels are not as great as would be ideal, and so we need to make things simple and easy for people to understand then we need to encourage them to use the information, but we can provide a more fuller response in writing too.

MS ABRAMSON: Yes, because one of the issues that we did highlight in our report is - and you're a substantial underwriter - is there's a lot of brands but actually there's the one underwriter. So given that you're in the industry and that's part of your business model it would be very useful for us to have a considered approach.

MR CARTER: Okay, and we'll pick up that. I might just observe. Each of our brands potentially underwrites in different ways, I'll give you very simple example: I drive an old Holden. Most of our brands will not give me the cover for that car to the level - the value of the vehicle, not that it's particularly valuable, but Shannons, which is a specialist in certain cars will enable me to. I have to pay the price but that's fine because I have the cover so - but we can - - -

MS ABRAMSON: ...(indistinct)... helpful, thank you.

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MR HARRIS: Since we're on insurance - although it does bridge the two - then there's mortgage insurance.

MR CARTER: Yes.

MR HARRIS: So a number of parties have told us, somewhat surprisingly given there's relatively few providers of lender's mortgage insurance, but a number of loan providers have said that they - appear to say they don't go out to market to retender this option very often. It seems pretty unusual. It would be a logical thing to do: it's quite a significant price for the borrower who is required to take out that insurance, yet almost on their behalf, almost again acting in the customer's best interest you would expect that some part of the financial institution would say, "You know, we should retender this business every now and then, find the best price."

MR CARTER: Yes.

MR HARRIS: Does Suncorp do that or - - -

MR CARTER: Yes, we do look at each expiry. The thing with LMI is you need to look for a cycle. We've had a very good housing cycle, at some point that will change, and so the contracts tend to be a bit longer because the insurer's going to want to see a little bit more than just one or two years of the cycle. We find that lender's mortgage - well, like everyone we use it ...(indistinct)... there are basically two models, there is the, you know, lender's mortgage insurance issued by a lender's mortgage insurer and then there are a couple of the large banks who are running their own captive kind of model and not having to run necessarily insurance licences fully, shall we say, as others.

So we certainly look at that because the price to the borrower of the LMI is fundamental to being able to compete for that loan. LMI we find is really important for the first home buyer market in particular in this country, so again, if I look at the risk weights, if you look to lend more than 80 per cent of the value which particularly in Melbourne and Sydney but also Brisbane also Perth also Adelaide - is typically a first home buyer who doesn't have a 20 per cent deposit. So if you're going to lend in that market without LMI, the risk weights go up materially and therefore the price would need to go up materially. LMI does support a better price for the duration of the loan for the customer.

But there are two substantive providers in the traditional market. There are overseas reinsurers who are actively touting new business models for LMI and we would - we, like others, I'm sure, evaluate those opportunities as they come up. When our contracts expire with our current provider coming into that period we then look to evaluate whether it's worth considering change. We consider the experience our customers have had, the way the insurer looks at the claims, and have we had, you know, big arguments about whether claims will be paid or not - in our case no. And then the systems and other things: what is the work involved ...(indistinct)... because the LMI process is heavily embedded in our systems and our lending - loan-assessment origination process.

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And so it's sort of a six to 12-month activity to change insurers, so it's not simple to change, and therefore we tend to start with an initial evaluation at least 12 months out from the expiry date.

MR HARRIS: You're just going back to the broad proposition again that you see in the finance system generally quite a lot of emphasis on competition and quality of service, and you mentioned performance of the insurer in paying you as a financial institution, but the consumer's actually paying that cost.

MR CARTER: Yes.

MR HARRIS: And so again, appears to be less emphasis here on the price incurred by the consumer and more emphasis on the quality of service to the financial institution.

MR CARTER: I think that's - no, I don't feel that's fair. The price to the consumer of the loan itself would be materially higher without the LMI being there, so the consumer would pay for that throughout the loan. Secondly, LMI enables - it's true that LMI does cover the - any loss on default to the bank, but it also enables the risk characteristics of that market which is inherently a little bit more risky for first home buyers in particular, high LVRs as well. It does enable the risk to be more acceptable, so it causes us to want to compete in that market which must be good for the consumers in that market.

One of the areas I would highlight though that is a challenge is first home buyers are often also first home builders, and the current macroprudential focus on interest-only picks up construction loans as a part of interest-only because for the first part of their duration as the loan - as the house is being built, they are interest-only in nature which is a logical thing to do. Customers are typically paying rent whilst they build the house, then they move in, then they go to ...(indistinct)....

But we have to include that in our interest-only cap, that lending. So again at the margin it makes that relatively less attractive, that market. So an unintended consequence, no doubt, but, you know, one that we would have preferred not to have been included in the interest-only cap to enable us to fully support that market.

MR HARRIS: Okay. Just one last question on LMI. So we asked at least one of the major banks last week who I think didn't have any information. We'll probably pursue this directly. So what's the performance of LMI generally in your experience? I mean, ASIC as you undoubtedly know has reviewed a number of insurance products and found that some of them are, you know, pretty disgraceful in terms of the price that they charge and the actual claims performed - - -

MR CARTER: Yes.

MR HARRIS: - - - against them; is LMI in that category?

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MR CARTER: Again, you'd need - and we haven't had a bad down cycle across the country in housing for some time, but I think one needs to look through the cycle. So if you looked in recent years, the claims payout ratios have been reasonably low, reflective of a very strong housing market.

However, if one looked in Western Australia - and we've seen one of the LMI providers comment quite specifically on Western Australia - the claims payout ratio has been relatively higher. And if you looked at parts of regional Queensland, particularly in the mining towns, whilst we ourselves haven't suffered a lot of defaults in that market, we chose not to be too aggressive in gaining share there. We have seen elevated payout ratios, but again, against a backdrop of a very benign housing cycle over the last quite a few years. Interest rates go up, unemployment levels go up, we would see a different cycle for the LMI providers.

MR HARRIS: Well, as I said, we might come and ask for some information.

MR CARTER: Yes, we'd be happy to supply that information.

DR KING: Just one more on LMI before we finish up: so you've said the providers - the external providers really want to do a contract long enough to go across the cycle, are we talking four, five, six years? How - - -

MR CARTER: Yes, I think typically the economics would work at about five and then potentially extending for shorter durations, maybe two years at a time.

DR KING: Okay.

MR CARTER: There is a ...(indistinct)... cost of - - -

DR KING: Setting it up.

MR CARTER: - - - setting it up, getting it up and running, changing underwriting, all that sort of stuff.

DR KING: Okay. So during that period of - if I came to Suncorp for a home loan and I had only, let's say, 90 per cent - 90 per cent LVR, so only 10 per cent deposit, the LMI coverage that I would need, that would simply be in a sense a "take it or leave it" offer for me the, the customer. I don't have a choice of saying, "No (indistinct words)."

MR CARTER: It's not portable and there isn't a choice, no. We use a model with a single provider. I'm aware a couple of major banks use an in-house captive as well as an external provider, although I don't know whether that is for customer choice purposes or lender choice as to which risks they keep themselves and which risks they move outside, and that probably reflects the fee the customer is charged for the insurance.

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DR KING: Okay. I mean, so when you're tendering - I mean, normally if you - you know, if you're a large corporate and you're tendering for a service provider, which is what this is, there'd be some sort of volume discounts built in or, you know, there'd be various - you know, "If you meet this level you get this discount, if you meet" - do the contracts have that sort of volume discount or feedback, and if so how does it work?

MR CARTER: Yes, again, the contracts will be varying over time. Things like discounts and rebates modernise, I guess, in terms of people's perception of them, but typically there is an agreed price that would be able to be passed through to consumers, so a discount from the rack rate, if you like, which would enable the price to be more competitive for the customer. There is in return for exclusivity often support to invest in the origination infrastructure, for example we've used support in the past to invest in things like fraud controls and fraud detection in the origination process, and then there is typically a sharing in some form of the benefit of good underwriting, i.e. lower claims, and that enables, you know, the lender - that's to, I guess, encourage the lender not to just turn a blind eye and accept everything, even if the risk is not good. Now, responsible lending encourages you to do your lending the right way anyway, but they're the kinds - tend to be the features.

MR HARRIS: Okay. Thank you very much for your time and for Suncorp's participation both back at the roundtable and your submission the other day, so thank you very much and we may be in touch on further days.

MR CARTER: Thank you. Happy to help. Thank you very much.

MR HARRIS: Okay, Nick Gruen, come on down. Nick, can you introduce yourself for the record.

MR GRUEN: I can.

MR HARRIS: Once you get the glass of water. Get the glass of water.

MR GRUEN: Yes, I'll get a glass of water and I'll get - try and get myself ready.

MR HARRIS: All this goes over the microphone too - - -

MR GRUEN: Yes, I know, very good work, isn't it?

MR HARRIS: Pour your glass of water before we're talking, otherwise you're listening on the thing.

MR GRUEN: It's good quality water.

MR HARRIS: Yes. Now these ones, there's no inaudible bits at all with these kind of microphones.

MR GRUEN: Okay, well do you want me to go?

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MR HARRIS: Introduce yourself for the record.

MR GRUEN: Yes, for the record, Nicholas Gruen is my name. I founded a company called Lateral Economics on April Fools' Day in the year 2000, along with a mortgage broker that I might not talk much about that, and I presented a submission to the Commission which, in its wisdom, it roughly ignored and I'm here in a spirit of curiosity to understand how worthless it really was. So, I guess - - -

MR HARRIS: You know us, Nick, we never ignore anything. We may not have referenced it, but you know we never ignore it.

MR GRUEN: Well, by ignore it, I'm not hungry for the column inches, I'm talking about in your thinking.

MR HARRIS: Yes.

MR GRUEN: It doesn't appear, and nor does any of the possible directions that it might take, that it might have taken you. So that was really what I was trying to - that was the main thing I wanted to talk to you about. But as I tried to master what is a very large document, I came across some things which I thought might be worth discussing a bit later on.

MR HARRIS: Sure. So I've got a bunch of questions which came up from my original reading of your submission, your couple of online articles and most of the Bank of England paper that you referenced, and most of the questions that I've got are relating to what I consider to be practical implementation kind of activity which goes to the question of how could this plausibly work without being more than I think the destabilising influence or the disruption that you might have envisaged.

But what I thought I first might do, rather than jump into that kind of questioning is give you the opportunity to talk about how you envisaged the proposition that you had might work, and particularly what aspect of competition in banking you're targeting with it.

MR GRUEN: Okay. Well, I guess it might be - that may be one way into that would be to discuss what I suggested was a more general proposition about competitive neutrality, because it seems to me that there are some areas - and this was the idea that the Commission is a great champion of competitive neutrality, if you like, as a shield to business and not a sword. Then the question becomes whether one might use it as a sword, not a shield.

It's quite obvious that what I've suggested in banking shouldn't simply be implemented on the grounds of competitive neutrality. As you say, there are a million practical, structural things that would be a very big change. As I called my paper that I published in the UK, it was a modest proposal for radical reform. But there is also the

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wealth management side where it's not - whether it's a modest proposal for more competition.

Now, that is not technically relevant to the way in which you've - the way in which you've divided up the division of labour between two inquiries here, because you've got super as a different inquiry. But as far as I understand the report, you are looking at wealth management.

MR HARRIS: Yes, we were going - - -

MR GRUEN: So, it is quite easy to say that if the government is producing wealth management services, it is a worthwhile question to ask, "Could this be cost-effectively added to the stock of competition in wealth management," and it was that that I was inviting you to deliberate on. I think, though it's such a big report, I can't - I haven't read every page - but having done word searches and read where I thought these issues would be, I would have thought that was worthy of some discussion.

So that's, in a sense, in the nature of some kind of introductory comment, so I'd be interested in, you know, what your - what you make of the idea of competitive neutrality as a sword rather than a shield.

MR HARRIS: So, I don't think in doing our policy design response we necessarily choose responses on that basis. We ask ourselves originally the question, "Is there evidence that market power is being used for advantage in this market and, if so, what are offsets to that market power?" and that's pretty much the way we've tried to structure the report.

While there is evidence of market power, a solution which is one that, as I understand your proposition, says we could use public funding to create an alternative source of competition in this market, it does seem to be reasonably radical, and I think from our perspective, therefore, it's not a question of whether - how it's sort of necessarily classified, it's more a question of saying, "Does the solution match the scope of the problem?"

MR GRUEN: Well, yes. So, I see the things that - I don't - I'm not trying to use public funding to do anything. It's possible that some public funding comes along, but it's very minor. What I'm talking about is existing assets, existing institutions. So, we - the Commonwealth - and so, the Commonwealth provides wealth management services to its employees. That's called superannuation. You are looking puzzled.

So, it's not a matter of saying, "Oh well, we've got a problem, make the government fix it," it's just thinking of these assets that governments own as a natural and normal part of the market, that we make sure they're not competing on unfair terms, and then they're a participant in the market. This is - you know, I just don't feel - I can accept that what I proposed in banking is radical, like, that was in the title of what I proposed. I don't accept that saying that if hundreds of thousands of public servants can access Commonwealth wealth management services that it is particularly radical to build an interface which allows anyone to do that.

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MR HARRIS: No, no, but you are proposing - to get it clear then, so that we're not just tap dancing around the edges, you are proposing a proposition under which a sovereign entity takes deposits and enters the loan market and using those deposits. So, my version of them funding - - -

MR GRUEN: Well, just hang on, we're talking about different things.

MR HARRIS: Correct me in substance on that, so - because that's the way we read your paper and your online articles.

MR GRUEN: I'm talking about Commonwealth superannuation at the moment. So, the submission I gave you talked about competitive neutrality. I fully accept that the banking proposal I put - certainly just me calling it competitive neutrality doesn't go half - doesn't go a quarter, doesn't go a tenth of the way of considering the implications of it.

So, just to consider competitive neutrality, I wanted to - I suggested that a way into that, to talk about simply that principle, was to talk about Commonwealth provision of wealth management services. Okay, that's what I proposed briefly to discuss, because I want to explore the question of competitive neutrality without all the extraneous stuff, which we hopefully will get on to.

MR HARRIS: Okay. But the fact that the Commonwealth has accorded itself as an employment - a factor of its employment, the opportunity to play in wealth management via superannuation doesn't argue, does it, for it to do the same in banking?

MR GRUEN: No.

MR HARRIS: No. So, what we have is - we have a fact of life and - - -

MR GRUEN: So, I'm talking about the Commonwealth - I'm trying to focus on what the Commonwealth does with this asset, which is that it set itself up to manage a large amount of Commonwealth employees' money. That's what I'm trying to focus on, so that we can have a discussion about competitive neutrality, and then we can talk about banking. Now, your report talks about wealth management.

MR HARRIS: It talks about wealth management not in the sense of managing an asset, but in the sense of saying, "Is it a source of competition for a provider in the banking system?" That's where we do wealth management. Otherwise, in superannuation, to the extent that the Commonwealth's activity comes up in superannuation reports, it will, I guess, feature at the margin. But, you know, again in the superannuation reviews, we were asked a different kind of question. We were asked, "What are the efficiency characteristics and can you better apply them, including through competitive solutions through default superannuation?"

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So, there were a series of questions that are asked of us in that terms of reference. But for the purpose of competition in the banking and finance system, the fact that the Commonwealth - as I said, it accords itself the ability to play in wealth management doesn't demonstrate one way or the other whether it should accord itself that privilege to play in the provision of other financial services. I mean, it could, but the threshold question for us is, what's the competition issue that such an intervention is meant to be solving?

MR GRUEN: Yes. Well that, to me, seems like a very ideological way to put the question. The question is - for me, there are assets and we want as much competition as we can have. We don't say - you know, we could say, "Should we let" - we could ask any number of deregulatory questions, but we don't say - we don't - it doesn't seem to me that we say - I mean, for instance, these arguments about foreign investment, people say, "Do we have a problem with foreign investment?" - which seems like a very odd way to ask the question.

You've got a bunch of assets, and a market is a bunch of assets which are, if you like, firms in the private sector or the public sector, and they're competing, they're participating in that market. It seems very odd to simply say, "Oh well, we won't - we won't - we've built this asset" - and here I'm talking about the Future Fund, and so on, or Commonwealth wealth management assets. "We've built this asset, we built it for that reason, therefore we won't - even though it would be a very minor cost to allow it to participate in that market, we won't do it, because we will only let - do it if we're - if we can see a problem." That seems to be a strange way to look at it.

MR HARRIS: No, but I think as I said in my opening comments, I wasn't looking at it that way. My questions with your model are entirely relating to the ones that would occur were it to be enabled, were it to actually enter markets.

MR GRUEN: Yes.

MR HARRIS: And I would like to get onto them in due course, but - because I did read in some of your public comments this frustration that you have about what I would call a philosophical difference. So, to the extent we're putting labels, yes, we're ideological and - well, you're philosophical. But the bottom line is, we're not going to get anywhere with that kind of activity between us here today.

I'm actually trying to work out why you prefer to see competition come via this mechanism. I think I heard the answer, something that you just said, you suggested that we should have as much competition as we can. In other words, any participant, including a sovereign-backed participant, is a legitimate participant in any market.

MR GRUEN: So long as there is - that's right, so long as there are - so long as there is competitive neutrality. So, I don't want to - I would support the Commission's view that you don't want to have government-backed organisations taking advantage of artificial benefits that they have. For instance, different tax arrangements, and so on. If they do have different tax arrangements, then you try and make allowances for those, okay.

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MR HARRIS: So, in the case of the banking system, which so depends on confidence, the absolute safety of a Commonwealth-supported entity - we can debate support, but the bottom line is an entity that is perceived by the public as that, will in some circumstances be the primary place to go in a flight to safety.

And we've seen that in a global financial crisis where regardless of what the price was, people have said, "I want" - I've said, a large investor said, "I want other safety, and we are happy to take negative interest rates as a consequence." So how would you deal with that in a competitive neutrality sense? The participant is absolutely the safest place to go.

MR GRUEN: I would deal with it in the same way we do with banknotes, or we did in 1844, which is the market will choose who is better - who is safer, and the central bank is a safer provider of credit. Therefore, when it - when the Bank of England becomes the dominant issuer of banknotes, that's the market speaking.

So I don't regard the fact that the Commonwealth is the issuer of currency as a - it's not like it doesn't have to pay tax and the others do, it's actually - you know, this is why we don't have tax farming and things like that. There are things that the Commonwealth does that it has a cost advantage doing.

MR HARRIS: So, just on competitive neutrality because that was your preferred arguing base, just on that - so, the notes isn't really a question, because we don't have multiple parties. We once did. Historically, we had many, many parties promising to pay you.

MR GRUEN: It's the same, it's analogous situation.

MR HARRIS: But we don't have it anymore.

MR GRUEN: Yes.

MR HARRIS: We have one only, whereas we have many parties in the financial system at the moment. So, were the Commonwealth to turn up and become a player in the banking system, and were they be a flight to safety, even though deposits were guaranteed as well by the Commonwealth in some other parts of the system, and we've just had some of the smaller players here talking about whether too big to fail has been a perception problem for them in the marketplace and, clearly, it's a perception problem that translates to actual cost to them in terms of rating agencies' use.

You're going to have - if you have this flight to safety, if that event occurs and you have a Commonwealth participant, it's going to be the preferred place to put your deposits for some people. And the smaller parts of the financial system at least will eventually suffer.

MR GRUEN: And everybody - - -

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MR HARRIS: That's a competitive - I'm just going on a competitive neutrality preferred argument basis. That's a competitive neutrality problem that I cannot see anybody offsetting.

MR GRUEN: It's not a problem.

MR HARRIS: Because it's inherent - - -

MR GRUEN: It's not a problem.

MR HARRIS: Well, it's not a problem to see a flight to safety so that the smaller financial institutions in our current system, if they lose their deposit base to the Commonwealth entity that you suggest be in the marketplace, that's not a problem.

MR GRUEN: Of course, it's not a problem, it's a - it's a flight to safety. The market wants safety and these ones can't supply it.

MR HARRIS: But in a disruption sense, you're not bothered by that?

MR GRUEN: I don't know what you mean by a disruption sense. We guaranteed the banking system. Everybody had a Commonwealth guarantee in 2008.

MR HARRIS: Up to a potential value of dollars.

MR GRUEN: Yes.

MR HARRIS: Not an absolute. Indeed, the regulators have tried to go on the record subsequently as saying it's not as substantial as people might have believed.

MR GRUEN: I know, they're frequently on the record saying that - - -

MR HARRIS: So, I think there's more evidence - - -

MR GRUEN: - - - including before 2008.

MR HARRIS: I think there's more evidence on my side than on yours to say, and that's why I say, you will see institutions potentially shut their doors. And that does seem to me to be an inherent problem with creating the institutions that you want to create in the first place. That is, it will add to instability in certain circumstances.

MR GRUEN: Well, I guess, yes, the idea that this is instability, when what it's doing is, it's doing what we did anyway, which is to guarantee the banks. So, yes, that's the whole problem and we're all trying to pretend that it's not the problem. I mean, if we're going through - if we're going through economic circumstances where at some stage people might want safer - a safer place to put their money, then - and suddenly that then becomes not a matter of meeting that need, now we're talking about competitive neutrality. Now we're

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saying, “Look, the smart money has long since departed, but we want the little people to keep their money in a bank that’s going down.”

MR HARRIS: I’m just simply saying it’s a characteristic of the entity that you’re proposing to be created that can’t be dealt with under competitive neutrality. You’re for arguing a basis for doing it. I’m simply saying you can’t contract it away or eliminate it and, therefore, it it is one reason why you can’t be competitive and neutral were we to create this.

I would like to go on and add to that the loan activity, because again, if I read your public comments on this correctly, not so much in the submission you put to us, but in the things you said to it publicly about the proposition, you’re talking about low-risk loans being the primary target for this new Commonwealth Bank entity.

MR GRUEN: It’s the Reserve Bank.

MR HARRIS: Yes, well - - -

MR GRUEN: It’s not new, it’s an existing asset.

MR HARRIS: Okay, but - - -

MR GRUEN: And all of the banks bank with the bank.

MR HARRIS: Hang on - - -

MR GRUEN: They bank with the people’s bank.

MR HARRIS: Yes, but I’m sort of taking a fact that you did state in relation to your model, and suggesting that - - -

MR GRUEN: Well, I didn’t say that in the existing model that there was another entity; it’s the Reserve Bank of Australia.

MR HARRIS: No, I’m trying to be - it doesn’t have to be the Reserve Bank, it could be any kind of entity that has similar characteristics.

MR GRUEN: Well, then it wouldn’t be my proposal.

MR HARRIS: Okay.

MR GRUEN: So, why don’t we talk about what I want to talk about?

MR HARRIS: All right, we’ll talk about the Reserve Bank. If the Reserve Bank is a borrower of low-risk loans then - - -

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MR GRUEN: A lender of low-risk loans.

MR HARRIS: Or a taker of them, so they're out of the marketplace for other participants. So, they've lost some low-risk loan activity.

MR GRUEN: Correct.

MR HARRIS: Which means other participants in the marketplace are, by definition, higher risk than they were.

MR GRUEN: Correct.

MR HARRIS: So, again, in this circumstance of instability, we're leaving a higher risk with other parties, and we're happy to do that.

MR GRUEN: M'mm.

MR HARRIS: You don't think that's a disruption within - - -

MR GRUEN: Of course it's a disruption; I thought you people were into disruption.

MR HARRIS: Is it a - well, let's not go - I mean, is it a pro-competitive disruption?

MR GRUEN: Well, it's - - -

MR HARRIS: Is it worth having as the participants disappear from the marketplace because they've been induced to only remain in high-risk loans?

MR GRUEN: Well, these - I mean, this is the point. I mean, I can provide you with the analogy of banknotes. There were high-cost participants in the market for banknotes, and there were - was a low-cost participant in the market for banknotes. That was the Bank of England, the central bank. So, then the market works out that nobody wants these high-cost notes.

So, if you are - so what - we've got a market at the moment where low cost - sorry, low-risk loans are priced at the same from 80 per cent down to - down to zero loan-to-valuation ratio. This is not consistent with a competitive market. The private sector, for reasons that I've outlined, is far more - it incurs all kinds of costs in managing these risks that the central bank doesn't manage, the central bank doesn't bear.

So, what we've got is we've got a situation where these banks get access to that, bank with much greater efficiency, the little people don't. So, there's competitive non-neutrality. And so, I guess, yes, you want the market, like we have with banknotes, you want the market to reflect resource costs, which is not what we're doing.

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MR HARRIS: I guess my - just before you go, Stephen, my overall summary though, Nick, is, the problem that I'm identifying here is one where you are skewing the marketplace in a fashion that cannot be competitively neutral with those things.

MR GRUEN: As with banknotes.

MR HARRIS: I just wanted to be clear, that's the problem.

MR GRUEN: Yes, that's true, that's true.

MR HARRIS: And you're just accepting that that's - - -

MR GRUEN: I'm saying that the Commonwealth is a vastly lower cost provider of low-risk loans.

MR HARRIS: And you are happy with that cost on one side, because you think the advantage is greater on the other side, the benefit.

MR GRUEN: Well, sorry, I was just talking about benefit, not cost. You're talking about a cost of the shake-out of higher-risk lending. You're talking about that as a cost, and you're talking about it in terms of instability, rather than - rather than a market adjusting with plenty of disruption, I completely accept. The other thing is, let's - if we want to look it in that way, that there are benefits and then there are costs, I've had senior public servants say to me that they were looking forward to the Productivity Commission exploring that and giving them some guidance on it, because they're interested in the question.

MR HARRIS: Many people - - -

MR GRUEN: I would be interested. I think it would be good if the Productivity Commission, rather than say, "We're a bit worried because there's an instability problem," actually provided us with some analysis, like the Bank of England does.

MR HARRIS: Sorry, I think your dismissal of our worry as being not contributory to analysis is a bit poor. That is part of an analysis for us to consider - - -

MR GRUEN: Well, it's not on the paper, it's here. This is the first I've heard of it.

MR HARRIS: Well, that's why you came along today so you can hear it. If everything - - -

MR GRUEN: What about the public servants who have made comments to me that they thought that the Productivity Commission - they were looking forward to the Productivity Commission's analysis of the question.

MR HARRIS: Nick, many people have expectations of us, and the fact that we disappoint them is hardly a surprise to you or to me. Every one of our inquiries is meant to cover

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everything we possibly can, but, of course, can't do that. In any event, I was trying to explain to you how, on a competitive neutrality basis, there are some factors that, in our view, would be quite serious - - -

MR GRUEN: They are serious, that's why it would be good to talk about it.

MR HARRIS: They're not small - - -

MR GRUEN: Yes, they're not small, they're not. Might be worth a sustained discussion.

DR KING: I was going to follow up on your point, Peter. So, I think it was 60 LVR - 60 per cent LVR was - - -

MR GRUEN: That was a for instance.

DR KING: Yes, so let's take that for instance, let's say that was put in place - so, in this new body.

MR GRUEN: So, what, in - - -

DR KING: In the RBA.

MR GRUEN: What was it? Was it 1910?

DR KING: I was going to say RBA.

MR GRUEN: No, it wasn't, it was 1959, sorry.

DR KING: Where do you see - so, I'm taking your money example. Do you see people who have - can't meet those standards, so, an LVR - say, a first home buyer with an LVR of 90, so they can't get the Reserve Bank's product by - - -

MR GRUEN: Well, they can. They can get the Reserve Bank's product on the first 60 if they can find the next 30.

DR KING: Okay, so they can't get the Reserve Bank's product to fund their purchase.

MR GRUEN: Correct.

DR KING: So, coming back to Peter's point, doesn't that just mean that you're just exacerbating a problem that's been pointed out by numerous economists in the current system which is that a too big to fail type system with a residual around the edge just pushes - it's just an adverse selection problem. You end up with all the problem loans going out to, in your case, everyone but the Reserve Bank and - - -

MR GRUEN: Well, any - - -

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DR KING: I mean, what possible way does that make a system - a banking system that is either economically stable, or politically stable - - -

MR GRUEN: Well, you're a fine bunch of socialists, I think, you want this to be covered collectively. I mean, if you're taking out a risky loan - - -

DR KING: No, I'm asking a question.

MR GRUEN: I'm trying to answer it. You're taking out a risky loan, aren't you trying to - if you're taking out a risky loan, shouldn't that be priced in? Shouldn't these be - isn't that the skill that we want from private banking, people who can make decisions about what kinds of loans they want?

DR KING: So, you're quite happy with simply saying the government body takes all the safe product, with the risky product you take outside?

MR GRUEN: Anyone in the market who wants to - anyone in the market who wants to compete for the safe product takes the safe product.

DR KING: Except the government body?

MR GRUEN: No, the market.

DR KING: Well, you've said the government body doesn't compete that, you've said 60 per cent LVR for the government body.

MR GRUEN: That's right, correct. Sorry, I was talking about the 60 per cent: everyone, including the government body, is free to compete with that - for that, correct.

DR KING: And on your basis, you believe the government body will probably get a monopoly on that, given your - - -

MR GRUEN: But it will have a very large market share, no doubt about it, correct.

DR KING: Given your money analogy, you'll expect a monopoly.

MR GRUEN: Yes.

DR KING: And for the rest of the high-risk loans, you expect these to work out - - -

MR GRUEN: No.

DR KING: So campaigns here, and so on - - -

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MR GRUEN: No, I mean - well, they - if - it's quite possible that - in fact, you would expect that this would bring down the average loan-to-valuation ratio of new loans, that banks would not - if you get - if part of the mortgage that you've got is from 60 per cent upwards and previously you've been funding 90 per cent loans, you don't fund 90 per cent loans, you fund 85 per cent loans or 80 per cent loans, and you do it probably at a higher price, and then you're starting to see markets price risk.

DR KING: Okay, so this would - so, your new homebuyer would be massively adversely affected, for example, by this, because they would be left out. They're the adverse selection group, they're the high-risk group that you're talking out there in the marketplace and saying, well - on what you just said, you don't expect them to get a loan, you don't expect the 90 LVRs to even get a loan.

MR GRUEN: No, no, I - it's true that you would - the - one would expect the market to be less generous at the higher level because greater risk has been taken on, that's absolutely true.

DR KING: Okay, so - - -

MR GRUEN: So, then you've got to - so, you've got to decide on the costs and benefits of these two markets, as the Chairman was saying.

DR KING: Okay.

MR GRUEN: Yes.

DR KING: Yes, okay. So, let's now take a different - slightly different scenario.

MR GRUEN: M'mm.

DR KING: So, the next downturn. So, let's say - obviously, there's going to be fewer loans out - take your approach, there's fewer loans out in the private sector, but they're the higher-risk loans. Maybe not 90 LVRs, but maybe they're not writing anything above 80 LVRs.

MR GRUEN: Yes.

DR KING: But there's a downturn, which inevitably happens in these sorts of markets. You would expect the government just to stand on the sidelines and say, "Well, we're not giving any guarantee," or is there a guarantee on these private loans?

MR GRUEN: Well, that was - when I talked to Martin Wolf about it, he immediately jumped to the conclusion that it might be no longer necessary. I don't - it's not a - that's a detail to be worked out. If you - if it - you can see a case for it, you can see a case against it. It changes a lot. But it's possible to argue, and I don't claim - I mean, I don't claim I - and I would suspect I would be suspicious of anyone who could claim that they really know.

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If you went to this system, whether the extent to which you need some sort of residual system like the one we have now for the whole box and dice. You can certainly see a lot of things that you don't need to worry about, because you've got a functioning payment system, for instance. So, it's arguable that you don't need it; I'm not arguing that particularly. Those are the kinds of things you might have considered in your report.

DR KING: And I'll finish up in a second, Peter. Do you see these commercial banks as being - as funding their loans, and they're still making loans, these particular loans.

MR GRUEN: Yes.

DR KING: Do you see them being funded by deposits, or are you thinking they're going to go to complete wholesale?

MR GRUEN: It's up to them.

DR KING: No, so - - -

MR GRUEN: Well, okay, I take it your point is that it will be harder to fund via deposits.

DR KING: If they are funding via deposits, then do you believe that the government would stand back and let those depositors lose their funds?

MR GRUEN: Well, they would be - those deposits of the private system in that - in that situation are likely to be paid a higher interest rate, and then you have the kinds of dilemmas that we now have with, you know, Pyramid Building Society and those kinds of things. So, I don't have a "yes" or "no" answer to that.

DR KING: All right. So, I think Pyramid is a - and I'll leave it at that, you know, is what you're doing creating a private bank - a government banking system, which if it doesn't get a monopoly in deposits, it will end up leaving a commercial rump which are a bunch of Pyramid Building Societies?

MR GRUEN: No. I'm sorry, I think you're - I think you're playing some word games there. I'm saying that you have transformed the nature - these are - quite the case, I completely concede that deposit funding of commercial banks in this model would be likely to attract higher interest rates and would, therefore - and high risk, there's no question about that.

We have a system at the moment that is designed to somehow paper over that in order to provide us with a payment system, for instance. There are - in the age of the internet, we can do better than that. That's the argument.

MR HARRIS: Well, I'm afraid we've reached the end of our allocated time. We have the Consumer Action Law Centre coming up next. So, I don't know Nick, I doubt we've

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satisfied you, but there will be opportunity if these senior public servants are very interested in this will - - -

MR GRUEN: I thought my allocated time was - so, the allocated time was to - - -

MR HARRIS: 12.10.

MR GRUEN: 12.10, all right. Well, I was brought on ten minutes late.

MR HARRIS: Okay. Well, I'm just trying to stick to my schedule, so I thought we were - - -

MR GRUEN: Bored.

MR HARRIS: Anyway, thanks.

MR GRUEN: Okay.

MR HARRIS: So, I think we have the Consumer Action Law Centre. When you settle, if you can identify yourself for the record too, that would be great. Yes, the water, the water.

MR BRODY: Thank you very much for having me present today. Gerard Brody, I'm the CEO of Consumer Action Law Centre.

MR HARRIS: Do you have an opening statement?

MR BRODY: I do, I do. Consumer Action welcomes the draft report published by the Commission and many of the recommendations. I'd like to start my comments on three areas of the report: proposals to strengthen the power of consumer choice; proposals to address barriers to effective competition, like conflicts and commissions; and proposals relating to technology payment systems and open banking.

Before I do that though, I'd like to make the point that while we support efforts to make switching easier for consumers, the evidence shows that providing more information and a few prompts will not overcome consumers' perception that the potential benefits of switching are simply not worth it. Sticking with the same product and provider can be a rational decision.

Consumers, we believe, should not be penalised for this loyalty; the result should be neutral at worst. Remedies that focus on prompting consumers to switch do not encourage firms to treat their existing customers fairly in the first place. That said, we'd like to voice our support for the discussion and draft recommendations that strengthen the power of consumer choice in insurance.

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In 2015, Consumer Action called on insurers to be more upfront with their yearly price rises on renewal notices. We surveyed the community and 86 per cent of those surveyed wanted the change. We called on insurers to include on renewal notices not only the price of the premium for the forthcoming year, but also the price paid last year and the reason for any change.

Unfortunately, there hasn't been any meaningful response from the industry. This change, we think, will do two things: first, particularly if the renewal discloses a premium increase, it would prompt people to question the value of their own insurance and shop around; second, information about the reasons for increased costs might help people take steps to mitigate their risk. For example, if they live in a cyclone-prone area, they might learn about what changes they can make to their property to reduce their risk and premium.

We also strongly support the proposal to extend a deferred sales model to all add-on insurance products and sales channels. The harm caused by junk insurance, as we call it, is immense. In our submission to the Royal Commission into Misconduct in the Banking and Finance Sector, we estimated that the misconduct in the add-on insurance industry is likely to cost consumers over a billion dollars over the last ten years. That's money that should be returned to consumers' pockets.

Since 2016, we have run an online tool called Demand A Refund which enables people to complain about the sale of add-on insurance and request a refund from the insurer or financier. Almost $1m has been claimed through the site. While most of the complaints relate to car dealers, around 33 per cent relate to other sales channels, like banks or finance institutions, so it's clear that the harm is occurring in other sectors.

An effective deferred sales model will break the sale between a loan and insurance, reducing the opportunity for pressure. However, it is important there is careful design of a deferred sales mechanism. Unless it is robust, there will be circumvention and regulatory gaming.

We've already seen proposals for bridging insurance covering the deferral period, which would establish a new opportunity for high-pressure selling. Examination of gaming or circumvention is important, because the real core of the problem is commission selling. The use of commissions drives reverse competition, where insurers are competing for access to the market through car dealers, banks or other sales channels.

This additional cost does not deliver a public benefit. That is self-evident when we see claims ratios of less than 10 cents in the dollar. We would encourage the Commission to require industry to set claims ratios that deliver consumer value, and then demonstrate that they can meet those; a performance standard, if you like. Such a reform would provide an incentive for insurers to compete in a way that benefits customers.

There are other product-bundling practices in the finance sector that we consider should be examined as well. For example, the practice of bundling mortgages with credit

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cards. This is inherently anti-competitive as it hides the true cost, makes switching more difficult and raises responsible lending issues.

An EU report from 2016 that collected and summarised the evidence on barriers to effective competition in the European mortgage market noted that it did not find any compelling evidence that such practice was justified by efficiency purposes.

I would also like to voice support for the Commission's draft recommendation on home loan pricing disclosure. Unadvertised discounts are likely to mean that less savvy consumers end up paying higher rates, because they don't know to push their lender. As I said at the beginning, in a competitive market, people should not be punished for being less literate or engaged.

To make sure that publication of a benchmark rate or rates actually helps consumers, we would encourage this idea to be consumer-tested. We think for it to be effective, it will need to be as simple as possible and - to enable people to understand it. The Commission's draft recommendation talks of a tool which can respond to different combinations of loans or borrower characteristics. We suspect that the more complex this is, the less likely it will be used. Benchmarks work best for consumers when they are easy to understand and clear.

I'd like to respond to the Commission's recommendation about - around brokers and the proposed best-interests duty. Brokers act to - sorry, act as advisers to consumers, and the public expectation is that they are acting in the customer's interests, so this recommendation is very welcome.

However, there does not seem to be - there does not seem to be a clear policy reason for the best interest duty to only apply to brokers owned by lenders. We consider that it should apply to all brokers. I must say that in our legal practice, we rarely see a broker sale add value to a consumer. Rather, the broker is used to find credit that is unaffordable.

We also support the view that mortgage broker commission structures weaken competition and switching. I'd like to particularly make a comment about clawbacks, which are really an anti-competitive exit fee in another guise. Exit fees on mortgages were outlawed in 2011. We've had complaints about clawbacks. On one occasion, our client was unsatisfied with the service provided by the broker and wanted to refinance the loan so as to no longer be associated with that broker.

The broker later contacted the client advising that their commission had been clawed back by the lender and so the broker was in turn clawing it back from the customer. The amount claimed by the broker was in excess of $2,000 and requested within seven days. Clawbacks that charge consumers, we think, should be banned.

Finally, on technology, and payments systems and open banking. We're very supportive of the ePayments code being mandatory and consider that it can be strengthened. Mandating the ePayments code has been recommended by a number of inquiries, but we're yet to see it come into effect.

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Liability arrangements for the ePayments code should be maintained and extended to open banking. The ePayments code includes the longstanding principle of banking law that the financial institution requires the mandate of its customer to validly debit an account, and that only in exceptional circumstances can a customer be held liable for unauthorised transactions on their account.

We do understand the open banking proposed for Australia is to only allow read access to people's accounts, not write access, like there is in the UK. However, it's important that this sort of principle be maintained. Banks hold a position of trust, and it is not only fair but also efficient for them to be responsible for a third-party access to customer information or accounts. Banks are in a much better position to ensure security is robust.

The final report into open banking, recently released, identified a scenario where a bank shares customer data with a third party, but the data is inaccurate, incomplete or misleading. The third party then offers the customer a product based on that misleading information and the customer suffers loss. The report says the bank should not be liable for the product of the data recipient. This sort of outcome, we think, seems fundamentally unfair. Really, the principle should be that a bank is liable and it should seek recovery from the third party.

Finally, we'd like to make a few points about customer consent in a fast-moving market. We think it's a concept that needs to be fundamentally revisited. To really give consumers power in a competitive market, consent cannot be hidden in terms and conditions or through pre-ticked boxes. Consent to sharing data with third parties cannot be a condition of accessing a service or product.

The Open Banking Review did say that express customer consent should be explicit, fully informed and be able to be permitted or constrained to the customer's instructions. We think it should go further: consent must be separate, voluntary, clear, specific and time-limited. Consent also needs to be able to be withdrawn and withdrawn simply.

We would urge the Commission to recommend that industry develop a standard to make sure consent operates pro-competitively, not anti-competitively. Thank you.

MR HARRIS: That's very comprehensive, thanks for that. Do you want to start off?

MS ABRAMSON: Well, I was going to start off a little bit - I wanted to ask Gerard about general advice. Are there other issues that you want to do first?

MR HARRIS: No, no, just start there. I've got a list of things that came out of some comments. I need some clarification on consent at the end, because I didn't quite - but we're going to come to that.

MR BRODY: Sure.

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MS ABRAMSON: Yes, I just wanted to ask Gerard about this whole concept of general advice.

MR BRODY: Yes.

MS ABRAMSON: And, you know, a lot of evidence about this being misleading to consumers, but it comes back to this difficult point: what is it that you can actually propose in the area? So, I'm interested in your views and, also, a little bit more directive is, whether you think there are specific products which require specific types of disclosure. Kind of around the tier 1, tier 2-type conversation.

MR BRODY: I think that idea of general and personal advice and the different levels of obligation for officials who are advisers within them are sort of the wrong framework to begin with. I think what we need to be thinking is that if an - the obligation is on product issuers about the decision that's made at the point of sale, but also, on product issues around products - how they design products and whether it's suitable for who they're trying to sell it to.

So, then when you think about those that are involved in the distribution and sale, and particularly whether advising people, whether it's finance advisers, whether it's mortgage brokers, whether it's debt advisers, which I think is an area that's entirely unregulated at the moment, they need to have a best-interest duty.

MS ABRAMSON: I missed that, what advisers did you say?

MR BRODY: Debt advisers, for-profit debt advisers. They don't at the moment fall within the scope of the financial services regulatory framework, but are out there in the marketplace telling people how to consolidate their debts or how to deal with insolvency options. Those sort of bodies, I think, need to have a best-interests duty, so they are, as there is in financial advice, that should be extended to mortgage broking and debt advice. So, I think the concept of general advice doesn't fit in that framework very well.

MS ABRAMSON: So, I assume from what you're saying that the reforms around product disclosure and I've forgotten the actual name of it, but the new legislation that's proposed to deal with the distribution obligations and things will be things that go part of the way to what you're talking about.

MR BRODY: Indeed. So, the product design and distribution obligations, we think that they're a very important reform. We've got some concerns about how they're being designed at the moment.

MS ABRAMSON: Yes.

MR BRODY: That could be strengthened, which I'm happy to talk about, but they are an important part of the framework.

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MS ABRAMSON: All right, thank you. Peter.

MR HARRIS: Okay. So, let's go back to the start: commission and its utilisation in this industry. So, we've had some propositions that, yes, the commissions should generally be replaced by fixed fees. Moreover, they shouldn't alter with the amount of money that's being actually lent. On the other hand, the proposition has been, but if it's a fixed fee and particularly - sorry, if it's a fixed fee and it's paid by the consumer, people won't take advice, there seems to be a reasonably clear-cut advantage in that.

So, I guess, the argument's in favour of commissions, although we'll hear a little more about this from those who want to come in later this afternoon, because the Finance Brokers of Australia are coming to talk to us, but the logic appears to be consumers won't take advice if we change the nature of the system. So, have you got a perspective on that?

MR BRODY: I think that that needs to be tested, that claim. I mean, I think that - you know, it's put that consumers won't pay for advice. You know, I think people - the financial advice sector, they are now moving for fee for service and some people are still paying for advice. I think it will depend on different types of consumer sequence. Some people will see value in that service and pay for it.

So, I do think that there definitely should be a breaking down of the connection between, let's say, the amount of the loan size or the amount - the size of your wealth and the advice cost in a commission. So, one - another alternative which I think is worth exploring is that there is a fee for service but, for example, in the mortgage broking market it's paid for by the bank, you know, for the amount of work that it's done, not dependent on the size of the loan.

MR HARRIS: Okay, that seems a clear view. You also commented on our pricing - our as close to possible in real time median price for a home loan proposition, which I'm glad actually it's proving to be a little controversial now, because I was a bit disappointed it got so little attention right at the start, because it seems to be a reasonably significant thing that people might actually know before they go into a negotiation roughly what price they might expect, or someone else might have achieved in the reasonably recent past. But it's good that we're getting some attention now.

As best I understood it, you're supportive of the concept, you want to make sure that we don't make it so complicated that no one will access it. Is that right?

MR BRODY: That's correct, yes.

MR HARRIS: By that, you focused on the online tool and said, "Make it" - so you're, I guess - would I be right in saying you're drawing on experience with comparison websites where it becomes very complicated to get - and you end up getting so many model offers that it was actually pointless getting in the first place?

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MR BRODY: That's correct, that's our experience. Any sort of, I guess, marker in the marketplace about a price, I think it - for it to be effective for consumer decision-making, it has to be simple and clear and upfront. The more steps they have to go through to work out what is relevant for their circumstances, the less likely they'll take those steps.

DR KING: Could I just pick up on that? Do you see - there's two ways which you can go down, I guess we've seen one of them in energy where the government - in this case, presumably, the ASIC actually said, "Okay, well we're going to come up with the online tool to do this." The alternative is that, you know, I guess, with what we've seen with the ACCC trying to do in petrol prices is more get the information out there and say, "Come on app developers, come and develop your apps so that people can use them," and we are seeing some activity in that space in petrol prices in Australia.

Which of those directions - if we're going to have an interface that consumers find friendly, and so on, which do you think is the better way to go?

MR BRODY: Look, I think that's a really tough question, because our experience is that there are obviously benefits in a government-endorsed portal or tool, because it's free from conflicts and it can be trusted more by the community. But that said, they're generally not as dynamic, not as user-friendly, sort of, tools. Whereas ones produced by the private marketplace tend to be simpler to use, but they can be harmful when there are hidden commissions or payments that drive particular outcomes.

So, I guess, that if we were to go with a marketplace one, we should have a stronger framework of consumer protection around it, around all the standards would be for that sort of thing.

MR HARRIS: Okay. And imposing a duty to act in the borrower's best interest on a broker, do you think that's a good step but you wanted it to be comprehensive across all brokers? Is that - how can I put it? Is that an in-principle desire or is there an experience that suggests to you that that - you know, problems actually do exist with small or unaligned brokers that suggest they too should carry the kind of responsibility.

I mean, you would have read the report and noted that the ownership itself seems to us to be a significant conflict of interest in terms of a bank owning a broker. But going beyond that, there's also the possibility that the incentive payment systems could - although that's where we're a little wary about this whole question. So, it does relate back to the commissions thing. But you're saying you want it to apply to all. So, can I draw you out a bit on some basis for coming to that conclusion?

MR BRODY: Yes. And the basis is linked to, I think, primarily commissions which drive behaviour of brokers. I said in my opening remarks that in the disputes that are brought to our legal practice, we rarely see a broker add a value to a customer. The broker is rather used to find finance when other mainstream lenders aren't willing to provide it and, therefore, it's more likely to be an unaffordable loan with responsible lending issues.

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So, I think that that broker does that because it gets - it's looking for a commission, it's looking for a payment, and we see that commonly in the car finance area, but in other areas as well.

DR KING: Right. Can I just follow up on it a bit about knowing - you would be aware of the press reports following a broker report - - -

MR BRODY: Last year.

DR KING: Yes.

MR HARRIS: About the middle of last year.

DR KING: Off the top of my memory, suggesting that in the mortgage space there was significant - not necessarily putting in documentation, but fully reflected the truth of the borrower. I guess, one thing is - I'd be interested to know if you see that in your legal practice and, secondly, do you think that a best-interest duty would be enough to, sort of, bring those players back into line?

MR BRODY: We do see that sort of thing and, yes, it is often on the advice of a - the person, whether it's a broker, it's a car dealer, it's an introducer or someone that's helping someone access a loan product across all the various markets. Can encourage people what to put on applications that may not always be correct. So, that does - we do see that happening.

The best-interest duty would go some way, I think. It would give the consumer in that position a bit more of a - perhaps, a remedy in relation to when that duty is breached. I guess, that one of the big problems we see with responsible lending more broadly, it's from the individual's perspective. The remedy is often not a very good one, so you would get put back into the place you were before you took out the loan, which often means that you might get interest and fees waived, but you still owe the principal, because you got the benefit of the principal.

MS ABRAMSON: And I'm sure you Gerard - if you don't mind me interrupting - that best interest would allow you to claim, what a misleading or a negligent-type and that would lead to different - - -

MR BRODY: Potentially, that's right.

MS ABRAMSON: Potentially, yes.

MR BRODY: Yes. We do think that if the remedy for an irresponsible loan was, say, debt waiver, then that would focus the mind of lenders and brokers to make sure it was - they were complying with the responsible lending requirement to begin with.

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MR HARRIS: The codes that currently guide this industry in this area don't allow that to happen. Is that right?

MR BRODY: No.

MR HARRIS: So, in a sense, your argument is, you need some external regulatory intervention here. As you can, I'm sure, read from the chapter in the draft report, we waxed and waned a little about whether it was essential to have, as it were, black letter law here, or whether there were other mechanisms that, for example, banks might arrive at themselves for imposing the duty of care on their own bank-owned brokers.

This is actually one of the reasons why we're saying in this area you have to come up with something to affect the bank-owned brokers. Banks could possibly offset that, but you're, by the sound of it, lacking in confidence that that would be a sufficient solution, primarily because enforceability of the solution may be unclear or uncertain.

MR BRODY: Yes, I think that's right, and I think, yes, as I said, I think that the - there are a lack of consequences for the lenders and brokers when these duties - or where people are put into unaffordable loans is an issue, and it doesn't necessarily provide that right incentive for them to lend responsibly to begin with.

MS ABRAMSON: Can I just ask, and it might be because I'm not, sort of, quite firm myself, but do you have a dispute with the mortgage broker that goes to the dispute resolution body? But aren't there circumstances where the loan - as a consequence of an ombudsmen-type scheme, the loan may not be, you know, regarded as a valid loan, or is it only ever going to be waiver of fees or - - -

MR BRODY: In the main, the legal principle is to put you back into the position - - -

MS ABRAMSON: Position, yes.

MR BRODY: - - - you were to begin with, and that will depend on a range of things. But most cases you'll have to - you've got the benefit of that principal. So, if you bought the car, you have to pay for the benefit of using the car for a period. The car is sold, you've got the home likewise. So, you know, that's what I'm saying, it's not as efficient enough, sort of, remedy at the individual level.

MR HARRIS: Then finally from me anyway, on consent, so you suggested that - and I don't know whether this is directly our draft report or a more generic proposition, but you're suggesting - well, I took your remarks to suggest there was an insufficiency in current arrangements around a consumer's consent to have their information utilised by a party considering them for a financial transaction. Is that driven by the advent or the probable advent of comprehensive consumer credit reporting or is it driven by something else?

MR BRODY: It's broader than that, I think. So, we see already businesses when - we're actually about - my organisation is about to release a report this week on lead generation

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as a marketing tool, which has, sort of, considerably grown in the online environment, and the way in which marketing companies, you know, put competitions online or a survey, and that's used to gain your customer details, that are then passed on to a third party to market your particular products.

They rely on consent practices. They, you know, by ticking a box or in the terms and conditions, that customer has consented to receive that sort of marketing. And what we're saying is that the consent practices by most businesses, I think, in Australia, and clearly in the finance sector, importantly in the finance sector, tend to rely on not bringing to the attention to the customer important facts and, sort of, bundling consent into terms and conditions or other ways.

So, what we're saying is that we'd like to see - particularly around important areas like sharing information, that there be a stronger consent regime, and potentially - we don't have a particular view about what it looks like at this stage, but potentially a standard of some type that must be complied with to get customers' consent, and that allows consent to be withdrawn. You know, once you've ticked those boxes, sometimes it can be very hard to, sort of, untick them, and stop - once your data's gone, it's gone, if you like.

MS ABRAMSON: Gerard, does some of that though come into unfair contracts? So, you're talking about conditions that are imposed. The one I was thinking about, which was brought to my attention, was disclosure of a PIN and then, you know, the bank would have a right to say, "Well, actually, we don't have to cover you in those circumstances." But it seemed to me that some of those conditions - I'm not putting it as a live - just by way of example. But some of those type of conditions might be deemed to be unfair contract terms. I'm not talking about negligence, I'm talking if somebody comes along and steals your PIN.

MR BRODY: So, are you talking about - sort of, there are some, for example, pay-day lenders out there that use what's called screen-scraping technology. So, as part of applying for the pay-day loan on line, you hand over your banking password, and these days they're also handing over their myGov password, so they can get - they can sort of scrape your income details from Centrelink and your - - -

MS ABRAMSON: No, I wasn't actually referring to that.

MR BRODY: Yes.

MS ABRAMSON: But that - you know, I wasn't aware of that. I was thinking about traditional banking.

MR BRODY: Right. So, where that's an unfair contract term, look, it may be arguable - I don't know of any, you know, regulators that have looked into that analysis. Generally, it's presented as a condition of getting the service. So, yes.

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MS ABRAMSON: No, I was just interested. One other thing, if I may, Peter, I just wanted to ask about is underwriting of insurance products, you will know that we had a reasonable amount to say about - I think we used the words, "A blizzard of lots of products, but not much choice." But in - how would you make - say, you had a regulator said, "Well, here are all the products that are underwritten," or even on the insurer. So, how would you go about ensuring that a consumer actually had an interest in understanding that information? Like, we talked about that with loans, how do you make it so the consumer actually thinks, "Well, that's something I should check out."

MR BRODY: I think that's really difficult, and I think we might be, you know, in some sense, putting our head against a brick wall if we think consumers necessarily kind of care. They're going to care about what's been told with them at that point of sale, and particularly the advertising practices. Some of them over a phone sale, interaction, or what's on - showing them online. So, I guess, if you really wanted the consumer to know those things, it would have to be served into that point of the transaction.

MR HARRIS: Sorry, I didn't want to get off consent before asking. The hardest thing for me though is solutions on consent, because this - once you've given it, it's gone. How can you recreate a circumstance where someone has to reaffirm? In a lot of ways, they probably won't even know what the information subsequently will be used for, will they? So, it seems just - it seems very tricky to give a person the ability to reconsider. Moreover, if you started down that path and imposed an obligation but it was undeliverable, then aren't you, sort of, almost discouraging a lender from being in that business at all, because now there's a liability that I can't discharge if I get him to consent again, because, you know, it's proven to be impracticable.

DR KING: Or there's a risk that you create a law that's just simply unenforceable.

MR HARRIS: Yes, I'm not against the concept.

DR KING: Yes.

MR HARRIS: - - - I'm just trying to - - -

MR BRODY: No, I appreciate that, and I guess that I'm not sure that we have all the answers on this issue either. I guess, what we'd like to see is, yes, some further inquiry and analysis into how to make consent in a, you know, modern, online market economy environment, work pro-competitively and not anti-competitively in a way that sort of reduces real customer choice.

MR HARRIS: Because in the US they've had some quite significant problems with people hacking consumer information sources and there's been a very serious one late last year.

MR BRODY: Yes.

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MR HARRIS: The first solution from the consumer credit entities is to tell a customer that you can freeze access to your information. But, of course, if you freeze access of your information, then if you're in a circumstance where you're still involved in a transaction, the transaction will fall over.

If you were in a, what I might call a circumstance where you're persistently likely to want to access credit temporarily, and that's credit cards, and you freeze access, your credit card could die on you. So, it doesn't seem to be a solution to go down those sorts of remedies that we saw in the US.

MR BRODY: I think, as I understood the freezing access to your credit card report is your freezing as to that information. It doesn't stop you using existing credit products, because there's no reason for your credit provider be consistently checking your credit report. They generally only look at it when, you know, you apply for a loan. That's the point they look at it.

So, yes, it would have implications if you were mid-point and going around shopping for a mortgage, that might create problems for you. But for many people, they're not in that moment, and so a freezing a credit report at that stage while - it might be a useful thing for them.

MR HARRIS: Okay. Well, I tossed it out there deliberately to see whether (a), you thought about it and, (b), when you had something, because that appeared to be - I mean, the US financial system is different to ours, obviously, but it appeared to be at least something that people generally thought, "Oh, well, that's probably what you can do, it's probably" - now, it's for a different circumstance, it's for a hack, but if the concern was consent needs to be re-established - - -

MR BRODY: I guess, the other thing I would say in that circumstance is to think about how you can compensate the customer. So, if they, for example, were going to shop for a home and they missed that opportunity, you've got to compensate - compensable loss that that credit body, perhaps that didn't have the appropriate security standards, that allowed the hack should be liable for.

MR HARRIS: All right, that's quite interesting. Stephen, do you have - - -

DR KING: Not on credit - - -

MR HARRIS: No, we're moving off topic.

DR KING: Okay. So, there's a couple of - let me do a couple of quickies. Firstly - which have no connection to each other. Firstly, you mentioned commissions and issues of commission. One of the things that you might be able to very quickly help me understand, internal bank issues haven't been raised to us. Now, internal bank issues, obviously, have been a huge issue in the States, for example, Wells Fargo and their internal incentives. And

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it's not the sort of thing that we can actually ask the banks, "Oh, your internal incentive system's stuffed."

I mean, any views on that? I mean, it literally just has not been raised to us and so is it the case, well actually the banks, internally at least, don't seem to be - you know, the Wells Fargo case, it was the incentives to open accounts in people's names even though they didn't know about it. I mean, that's an extreme, but do you see anything happening in that space?

MR BRODY: Look, I think that has been an issue. Both the individual incentives for bank staff, but also targets that are put on bank staff does drive behaviour in banks that put people into particular products. I think the example of consumer credit insurance is a key example. So, you've recommended deferred sales mechanism be brought in - be on car yards. I think banks would be a perfect place to add it to for exactly that reason.

So, I do think that's an issue. Look, there has been some changes in the banking industry that they've adopted in the last 12 months following their own review that was conducted by Stephen Sedgwick. I think a lot of his recommendations around this issue were very sensible. What is more difficult to follow, if I'm honest with you, is the extent to which the banks have implemented those. I try to follow it by looking at the various media releases they put out, but there's no, sort of, one central place where you can really work out to what extent they have implemented those recommendations. I think understanding, that would be more helpful, but, you know, I think for example, the consumer credit insurance is a good example of the way in which incentives encourage - - -

DR KING: Yes. No, that is one that's obviously been brought up to us before. Yes, good point. The final one I had was just on funding, which you've mentioned in your earlier submission, your submission at the Royal Commission, I think you mentioned it as well, you mentioned it in the introductory remarks here, particularly with credit cards and the bundling. I'd just like a bit more detail on where you actually see the problem there with that.

MR BRODY: There's a couple of different problems. So, I think that once you bundle a product grouped together, particularly a mortgage with a credit card, it does make it difficult to switch. There are barriers to switching, because you've got to switch - you can't, sort of, untangle the bundle often very easily. If you want to get a credit card over here, if there's suddenly a better deal at a different provider, maybe you've lost the benefit associated with your mortgage. So, that's the first barrier.

I think that we see more fundamental concerns with responsible lending issues. So, people have gone to get a mortgage. They had no intention to get a credit card, that wasn't part of their requirements and objectives as the law requires the bank to access, but they're - "You know, this is the bundle we've got."

DR KING: Yes.

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MR BRODY: So, suddenly they're with - they've got a credit card as well, and, you know, our view is the credit card is a very dangerous product that can lead to unmanageable debt quite easily, and that's the responsible lending aspect too we're concerned about.

DR KING: Okay, so yes, it is the case that you pay the flat fee per year through your bundle.

MR BRODY: That's right.

DR KING: But there's a credit card thrown in for free.

MR BRODY: That's right.

DR KING: Effectively, it's a credit card.

MR BRODY: That's right.

DR KING: No, that's good.

MR HARRIS: Julie.

MS ABRAMSON: Yes, I just had a final question, which is really - one of the things that we've been thinking about, because, of course, we're looking through a competition lens, is - and I've heard everything you've said, Gerard, about duties - the duty of best interest, but about planners, wealth management advisers advising on loans, and I wondered if you had a view about that, because it may be tied to what standard you think people might - - -

MR BRODY: Yes. Look, I would encourage you to think about that issue, and I think you also need to look at people, I guess, outside the finance sector and their role, like real estate agents and others in terms of the incentives that are provided to them to direct you towards particular products offered by particular lenders.

You know, I don't think there's anything wrong with a financial adviser providing you with a full service and, you know, if you are seeking a loan, then that might be quite convenient and helpful, but they should be regulated by the same standard.

MR HARRIS: We did get - we had FINSIA. Now, I'm not going to get the acronym right. We had FINSIA as a submitter last week and came to hearings, and they were talking about the difference between professional standards as required by a financial adviser, a wealth adviser, if you like, in my simpler terms versus a mortgage broker. Didn't have the same requirements for professional standards, and this seemed to be a matter that you might address in the context of if you were to, as it were, put mortgages in as an asset that a financial adviser would handle, presumably, because they've got a - they've got already, you know, a requirement for - to meet particular quality or educational standards, that that could actually be a benefit to borrowers in this market versus a mortgage broker.

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Do you have a view on, sort of - given that you presumably see them from time to time, both, do you have a view on that?

MR BRODY: I think that at a general level we should be encouraging professionalism across all these sectors, and they should have similar or, you know, the same sort of standards when it comes to education and continuing professional development, and training, and so on. So, I guess that I'd hope that, perhaps, yes, the financial advice sector, there has been the obligations placed on them under law reform and under industry codes of practice. If they could ratchet up what happens to the mortgage broking industry, then that would be positive.

MR HARRIS: All right. Can I ask just a broader - this is my last question around a broader proposition. We are trying to get a view, not so much, perhaps, of direct interest to your centre, but we're trying to get a view on ASIC versus the ACCC as the potential competition champion. And, I guess, because you see both of them in action in marketplaces where you are, even though the proposition we have in mind with a competition champion is one where they will be working at the highest levels, you know, through the Council of Financial Regulators and that kind of thing, nevertheless, because you see them in action, did - when you read the report and struck this recommendation, did you have a reaction to it that said one or the other is more likely to be, you know, a useful party to be appointed by the Treasurer as the competition champion?

MR BRODY: I think that our view would be that the - it would be more effective for the ACCC to play that role. They've obviously got competition as their mandate across the economy. They've recently been given a new bucket of money, as I understand it, they've developed a unit. Perhaps that needs to be expanded and more money given to them if they were to give this ongoing competition champion role, but I do see fitting in with that function they've already been given.

That said, I don't see - and I know that ASIC has put forward that it should have, sort of, competition among its objectives as a regulator, and I think that would be a good move as well. There are various decisions or, you know, regulatory decisions that ASIC makes that, you know, a pro-competitive lens might give them more power to make a good decision that benefits customers.

So - and they are doing many things about that, I guess. So, for example, they are looking at the deferred sales measure in car finance, and that looks to be something that ASIC's able to implement. But I think if they had a competition, some objective, that would give them strength to make those sort of regulatory interventions.

MR HARRIS: So, you're really saying, shrink the both of them, rather than necessarily having a preference for one?

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MR BRODY: I think that at the high level though, the main focus of competition, it sits with the ACCC. You know, ASIC's main focus is around, you know, enforcing compliance with the law and ensuring that there are those perverse outcomes in the marketplace.

MR HARRIS: That does it for me; are you guys done? We are only one minute past time. As good as my record in Sydney last week, where we were absolutely on time both days. So, Gerard, thank you very much for your time.

MR BRODY: Thank you.

MR HARRIS: Your original submission and participation today, hopefully, ongoing access to your background. So, we're going to take a break now for lunch and restart at two with the Finance Brokers Association of Australia. Thanks.

ADJOURNED **[1.02 pm]**

RESUMED **[2.05 pm]**

MR HARRIS: We're now back in session, and I think we have the Finance Brokers Association of Australia. Could you identify yourself for the public record please?

MR WHITE: Yes, certainly. Peter White, I'm the Executive Director.

MR HARRIS: Peter, do you have some opening comments to make?

MR WHITE: Yes, I do. I'll just give a bit of background and there's some points that I'd sent through that I'd like to comment on. So just for a bit of understanding, the FBAA was established in 1993 and is the leading professional body for finance and mortgage brokers nationally, representing over 8,200 members and additionally some 13,000 industry stakeholders.

Myself, I am a 30 year industry practitioner with extensive experience in retail banking, non-banking, private investment banking, mortgage management and broking. A couple of things of note, I established RAMS's first sales office in the early 90s and was Mark ...(indistinct)... CEO or first CEO was at home loans in the late '90s.

Since 2003 I have been Executive Director for the FBAA, part of the executive team, volunteering my services until 2010, where I took over responsibilities as CEO and still today head the business association as the executive director, key responsibilities being government, media and strategy.

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Today there are five primary items I have listed for comment, being that of lenders mortgage insurance, global commission practices, claw backs, broker market size and of course Australian broker commissions, and I will address them in that order.

So firstly on LMI, just as a point of note I was interested to read that there was a pull out comment made by me in the PC's paper that was made from around 2011, and it's now some nearly seven years. Although those comments might have been accurate at that time, they may not necessarily be representative in today's market place. It was a comment where it says that the national president of the FBAA, which I was at that time, said that about 90 to 95 per cent of people didn't understand what LMI was.

Correct then, I wouldn't put my hand on my heart and say that's necessarily the data as of today.

MR HARRIS: I don't want to break your flow up, but are you actually saying you want us not to use that quote?

MR WHITE: Well, it was accurate at the time, I guess it was a point in time, it's not today.

MR HARRIS: No, what we do in our operations is going through and sieving things. Someone says something and we think, "Well, that's reasonable, interesting and reasonable".

MR WHITE: It was reasonable at the time.

MR HARRIS: Okay, we'll bear that in mind, thank you. Sorry, keep going.

MR WHITE: Also following on in the lenders mortgage insurance space, there was various media commentary being editorialised by CHOICE where it says the abolition of the insurance, LMI, as it is not insurance that provides any value to the consumer, it provides value to the lender by insuring them for risk of default.

The closing comment relating to the relationship between lender and insurer in isolation is correct, but it is not complete. Without LMI rates would be higher as the cost of funds would increase, and buyers would not be able to borrow the 80 LVR, the loan to valuation ratio, and possibly restricted to much less than this.

The FBAA is the original and leading advocate for better disclosure of LMI as it should be disclosed in the key fact sheet to a home loan, as was agreed by the Treasury Working Committee to the NCCP, where progression to implementation was stopped on 15 February 2013 due to a pending federal election later that year. We believe that most certainly disclosure piece needs to be correct and not buried within the documentation of a loan.

Further to such disclosure however, LMI should be formally discussed at the very beginning of an application process by all brokers in the market place and lenders alike, as

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disclosure and comprehension are not synonyms, you need to educate. The discussions around portability and proactive rebates is something that is worthy of further discussion, but I won't touch on it terribly much at this point in time.

Looking at the global market place, there is various commentary in the market that says that brokers in Australia are amongst the highest paid in the world, but this inaccurate. In 2016 the FBAA conducted global research which analysed brokers' home loan commissions across seven countries and the results showed that Australian brokers are actually amongst the lowest paid in the world and amongst the only ones that suffer claw backs in the manner which they do. I'll talk about claw backs next.

I do have a copy of that research paper here if you would like it.

MR HARRIS: Sure.

MR WHITE: And a summary of it as well. Additional commentary refers to that brokers are being paid a lot more than what financial planners do, and this too is not the case. Various commentary in the media refers to financial planners being paid $100 to $700, yet our research shows that up to $1 million of assets under advice. Financial planners charge 0.75 to 1 per cent as an upfront fee, and 0.25 per cent on an annual renewal or review, if you like, the equivalent of a trail. Once the amount under advice goes above $1 million it drops to about 0.55 per cent. And that is as of information to date.

Moving on to claw backs. I'm well known for my advocacy against unfair claw backs in the market place and they need to go. But it's important to note that claw backs only apply to upfront commissions and not to trail in the main. I agree that claw backs may inhibit the movement of loans between borrowers and lenders, plus unquestionably it's commercially unfair.

To do your job, get paid for it, and then risk losing your income for doing your job for up to two years for things which are outside your control is completely unacceptable and this must change. The broker's duty of care to a client is unfairly commercially challenged due to this and this must be removed to ensure the best interests of the clients are always first, without the potential commercial disruption.

Briefly just on broker market sizes. There is various opinions in the market of the size of the broker industry, as commented in the media and various regulatory papers. The FBAA this week will launch what is called the Consumer Broker Index, which shows from the extraction of ASIC's data, as supplied by them, that as of April 2017 there were 26,037 consumer brokers and businesses in Australia.

This is broken up by 21,681 credit reps, which are brokers, 4,356 licence holders, which are predominantly businesses, it is 82.23 per cent weighted East Coast and the largest concentrations are in New South Wales, then Victoria and then Queensland.

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It shows that the industry has been growing at an average rate of 9.16 per cent over the past three years, but is slowing against the average growth over the past four years. Additionally, I have some summarised information in regards to that data, and the actual index will be available as I get through to about the middle of the week. But that is there for yourselves as well, so you can see that.

Broker commissionsare I guess the largest part of this. I'll try and move through this as quickly as possible. I am concerned with some statements that demonstrate possible limited understanding of commissions in saying that mortgage brokers must get consumers a cheaper rate, or that the mortgage broker remuneration needs to be reduced or changed to fee for service.

The FBAA would like to put forward some points, possibly broadening that thinking. In the past the FBAA has made previous submissions on the mistreatment of existing customers by banks, the fact that banks are inherently conflicted and the adverse impact of LMI prohibiting consumers switching loans.

There is an inference that the role of a broker is to get the lower rate for a consumer. This is not correct, as brokers by law provide credit assistance, which does include looking at potentially better interest rates, but is far more than just that and includes product suitability and various other components. By misstating the purpose of a broker, one is then able to go on to suggest brokers are failing, which further allows to suggest the failures are caused by poor disclosure, conflicts and excessive remuneration, and then lead to recommend changes.

Brokers increase competitive pressures, making all rates lower. Alternatively, without brokers consumers would only have the 100 per cent conflicted direct channel option, which is inferior. The broker industry has provided significant positive impacts to market, interest rates margins have come down, lending in the late '70s through to the '80s before brokers were involved saw margins of cost to funds above 4 to 6 per cent on home loans, today it is around 2 to 2.5 per cent.

There is more competition in the home loan market than there has ever been before, and all consumers are the beneficiaries, regardless of whether they use the broker channels or go direct.

The notion of conflict is misplaced. At a basic level, simply receiving remuneration amounts to conflict. An employee receives more promotional opportunities or more money the better the job they do. In sales-remunerated roles, this is even more apparent, yet it does not always equate to poor outcomes.

Direct channels are 100 per cent conflicted; they cannot turn around and recommend the bank next door has a better product or cheaper interest rate. Brokers must offer better alternatives to the 100 per cent conflict of a product provider. How can a broker with product choice be viewed in a lesser light? At worst, a conflicted broker is delivering the

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same result as a direct channel at no additional cost to the consumer. The focus on broker remuneration seems to have no end purpose other than to disrupt industry.

The PC suggests there is no transparency in broker fees, yet the commission disclosure requirements under the NCCP are extensive. The finding also ignores the fact that, without the presence of brokers, banks would be under no pressure to remain competitive or to be looking after their clients.

The real barrier to consumers in switching mortgages is actually lenders mortgage insurance, which is not portable nor rebateable in most cases due to the credit policies. So the focus on broker remuneration seems misplaced as broker remuneration is a supply side cost. There is no suggestion that the broker remuneration is increasing rates by consumers or that changing broker remuneration will reduce rates to consumers.

There have been various commentaries in industry media which I would like to briefly address, and one of which - both of these have come from the PC - one is in relation to - the first one is in relation to there is a large apparent additional to industry cost since the mid-'90s, and I would say that the distribution cost has always been there, whether it be branch network costs or for broker networks, which I would argue are around 50 per cent cheaper than branch networks, and lending margins since the '90s have reduced, not increased, so there is no additional cost to industry or borrowers at all.

There is a cost for distribution across all retail business sectors around the world. In lending it is either the branch fixed fixed costs, or the significantly more cost effective broker variable fixed costs, and additional comment in industry media talks about trailing commissions being designed to increase churn and manage customers on behalf of the banks.

Yes, the reality is that when trail commission first came out it was first as a design to reduce inappropriate churn of portfolios, that was the case. But over the many years this has been in place trail income, regardless of what is written or the verbiage within a contract between a lender and an aggregator, is it sits between the lender and aggregator, not direct to the broker, the broker's agreement or with the aggregator, is to undertake actual work on behalf of the lender which would normally be done by bank branch staff or by head offices.

This includes such things as originating the loan, so advertising and marketing, and it can take upwards of 10 clients before you actually get the right to work with one borrower. Assisting borrowers to navigate the approval process through to settlement, assisting the borrower post settlement with queries or issues, conducting annual reviews of facilities to ensure that the loans have not become unsuitable as lending and borrower circumstances do change.

Trail does not restrict the movement to restructure or refinance a loan, should such need be the consideration for the best interests of the borrower. So if a trail stops with one lender, it then restarts with another. It is not the barrier for movement.

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The use of brokers evolved from a clear recognition that the valued proposition of using a broker was more attractive than branches and staff. The proliferation of brokers has occurred because of the benefit derived by product issuers from an expanding broker network and, implicitly, product users know that a broker distribution model is cheaper and more effective than staffing branches, which is why it continues to thrive.

The discussion around fee for service model is not viable, as it will result in consumers having to pay from their own pockets to intermediaries for the services that should be paid for by the bank, i.e. as brokers provide credit assistance. That would mean intermediaries would earn less, making the profession less viable and see many exit the industry, thus diminishing the influence they have on lender conduct, pricing or service levels, and the direct channel becomes more profitable. The consumer loses every time. Thank you.

MR HARRIS: Thanks, Peter. I might try if I can to reverse the order a bit, because I think our primary concerns - I think if we get to LMI, which you started out with, we'll probably be on reasonably solid ground collectively. But I just want to be sure, you have read our recommendations?

MR WHITE: Yes.

MR HARRIS: Not just the media reporting?

MR WHITE: No, I have read the recommendations.

MR HARRIS: Okay, good, because I'm going to be presuming that's the case.

MR WHITE: Unfortunately the media influences people's thought process.

MR HARRIS: The media is very active and yes, we're all in the same space. Churn, can I start with churn? So it has been put to us throughout the course of the development of the draft report, and subsequently, that banks and certainly some brokers believe they are being paid to reduce churn. You were fairly explicit I think about the fact that might have happened years ago, if I understood what you just said. The implication of that is it is no longer the case.

So if we were to ask either banks or the aggregators for which many brokers work for a copy of the obligations that they expect as a result of the payments that they're making, would we find, because we have asked for these things and we don't necessarily get access to them, would we find then that there is no obligation to prevent churn on behalf of the broker?

MR WHITE: As far as the verbiage is concerned within the contracts, as far as I'm aware, and I haven't read one for a while, so I'll caveat that position, I don't believe you'll find it detailed in that level. But if you're speaking with any bank it is not a giveaway, you are expected to undertake a certain level of duties that would normally be undertaken elsewhere. That's why it was given. And yes, originally it was for churn, because there

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was a whole lot of inappropriate actions happening in the very early days when this started, and they're the sort of things we wanted out of the industry, we just need it moved on to another sense.

MR HARRIS: Right. And yes, you've referenced the - if you like, the alternative to brokers being the branch, and pointed out it's 100 per cent conflicted. If anybody's conflicted, it's 100 per cent conflicted. But equally, it's been argued that brokers are being paid this ongoing trailing commission in order to manage the customer.

Now, that activity would normally then, in the alternative, undertaken by the branch, one would rationally assume that branch's job was to ensure the loan didn't shift to another party. You can see can't you how we could conclude from that that's what a broker is being paid to do, ensure the loan doesn't move to another party.

MR WHITE: I most certainly can see where the parallel is drawn as such, between the bank, but there's two different things at play here. I mean, even within the banking system they have proactive teams to ensure that when clients are trying to refinance that they are a retention team trying to hold people in place.

The broker isn't driven by that mentality as far as where trail income comes from. I do understand the thought process, but understand that when a loan closes, it gets refinanced elsewhere, yes, the trail will stop there, but it will re-continue with the next loan. So that service standard gets maintained for the borrower across the premise. It doesn't force them to stop.

Claw back does, because somebody works - does a lot of work to actually originate a transaction, and all of a sudden, for up to two years, you can lose you income for doing your job, which just commercially doesn't make sense. That is certainly a barrier, as well as the high cost of LMI.

MR HARRIS: That's right. We could see the claw back was worse than a trailing commission, but it was again put to us, and this is the problem, you only get what you get, that that's pretty much been eliminated. I will not say been, I will say being eliminated. Is that not the case? Should we be worried by claw back still persisting as a preferred activity from the banking side?

MR WHITE: In my personal view I believe that claw back is something to be concerned about. I understand the rationale and why it was implemented and it came in when the Labor Government banned exit fees, and there's a whole history that sits behind that. But at the end of the day, everybody gets paid to do a job, and once you've done your job you've ticked that box. Somebody should not commercially then have the right to claim that back over two years. And I believe that is something to be concerned about.

In overseas standards in our global research paper, in America for example, brokers are paid upwards of 2 and sometimes 3 per cent as an upfront commission without any trail, at the high end of scale they have fees they have to pay, but there is no claw back. If the

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lender finds that you're churning business on a regular basis, they'll tap you on the shoulder and say, "Hey, what's going on". But they are there, at - when you look at the math, at a far more beneficial financial position then Australian brokers are, and that's without a claw back position. So the books churn, which is not necessarily a good outcome.

MR HARRIS: No. I think in part that US experience was known to us and was - our view is that there are different models overseas, but I think we're more thinking of France and Netherlands where there are apparently lesser charges - you've said not - which is why we're very interested in that detail because it was again put to us that they were lesser, from a banking institution that should know. But anyway, we'll have a look at the data and see what the data says.

MR WHITE: We did look at Holland and it showed that they had moved away from a commissions-based premise to fee for service as such. And most of the fees were sitting around 3000 or 3200 Euros per transaction, which actually went up more.

MR HARRIS: Well, if you've got data, we're interested in data.

MR WHITE: Yes.

MR HARRIS: I have other questions, but I'm going to give everyone else a go.

DR KING: We're more than happy for you to continue at the moment.

MR HARRIS: All right. I'm very interested in the fact that you are I think the first substantive person, he says, looking at the back row, but anyway, the first substantive person to tell us that you have an estimate, even if it's only your own personal estimate, of the difference between the cost to the banking system of having a broker-oriented network and having a branch-oriented network.

MR WHITE: Yes.

MR HARRIS: You may or may not know, that's why I asked you about the report, we spent a lot of time trying to get access to data which would enable us to work out whether the price of a broker was justified by the cost savings. And that cost benefit would have helped us because we can see the benefit of a broker, we're just trying to look at the cost and we could get no significant evidence.

I think the Royal Commission - I don't like to say those words too often - but it is interested in this as well. But you at least appear to have some personal estimate, have I understood your 50 per cent comparator?

MR WHITE: Yes, I do. Yes.

MR HARRIS: Can you tell us a little bit about that?

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MR WHITE: Sure. I mentioned earlier, I actually established RAMS Home Loans' first primary office in the country, back in '93. As we progressed that period in RAMS, into the - as we progressed through the '90s, we were constantly doing an analysis between the branches and the broker networks, and it was literally half the cost as far as being able to run a broker network versus a branch network.

This is simple logical maths that sits behind it and I'll also come back to the thought on banks at the moment. I refer to banks being a fixed fixed cost. So regardless of whether a bank produces any revenue or not, they have a fixed cost that can't be mitigated. So they've got branch networks, staff salaries and so on and so forth. So whether they write loans, gather in deposits, becomes irrelevant, they have a fixed fixed cost regardless of outcome.

With the broker sector you have a variable fixed cost. So cost is quantified that the broker gets paid X out of the transaction, but only if they produce the results, i.e. settlement. So actually inherently by simple logic, far more cost effective.

I find it very difficult for banks to argue that they can't provide that information, they have major business units running broker networks which all have a P and L and we constantly say, "We can't do this", or "We can't do that because it's outside of our budget", someone needs to - so I said, "Well, if you've got a budget, then surely you know the answer to this", no. And they are listed entities and they have responsibilities to the public, so I'd be very surprised that information isn't there somewhere. We have people who now run aggregation firms in this country who have worked in the banks, who do say to me, anecdotally, it is ascertainable.

MR HARRIS: And the same would apply surely to business cases when a bank goes out to buy a brokerage. One assumes that there would be an internal business case which says this is the cost that we can save.

MR WHITE: Most certainly. They wouldn't be buying something to make a loss over.

MR HARRIS: I wouldn't have thought. Anyway, we will maybe persist with a little bit more information, but to the extent that - - -

DR KING: Just before moving off that, it's been towards us that it's actually not the right question that we're asking when we're looking at the costs, because the view is, well, the customers who go direct to a bank branch in some sense are different from those who go along to brokers and want the broker to search in their behalf for the best product. So we're not comparing like with like, if I can put it that way. Do you think there's any merit in that argument?

MR WHITE: Possibly not. You know, people go to brokers for a myriad of reasons; it's just not to get a cheaper loan. It's service. Many people use products like that are supplied through Harvey Norman and are higher income individuals because it's convenient and they just do it.

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So there's a service level standard, and I can recall very vividly during the mid to later part of the '90s where banks were closing branches left, right and centre around Australia, which pushed the broker's value proposition up through the roof. So your clients will go to branches for whatever reason they see fit. And usually it's transactional-based, not necessarily lending-based so much anymore. As we know, over 50 per cent of borrowers actually use a broker to originate a transaction.

So to me it's a service thing as much as anything else in regards to what happens at the broker level. And the way branches have evolved over the years, you walk into branches some days and you wonder if there's any staff there. So I don't think that that has the - people are going to branches for that reason.

MR HARRIS: I was going to move off the cost number anyway, but very interested - he says advertising - still very interested in the information that we might be able to obtain on that particular issue, for the purposes of - our analytical purpose here is to be able to put the cost on one side and if indeed it looks like it's a rational judgment being made, moreover it should therefore support the cost then paid to the broker for the purpose of the loan, and then you could say to consumers, this is not an exercise of market power. In other words, you're not being screwed.

MR WHITE: Yes.

MR HARRIS: Not to put too fine a point on it, that's what we're looking for in a competition-based inquiry. Yet when banks buy into the service, that might logically suggest that it's just a different way of extracting some money from a customer. I mean, you can see why we would be in it then, particularly because brokerages, you know, I think the larger ones have been substantially bought up by the banks and so we are just trying to get to the bottom of is this an exercise of market power or is it in fact a legitimate cost that you could say is justified either by cost saving by the banks on one hand, or service to the customer on the other hand, or perhaps a combination of the two, which would be a preferable - - -

MR WHITE: I think there's some logic that says it's a cost effective means of distribution. So if you acquire at the right price it's eventually a cheap customer versus a much higher cost of acquisition in the broader retail market space.

MR HARRIS: I wanted to ask about your membership. You tell us that you have - sorry, there were 26,000 brokers based around ASIC data.

MR WHITE: Yes.

MR HARRIS: I'm interested in your membership and the membership of other associations for this purpose of saying that the quality of service is supported by some kind of professional standard. You may or may not have heard, but we had some representatives last week telling us about the professional standards that apply in the wealth management industry, which has had its own particular problems.

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The professional standards in the mortgage broking industry don't appear to be of the same ilk. Now, that's a relatively recent thing, but I'm interested in that, because you're representing an association. So I'm first interested in do you impose upon your members a professional standard of some kind?

MR WHITE: Yes, we do, we have a code of ethics as well as a code of conduct that the brokers have to apply to. One of the interesting examples is that given my - I've been in the industry for a little while; I've always been very concerned that when people are new to industry they actually learn their base knowledge in a very sound manner.

So when the rulings came out for the NCCP back in 2010, our opposite number said that all brokers had to have a diploma. We said no, the law states Cert IV and you need to get your foundations right before you step onto higher education. A review of our membership shows that over 83 per cent of our members have done the diploma or a masters or doctorate degree in a relative finance discipline; they have extremely high professional standards in their conduct.

I did an audit of ASIC's data of their enforceable undertakings, bannings and disqualifications from 2011 to 2016, it showed that 9.45 per cent were our members. At the time of that banning or disqualification only 3.65 per cent were members at that time. We had already dealt with the other lots of problems.

So we see it from - when we look at the market place, that we know from our members' point of view, and generally as somebody who represents industry anyhow in the longevity of being in the industry, that brokers hold a very high professional standard. I don't think the measures with financial planning though quite balance, brokers in Australia can't manipulate markets, financial planners can.

I used to run a private banking suite, they most certainly can manipulate the financial market places or particular products, which they support and refer, there's a different plan.

MR HARRIS: Should we be interested in that? I'm not aware of that. How do they manipulate markets?

MR WHITE: Well, if you turn around and promote a specific investment product, that particular investment product, if it's done through a business unit, will flourish and increase.

MR HARRIS: I see. You're talking about a sort of some kind of pump and dump kind of - - -

MR WHITE: Yes, if you like, you can put it that way.

MR HARRIS: Well, I need - no, in my terms it has to be like that, I can't deal with - - -

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MR WHITE: No, that's fine.

MR HARRIS: I don't want to confuse, yes.

MR WHITE: But with brokers it doesn't change.

MR HARRIS: I see. No, they can't change that can they.

MS ABRAMSON: Don't tell me we're actually going to - - -

MR HARRIS: We always give people advice about the evacuation thing, and we think we hope - - -

DR KING: Hopefully it's another floor; it doesn't sound quite loud enough.

MR HARRIS: Yes. Hopefully it's a long way away. Let's go on. You mentioned that you therefore do effectively discipline your members.

MR WHITE: Certainly. We have an ACCC disciplinary tribunal, ACCC approved, yes.

MR HARRIS: And that means that they are excluded from being a member of your organisation, but they can continue to offer their service in the market place, can't they?

MR WHITE: Yes, they can.

MR HARRIS: And this seems to be a problem in the sense of a consumer potentially being misled, a person is a broker, they have to take down their statement on the window that says they're a member of your association, but they can otherwise persist in the market place.

MS ABRAMSON: Can I ask a question which relates to that? But in the circumstances where you remove a member because they don't meet your standards, is there any impact on the licence that they hold at ASIC, their credit licence?

MR WHITE: No. We would love it to be the fact. The law does not state that you must hold industry membership. We would most certainly be very supportive of that changing so it does, because we can disqualify someone, which means they have to take their shingle down. The disciplinary tribunal, depending on, can award costs to be paid, but outside of that it falls into your - it doesn't stop somebody from operating if they are able to get membership elsewhere, or they don't need membership, which is why you can see there's some disparities in membership numbers versus total market size and there's varied components within the market as well.

MR HARRIS: So this is leading up to our act in the consumers' best interest proposition, which again, because it wasn't necessarily clarified in the media, though we tried our best

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to do it a little bit since then, we were proposing for sure should be imposed upon bank owned brokerages, but we left the question open about independent brokerages.

Now, people have argued in these hearings those directions. But first the principle, do you think the industry should have such a duty of care imposed upon it?

MR WHITE: In principle, yes, I believe so.

MR HARRIS: And the question from your point of view then, noting that you've caveated it with "in principle", is that perhaps in a practical effect some of the ways that the future of financial advice and duties were imposed placed a larger burden on smaller firms, smaller brokerages, would you be concerned about primarily that rather than - well, no, I shouldn't put words in your mouth. Tell me what your concerns are.

MR WHITE: Well, firstly I'm not an expert on ...(indistinct)..., so I'll need to sort of position that to one side a little bit. But as far as the banks taking ownership of certain aggregation firms versus independents, there is a group called the Combined Industry Forum that we're a part of and they're working on disclosure pieces there. And I believe that having the disclosure piece appropriately positioned is I guess one of the pieces that we use to balance the market place.

The independents, I think there is a good balance. Certainly all the smaller sizes, they're generally up to about 500 brokers, they're rarely above that and I don't know why that is, it just seems to be where it balances out. But they're all providing a service. There's arguments of pros and cons on both sides of the fence, from how that positions.

So it's probably where my thoughts are.

MR HARRIS: You're wary of the idea. In principle you'd support it but you're wary of its practical application.

MR WHITE: Yes, I guess that's not unfair.

MR HARRIS: Okay. No, I'm just more trying to find out - because we have a recommendation in one case and an uncertainty in the other.

MR WHITE: Both are providing great services in the market, but the things we've got to watch is the vertical integration piece, the white labelling of products, to make sure that those are appropriately balanced and not misaligned.

MR HARRIS: And clarified, yes. No, I don't think - again, we're on reasonably common ground with white labelling. This question here is one where - how much confidence can you have when there isn't a duty of care? It's almost like the reverse, trying to prove that you are compliant in all respects.

Anyway, we can - do you want to do more on duty of care?

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DR KING: Yes. Well, following on from that, because you mentioned the white labelled products. It has been put to us that there's various vertically integrated broker models, there's various, for want of a better word, kickbacks, benefits brokers can achieve, incentives in place for brokers to provide the internal products. Are you aware of those, and so are you able to enlighten us further?

MR WHITE: Yes, sure. As far as those sort of products, some of it was actually only to the aggregator, not the broker, and some was directed to brokers. Most of those have already stopped, all right, and that was part of what's come out of the ASIC Remuneration Review from 2016 and various things that industry has done through the Combined Industry Forum to take steps to enhance better consumer outcomes.

So there were promotions, years ago now. So it's not current. But it stopped a couple of years ago, where banks would promote directly to brokers saying, "Hey, look, every loan you give us we'll give you an extra two grand" - hypothetical. And then there are other incentives that were then separate to that, that were more total volume driven that would go back to the aggregator. But again, these too have stopped, or have stopped in the main. Because obviously that is providing or risking a poor outcome.

DR KING: Are you aware of, within the vertically integrated aggregators, whether there are perhaps less obvious incentives given? I mean, the two that you mentioned are very obvious ones.

MR WHITE: Well, there's obviously sponsorships of conferences and things like that that transpire. And the industry is looking to resolve those to make sure that (1) that industry when they're holding conferences are 80 per cent or more of educational content, they're not just junkets as such, that location is appropriate for what they're doing as well.

And many lenders have - well, that integration piece have gotten behind those and swayed them. But again, these things are things that are historic, not necessarily today. It's always difficult to see what you can't see. So I don't believe in the current environment there is more than what we can see, or not much more than what we can see.

The past is something that I'd be more questionable over, but since the NCCP, so from 2010, and also where we are today, these things have definitely lifted the game, and rightly so.

DR KING: Do brokers working for integrated aggregators ever get pressure if they're not writing enough loans, enough in inverted commas, that relate to the owner of the - or the large shareholder?

MR WHITE: Not that I'm aware of, but I can't say that that would be a possibility.

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MR HARRIS: Do you think that brokers that work for - in a bank-owned entity are obliged at all to inform the consumer that they're negotiating effectively with their employer?

MR WHITE: There is disclosure pieces that need to be put in the credit guide that talks about that, and it's also being more ramped up through what the forum's been doing in the marketplace, so industry is pushing that out further to ensure that it is very, very clearly stated.

But it's interesting when you look at that, that in the majority of sectors, I won't say it's all but in the majority of sectors, that doesn't actually come into the actual discussions. Brokers in general, and I'm only talking in general, work in the best interests of the client. It's like anything, you know, there's always a small percentage that will do something wrong, and that doesn't necessarily meant it's systemic within the industry or the industry is bad.

MR HARRIS: I wasn't so much thinking of them even doing something wrong, as making - - -

MR WHITE: Decisions in that direction.

MR HARRIS: - - - the customer aware of the conflict that they themselves must face. I mean, effectively a broker going in to negotiate a loan if they're acting in the customer's best interest is effectively saying to that customer, "Now, I'm going to go into the next room and negotiate with my employer on your behalf".

Even if the employment arrangement is somewhat broken up by a contractual obligation and God knows what else, it doesn't matter. That's actually what we're sort of relying upon here, and at its very least, you would imagine, that that disclosure would need to be made, not just so much in a, you know, here's a bunch of papers and please tick the box basis, but you would think it would be a very important upfront kind of recognition thing, if only to establish trust.

MR WHITE: No, I agree. And it's - what I always talk about is truth through transparency. That transparency gives you the trust. Completely agree. But initially what was transpired was a disclosure piece in the NCCP through the credit guide, and industry is now ramping that up to make it far more transparent.

MR HARRIS: And you're confident they will succeed with this kind of process?

MR WHITE: I'm confident they will, it is something that is being worked on. But most certainly I'm confident. And our research into - or the industry's research into the market place sees that there is no barrier to doing that, no one sees it as a problematic thing. Industry sees it as an easy thing to do.

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MS ABRAMSON: Peter, can I ask you, you said it a few times and I understood what you said about best interests. So are you saying that in practice, even though the legal test is not unsuitable, that brokers in your experience - we're talking about the majority, not the small minority - are actually looking at the broader suite of products because they're looking at what's in the best interests of the client?

So would that mean that in practice you wouldn't expect much change in the nature of how people go about doing their job?

MR WHITE: That's correct. And also too, a lot of this is technology-driven. So when we talk about what is the selection in front of the borrower, potential loan options, they come off a computer system. It's not in the old days where it was manual hard labour to try and extract what was what. So the computer system - - -

MS ABRAMSON: That's why we're interested in integration though, what products are put before the customer.

MR WHITE: Yes. It's generated off the aggregator's loan system, management system, and that creates a suite based on the parameters of what the borrower's looking at the inputs and fields and so on, I guess to that. Where he says, well, here is a selection of things that unfortunately not unsuitable for your needs, and then there's recommendations and discussions happen from there.

MR HARRIS: And on white label loans, to the best of your knowledge, being an expert in the industry, is the same broker obliged to take the same disclosure process if the loan he or she comes back with to the customer is a white label loan, "I'm recommending you go with this white label loan", are they equally obliged to say to the customer, "But be aware, this loan is effectively being sourced from, again, my employer"? Is it clear?

MR WHITE: Probably not in those words.

MR HARRIS: Well, you know what I mean.

MR WHITE: Yes, it is. They must be obliged to do that.

MR HARRIS: You see it's like it almost looks like an impossibly unlikely situation for this to occur, is I guess the reason we're doubtful about it. It just seems so unlikely that a party will say, "I've gone very carefully to strip away the identifiers on this loan", to white label it, "to provide a different identifier, in order to sell it to you, but I'm still going to disclose that it's my owner".

MR WHITE: It has no material impact to the transaction in as far as what is a better option. The most appropriate options are whatever they are, that are not unsuitable. So if the lender's white label product happens to be that, then yes, they need to reinforce that this product is, if you like, for sake of a better term, their employer's product as such, or their

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owner's product. That's something the industry is saying that it should be done. But if it's not, it's not. And it's very transparent that it's not.

At the end of the day, what we've got to realise is home loans are fairly commoditised. There's some cases there's not a lot of difference between what may be selected as options.

MR HARRIS: I've got to go through my list, so you do that while I go through my list.

DR KING: Yes, so one of the areas we've asked for more information on is whether financial advisors should be able to move into offering home loans, apart from just mortgage brokers, so direct competition between the two. Do you have any comments on that?

MR WHITE: They already can. This was a large discussion back in - was it around 2009 I think it was - sitting at the table when we were working with Treasury to bring the NCCP in. Financial planners wanted just carte blanche, get a free ticket, and that was argued against because credit was something different again, it's another skill set, and there were components they were given credit for as such.

But financial planners have been doing it forever and a day, providing home loans. And in the analysis of some of the data I have here, you'll see that although the broker ACLs, for just an example, is 21,000-odd, the actual total ACL market is significantly more than that.

MS ABRAMSON: Peter, can I ask you - - -

MR WHITE: It's actually up around 39,000.

MS ABRAMSON: Could I please ask you a question about that? How can a financial - it might be my ignorance, how can a financial planner provide advice and offer a home loan without having a credit licence?

MR WHITE: They can't - well, they need to be a credit rep, and there are many, many credit reps - - -

MS ABRAMSON: No, I understand that. But at the moment in our system, when you say they can, because it's one of the other things that we're thinking about, they need to have the dual licence to do so.

MR WHITE: Well, no, as a financial planner, they could also be a credit representative, they don't necessarily have to hold the licence.

MS ABRAMSON: I'm sorry; we're on the same page.

MR WHITE: And there has been since the beginning. This is where there's disparity of numbers between those who are actually identified in ASIC's data as brokers versus the total.

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MS ABRAMSON: Actually, it's interesting, do you have an anecdotal - you gave us some figures before, I'm really interested in these, the number of people with a wealth management licence, for want of a better word, who also have a credit licence.

MR WHITE: No, we don't have that data. And I think ASIC may struggle to do that as well.

MR HARRIS: We've been to the official sources already. We were just hoping you might have - - -

MR WHITE: I've been doing a lot of digging on that data and I sort of know where the line gets a bit fuzzy. But look, anecdotally, planners have been doing this for a long time. When I was in private banking, a large part of that was also a financial planning wheel, not that I was part of that division. But that crossover as such has been there for a long time. But they would hold a credit representative status in the marketplace to be able to do so by law, on consumer debt.

MS ABRAMSON: Because one of the things we've sort of put out there and thinking about is whether there could be a mechanism that you wouldn't have to have the credit rep part of a financial licence and whether something could be done in that context.

MR WHITE: I would be concerned with that. I mean, it's a different skill set. There is credit already given to financial planners, I mean, as far as I'm concerned, they have a higher knowledge from my point, but their knowledge isn't in credit, it isn't in lending, and it isn't in consumer law in regards to lending. So that knowledge has to be framed and understood.

So I don't think it can be a free ticket as such, and basically it is what happens today, is that there's a certain amount of credit for a certain amount of knowledge, then you have to do this piece, then you become a credit rep, or whatever the case may be, some hold licences.

MR HARRIS: Can you explain to me, I'm sure this will be within your expertise; it goes to actually how the business is conducted at the coal face. With such a relatively large upfront payment that a broker gets with a loan, I mean, it's a biggish chunk of money, why do we not see some brokerages offering some rebates of that to attract customers? In other words, why don't we see cut price brokerage? Is it a contractual obligation? Is it the industry is on such incredibly fine margins that no one could ever be expected to do that without going broke? What's the reason?

MR WHITE: I guess the first thing I can say is I guess we talk about relatively large upfronts, my question is relative to what? To financial planning it's not, it's significantly less. And what you've got to remember is it's a cost to do business, it's not like a broker sits down with one client and writes the loan for that client. They may see 10 different clients before they get the right to write one.

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So there's that cost of time and the cost of marketing and advertising and what goes with it. But that rebate model used to exist: there was a company called Refund Home Loans in the past. It collapsed, for various reasons. But the model, depending on I guess how you price it, isn't sustainable because of the actual cost to do business.

Now, the average broker, once you take away the business cost, the actual cost to conduct business, might only be on $70-$75,000 a year. They don't make huge money. And they're small mum and dad business operators, a lot of them operating from home, some of them from small offices with staff networks, and yes, there are some at the big end of town as well. It's a different animal again.

But the rebate model is very difficult, because at the end of the day they actually don't make huge money, overall. It's not like a broker does 10 loans every month. They probably do somewhere between - settle two or three loans every months. Sometimes more for some, but not in the vast majority.

MR HARRIS: My "relatively large" was relative to any alternative system, although we have been given different advice on wealth than you - the numbers you've put forward today, but I'm not able to dispute them.

MR WHITE: My wealth numbers comes from the industry this morning.

MR HARRIS: Yes. I'm not able to dispute that. As much as anything, because apparently there is a huge differentiation there about charging, so I'm told. Anyway, let's leave that to one side. No, it was more if the payment to a mortgage broker was $500 upfront, and then, I don't know, $1,000 a year for every year that the loan's in operation, I would say there's very little chance of sharing much of that upfront with the customer. But if it's $3,000 upfront there's more chance of sharing it if indeed competition is strong in the industry with brokerages trying to cut each other's throats.

MR WHITE: Assuming their overheads makes it available.

MR HARRIS: Well, that's right, unless you're going to go broke, in which case - - -

MR WHITE: Yes. There are many, many brokerages that actually give back to their communities by way of charity donations and so on as well. So it's not like they sort of pocket big wads of money and don't do anything, they're very community-minded at the same time.

DR KING: Are you aware of any of the banks that explicitly require that any part of the payment to the broker is not handed back? The reason of course is that ANZ obviously won a court case a few years ago saying that they were allowed to do that with their mobile - - -

MR WHITE: With their mobile lender franchise.

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DR KING: Yes. So are you aware of anywhere - - -

MR WHITE: In the broker space I'm not aware within the contracts that there is a restriction for doing that. I may not be correct though, that's just my understanding.

MR HARRIS: Are these contracts the sorts of documents that when you ask for them you would expect would be made available?

MR WHITE: I couldn't see why not, unless there was a legal reason.

MR HARRIS: Yes. We struggle to see that too. Can we do LMI, are we able to get to end of fundamental likely agreement? You have put forward a proposition on LMI that the costs should be disclosed upfront as part of the agreement. Our recommendation was, knowing that in the past efforts have been made to look for some refund, this is an insurance product, obviously if the insurance products are fully used in other insurance products there is a refund, but that it failed in the past because of supposed complexity.

So we look at it and thought, well, why can't it be specified up front. In other words, if the loan - your LMI is for the first three years of you loan, if the loan goes beyond three years you don't get a rebate, the customer that is, if the loan is renegotiated or if your loan to valuation ratio improves sufficiently for you to no longer need the LMI. But where those other two circumstances have changed, you should get some form of repayment of the, again, a largish number, in the case of most LMI payments, you should get some of that back.

What did you think about the recommendation if made, for setting it upfront?

MR WHITE: Yes. It's a debate that I've had with the insurers over quite a protracted period of time, which was all in the public circles as such and they're not happy about it. But even as of the last week and a half, speaking to one of the insurers, the discussion on any sort of rebate, they believe would increase the cost of premiums, so disadvantage products.

I don't necessarily agree with that. I look at it in very simplistic viewpoints, this simplistic person. If I get a car, I get insurance, I pay it out early, I get something back because it hasn't gone full channel. If the LMI's business models are so stressed on their need to retain all incomes with no margin in it, I have certain questions over that as well. I believe there should be a rebate component, and there is under the credit policies. The problem is the credit policies are very restrictive.

One of the restrictions in the credit policies is if you want a rebate you've got to apply for it, if you're eligible for it, within 30 days. And that means you've actually got to go through the existing lender to get that rebate, who you've just gone and discharged a mortgage from who is not your friend any more. So chances of doing something in 30 days are very, very limited.

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Then they also talk about there can be no credit impairment, but it's not defined what that may be. So you might have been late for one month and all of a sudden they treat that an impairment issue and therefore you're ineligible. There's lots of other things that need to be concerned, but in the principle of the rebate, yes, I am very supportive of it.

Same with portability, they argue that the problem with portability is the risk dynamics between different lenders. So it's not just the profiling of risk for the borrower and the asset, it's also the different lenders. I would have thought today's technology and knowing I used to process LMI manually back in many moons ago, technology would make that rather simple.

MR HARRIS: Particularly if you establish the characteristics of the insurance as we've described upfront.

MR WHITE: Yes, they do.

MR HARRIS: The last three years or whatever the term is, if circumstances change or the loan is repaid within that period you get a chunk back. Seems a pretty simple kind of reconstruction, and I assume lenders mortgage insurers, if they were to say that premiums would rise, would be able to justify that against some claims experience as well.

MR WHITE: One would assume.

MR HARRIS: Which is information that we will probably be seeking from them and from the banks, because this has become quite an area of possible interest. Tell me, do you think a broker, being paid a trailing commission then by a bank to manage the customer, if that customer was a customer that obviously the broker would know, a customer that paid LMI, do you think it would be a reasonable expectation for that broker to advise the customer that they should be able to seek a refund of the LMI?

MR WHITE: Unquestionably so, yes. Yes, most certainly. The problem is is that the market place really doesn't know the parameters in which that revolves.

MR HARRIS: And one of the few parties that might have a better understanding is actually the broker themselves.

MR WHITE: Yes.

MR HARRIS: All right, I'm done.

MS ABRAMSON: I had one question, I'm sorry, Peter, I'm taking you back to something you said before. I do understand the difference between credit and wealth management, but I'm just interested, you made a comment where you said, "Oh, but they're different products", but your home loan could be the biggest financial product that any individual takes out. So why do you think that the obligations or the understanding of credit is so different from a wealth management product?

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MR WHITE: Well, there's different laws and different premise that apply.

MS ABRAMSON: I know that.

MR WHITE: So just because you're very good at wealth management, doesn't mean that you understand the premise of lending and credit, and vice versa obviously of course. So that's why I said it was different.

MS ABRAMSON: Thinking about it from a product point of view, I know the legal regimes are different, I understand that, but what's so different about the nature of the products? I'm not talking about super, I'm talking about a home loan perhaps versus a managed investment which could be also in a real estate vehicle.

MR WHITE: In simple terms, one's debts, one's investment. So they're two sides of the coin to start with. Also too, I guess the laws that revolve around credit are very different - or are different, I should say, to the laws that revolve around investment. So there's different knowledge sets.

As I said as well, there are many crossovers and there is - for example, we have credited knowledge given to a certain component, but there's still a piece that needs to be filled in. So just an arbitrary blanket across it, to me, I'd think would be a challenge, only because of that little piece that sits there that needs to be known and understood.

MS ABRAMSON: I understand.

MR HARRIS: Done?

DR KING: Yes.

MR HARRIS: Peter, thank you very much for making the time and effort and for being one of the few people who has turned up here with data, so we want to give gold stars for anybody who comes with data.

MS ABRAMSON: Indeed. The team are running towards Peter.

MR WHITE: I came prepared, and our index will be available shortly, to have it today.

MR HARRIS: We might need to come back and ask you some questions about data too, so hopefully we'll be - - -

MR WHITE: Certainly, my pleasure.

MR HARRIS: Thanks very much.

Okay, Maria Rigoni; Maria, come on down. You're one of our right at the start submitters; I

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remember your submission. It was short, so we've got a positive view of short submissions: you know, "Oh, I'll read this one tonight," you know?

Sorry, could you identify yourself please, for the record?

MS RIGONI: I'm Maria Rigoni, I'm a mortgage broker.

MR HARRIS: Do you have some remarks you'd like to make?

MS RIGONI: Yes, I do. I hold a Bachelor of Business qualification, with management and psychology, majors in management and psychology, obtained through Swinburne University, and the required mortgage broker qualifications.

I was a full-time employee of the Commonwealth Bank for most of the period between 1970 to 1997. My company, Universal Wealth Management, has been a master agent member of Australian Finance Group Aggregation since 2001. I have obtained residential and commercial lender accreditations to introduce loan business to many, many lenders since 2001, including some who no longer exist. Most of the lenders have been on AFG's panel of lenders, but some have not been.

Mortgage broking: a product sale is between a buyer and a seller; I'm sure you know that. A competitive market place needs buyers who are seeking a solution to a need; buyers who are eligible to make a purchase; buyers who have financial ability to purchase; and buyers who can authorise a legitimate purchase, together with the product manufacturer/seller, who is able to satisfy the solutions sought by the buyers.

Mortgage brokers are not agents for, or employees of, credit providers or aggregators. Mortgage brokers have no authority to approve or refuse any credit provided loan. Mortgage brokers have no authority to accept or reject the lender loan contract proposed for the borrower.

The sale of a mortgage broker's service - which is our product - with a potential borrower - who is our buyer - occurs well before the separate sale by the lender of a loan - which is their product - to a borrower - their buyer.

The sale of a lender product launches at the point the lender receives for assessment a signed lending proposal from the potential borrower; the sale concludes at the funding settlement of the loan. The remuneration paid by credit providers directly to aggregators and indirectly to mortgage brokers is not paid by the clients, per se; it is paid from the credit providers' gross business revenue and is a tax-deductible business expense.

Mortgage brokers, mostly, do not have remuneration contracts in place with credit providers; mortgage brokers are indirectly remunerated by the lender via the aggregator, for the pre-qualification initiation of new-to-lender business, submitted for assessment and approval by the lender or the mortgage insurer, and accepted by the borrower.

Aggregators have - - -

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MR HARRIS: Well, thank the Lord for that, all safe.

MS RIGONI: Is that the first time we've had the - - -

MR HARRIS: We've never had it in my experience; five years, I've never had it. Sorry Maria, please go on.

MS RIGONI: That's all right. Mortgage brokers are commissioned by aggregators to track down and pre-qualify people who lenders on their panel may want to engage in a credit contract with, and then to submit the loan proposal directly to the lender for credit decisioning, using unique aggregator mortgage broker identification numbers and software.

Aggregators have access to all credit policy and credit product information for all lenders on their panel. Via individual lender accreditation, mortgage brokers are authorised by credit providers to have access to their specific lending credit policy; capacity to repay calculators; valuation gateway; supporting documentation checklist; assessment criteria; credit product information; interest rates and fees; loan scenario hotlines; online application gateway; and application progress tracking.

A mortgage broker client is a potential borrower seeking assistance in finding a solution to a desire for credit. Mortgage brokers are commissioned by potential borrowers to facilitate access to not unsuitable finance options. Sometimes, there may be no options or only one option; sometimes, there will be many options to consider.

A mortgage broker's business is often confused with mortgage management or white label, as many people call it. A broker business, and the roles and functions in the marketplace are vastly different. Mortgage brokers introduce pre-qualified loan proposals, with supporting documentation, to a lender; if the lender and the borrowers commit to a loan contract and the loan is funded, the mortgage broker is not directly involved in the lender/borrower relationship, nor responsible for any ongoing management of the performance of the loan account.

A mortgage broker business is in competition with every bank and mortgage manager in the marketplace for potential borrowers, not so that they can sell a loan product, rather that they can sell a mortgage broking service: a no cost to borrower service that obtains broad possible lender solutions for individual borrower requirements. A mortgage broker is a valuable consumer outcome that is a missed opportunity if the potential borrower goes directly to the credit provider.

I could go on, but, you know, that's probably enough.

MR HARRIS: No, it's an interesting description of the relationship. Can I ask you then: in the latter part of what you just said, you actually indicated that if a loan is funded, the agreement is between the borrower and the financial institution, and the broker, you said, has no ongoing management relationship.

MS RIGONI: That's correct.

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MR HARRIS: Now, we've had it put to us, including I think by Peter White - not so much what he said here today but in some other public comments he's made - that the fact - the reason the banks pay trailing commissions is for two purposes. Now, Peter has dissociated himself from churn and what he said today but certainly in terms of an ongoing management relationship, that appeared to be the rationale for paying trailing commissions. From what you've said, perhaps it's not quite as black and white as that?

MS RIGONI: It's not as black and white as that, and I have never ever been asked to sign anything or seen anything that tells me that I am responsible for that type of thing.

A few years ago, CBA tried to bring in this thing that if a customer's loan went into arrears, that they would contact the broker and the broker could ring the client and find out what was going on, et cetera, et cetera, et cetera. That was an optional thing, and from my perspective I chose not to do it. And I think what is trying to be forced upon the broking industry at the moment is that that becomes an additional part of what we do, and I think that individual brokers, small businesses, are being taken unfair advantage of through the accreditation system, and - look, we have relationships with our customers, ongoing.

And I've had an instance twice over the last couple of days: one on Friday night and one yesterday actually, where clients have contacted me and said, "I've received this email from my bank Maria, I don't understand it. Can you explain what it's about?" Right? I have no problem, that's part of my role because I introduced that client to that; they are unsure of what's going on, please ask me. Right?

So, from that perspective. But the idea of you get an upfront payment and an upfront payment is not really an upfront payment until the end of the clawback period, because it can be taken back at any time within up to - usually a hundred per cent within 12 months and then 50 per cent for up to another 12 months.

And for me, the clawback is the transference of commercial risk from the lender to the broker; it's clear-cut. And because we have no negotiation right in any remuneration contract, we're left sitting there. And when you look at bank-owned aggregators, the bank is negotiating a remuneration contract with themselves that affects all brokers that are signed up to that aggregator. So, how do you survive?

And with clawback, I can give you an example of a clawback recently that I've seen, where one broker did a loan for a consumer, for a legitimate reason; the consumer didn't want to stay with that lender because the lender couldn't provide them what they wanted, so they moved to a new broker and lender.

DR KING: After how much time, sorry?

MS RIGONI: After eight months, so the first broker was clawed back 100 per cent.

The second loan was in place and it was a two-tiered loan, where it was a refinance and a construction thing. In the end, after the business had been moved across, the lender decided that they did not want to do the second part that had been pre-approved, which is their right;

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they have every right to do that. So, that was eight months or seven months in position, so that broker is clawed-back 100 per cent of the upfront. So, then the borrower goes through it, because the borrower has gone to another lender.

With the new lender, the 18-month clawback position starts again, so it's not something that's isolated or anything, it's got nothing to do with what the broker does, whether the broker does a good job, a bad job or anything; it depends on what the borrower decides to do after they've contracted with the lender.

DR KING: If I put a bank's hat on though, I'd say, "Well, surely, it's part of the broker's job to make sure that the product that I'm offering as a bank - - -

MS RIGONI: Yes.

DR KING: - - - is a product that really meets that consumer's needs so that there is a very low likelihood that within the first two years, they're going to want to move on to another product."

MS RIGONI: Well, that's if you are fully aware of everything that's going to happen with that borrower, for the next two years, which you don't know; their circumstances can change. They might decide to do one thing and the lender only has an appetite for this and not that, so the consumer has no option if they want to satisfy their finance needs, to move to a different lender.

DR KING: Yes, I guess I'm just thinking, isn't there a bit of a role - you know, yes, there are things that can change for the consumer, but isn't there a bit of a role there for mortgage brokers? I mean, it may not be the degree of clawback, but isn't some clawback sensible, you know, from the bank's perspective, to make sure the broker is sending the right clients in their direction?

MS RIGONI: But the lender gets all the information about the borrower at the time, and the decision is made by the lender whether to approve that loan or not approve that loan, and then the borrower has the option to either accept that credit or refuse that credit.

DR KING: Yes, the broker doesn't have a decision.

MS RIGONI: The broker doesn't have any say in it; we're just doing what two parties have brought us together to do.

DR KING: Yes.

MR HARRIS: Sorry, I just want to stick on clawback, then. So, in your view, clawback is still quite a common element of arrangements?

MS RIGONI: Yes. And it also can put a broker into a position of insolvency.

MS ABRAMSON: That's what I was going to ask you.

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MS RIGONI: If they get a few clawbacks, because you've got no idea when these clawbacks are going to go, and you can actually be clawed back before you're paid the commission on the next deal.

MR HARRIS: Yes, but they're common. Because there have been different suggestions that they're being phased out or adaptations anyway that make them less of an anti-competitive device; that doesn't seem to be the case from your own experience, anyway?

MS RIGONI: Well, no, I think clawbacks are very real, and sometimes you might not get a clawback for 12 months, 18 months, but you don't know when they're coming, so the upfront commission is like a loan, you know, to help you run your business or something, and then it can be taken back at any time.

MS ABRAMSON: That was actually what I was going to ask you then. We had some evidence today that a number of brokers of small business, one or two people operations, how it is that you can provision for that, for the unknown unknown?

MR HARRIS: We were also told about these codes of conduct inside the industry, you know, collectively the industry has been working on combined industry forums and things like that. In your experience, are these - I mean, do you face competition from people who are probably less - how can I put it - attached to concepts of you know, good practice working on behalf of the customer and that sort of thing?

MS RIGONI: I am not a member of either industry body.

MR HARRIS: Right.

MS RIGONI: And in saying that publicly, I could lose accreditation because lenders can say, "Oh, you're not a member of those bodies and we want you to be, for accreditation purposes."

MR HARRIS: I think it's an offence to cause an action like that against people who give evidence to the Productivity Commission. I think I'll just note that for the record, thank you.

MS RIGONI: I was a member of the MFAA for ten years, and I was a member of the FBAA for a number of years; I was actually on the Victorian committee for the FBAA. And I just didn't think that the FBAA - I think they're very conflicted, the industry bodies, in that they are reliant on members, for accreditation purposes, must be a member of both of those - one or either of those - industry bodies.

I can't get accreditations with certain lenders that have come into the market because they say to me, "No, you're not a member, so therefore we will not accredit you," and I say, "Well, why would you not accredit a broker to introduce new business to you?" If a consumer comes to me and I know that that's the best product for that particular client, what do I have to say as a broker? I have to turn around and say, "Oh, I'm sorry, I can't do this for you because that lender is not going to accredit me because I'm not a member of one of those two industry bodies. I have an Australian credit licence, but that's not good enough to have an accreditation, so therefore you have to go into the market place and find a broker that does have an

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accreditation with that lender, or you must go directly to the lender yourself."

MS ABRAMSON: Can I just ask - I might have misunderstood this - it's a related question to what you said: your accreditation with one of the industry associations, you can independently belong to CIO, you don't need to go through your broker association to have your dispute resolution, which is a requirement of the licence.

MS RIGONI: The legal - yes?

MS ABRAMSON: Yes. You can do it independently, yes.

MS RIGONI: Yes. I have to be a member of the credit ombudsman.

MS ABRAMSON: Yes.

MS RIGONI: Yes.

MR HARRIS: All right, other questions?

MS RIGONI: You've asked a few questions during the hearing about LMI.

MR HARRIS: Yes. Julie, do you want LMI?

MS ABRAMSON: I certainly - - -

MR HARRIS: All right, from our - - -

MS RIGONI: LMI is not an insurance policy that a borrower can purchase; that's something that really needs to be understood. It is an insurance policy between a lender and a mortgage insurance provider, okay? So, with the things with rebates, it used to be reasonably common for people to have a rebate; I don't think any of the major banks have rebates anymore. And there was something said that, that's because they negotiated a cheaper policy, so it got rid of the rebate.

My concern with mortgage insurance is the premiums and how they're calculated and the loan to value ratios, and how they're divided up into zero to 300,000; 301,000 to 500,000; 501,000 to 1 million; and over a million. And they're divided individually from LBR, basically 1 or 2 per cent, going up.

So, a borrower can borrow say, 500K at a 94 per cent LBR and it'll be 2.8 or 3 per cent; if they borrow $500,001, the premium goes up to 3.91. So, for borrowing one extra dollar, there's a huge increase in premium price, and I don't understand the rationale for that, and I don't believe that that is explained to consumers, and it can cost them a lot more in mortgage insurance premiums just by borrowing very little extra.

MR HARRIS: And do you think they're relying upon the brokerage industry to tell a customer that?

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MS RIGONI: Well, quite often we don't know what the exact premium is until the loan documents are issued, or the approval is put in place.

MR HARRIS: But wouldn't you be - - -

DR KING: In your experience, after a couple of years, you'd - - -

MS RIGONI: We can calculate it, we can calculate it even on the aggregator's product comparison software; there's usually a mortgage insurance figure there, but it's not always what they're charged.

MR HARRIS: No, okay.

DR KING: In that situation, so, I've come to you and said, "Look, I need a $505,000 loan," and you do the calculation and on the calculation on the interface you've got the quote and you say, "The LMI looks a bit high. If you bring it down to 500 or 499, you - - -

MS RIGONI: Yes, I'd work it out.

DR KING: - - - would offer that price, yes.

MS RIGONI: I'd work it out, yes. Yes.

MR HARRIS: Yes, well LMI is an area of increasing interest I think would be the right way to characterise it, if we can get some data.

MS RIGONI: Yes.

DR KING: Can I just - I like the way you actually characterised working in the industry at the beginning; I wrote down a little bit here, I said, "introduction agency" which is sort of how I get your characterisation. It is, you're talking to clients, you understand the client's need, say, "Now, here is the product. Okay, I think this is the best product for you," that's what you get paid for, that expertise.

MS RIGONI: Yes.

DR KING: Then you help the client put in the paperwork, and it's arguable whether, you know, should the client pay for that our should the bank pay for that, you know, because you're saving the bank time and effort for that. That's all fine.

It's that trail commission paid by the bank I really have trouble understanding. I mean, the same way I don't understand - and I think you explained the clawback very well, and the issues associated with that and the fact that it's something outside the broker's hands. I mean, it's like these: we've been told, "Oh, it's a payment for ongoing management of the customer," but it's paid by - - -

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MS RIGONI: See, I don't believe that.

DR KING: - - - the bank - yes.

MS RIGONI: See, I don't believe that; I believe that it's paid as part of the introduction of the new business; it's paid as a, "This is your payment for introducing this business to us." And when you restructure a loan for an existing client, you don't get any upfront, but you will get the ongoing trail; so, that loan, you don't get any upfront but that loan becomes part of your portfolio, okay?

And that portfolio and the little dribbles of trail you get from each one of those loans in your portfolio, becomes a saleable part of your business.

MR HARRIS: Yes. No, we understand all of that.

DR KING: Yes.

MR HARRIS: We asked and we received this claims rationale that it was driven by desire for a bank - - -

MS RIGONI: I believe that the Combined Industry Forum - - -

MR HARRIS: - - - to see it re-managed. Now, I could point out the link between Stephen's question and something you said earlier.

MS RIGONI: Yes.

MR HARRIS: The Commonwealth Bank believes that if a loan looks like it's going sour, you, the broker, probably should do something about it. Well, that's a saving of staff time to the Commonwealth Bank, and I could see the Commonwealth Bank going, "Yes, we should get brokers to do all the hard work in this area."

MS RIGONI: That's right.

MR HARRIS: And I could see that rationale being used. But you're saying from a broker's perspective, "That wouldn't traditionally be considered part of our job?"

MS RIGONI: No, and it wasn't. When I first came into broking in 2001, we used to find the clients, fill in an application form, collect the supporting documents and fax it off to the lender, and that would be the end of what we had to do, you know? We didn't have to order valuations; we didn't have to do the data entry; we didn't have to follow everything to make sure everything moves over. If we don't follow everything these days, the loan just doesn't move. And - I think I've lost my train of thought, there.

MR HARRIS: Ongoing management responsibility, yes.

MS RIGONI: Yes, and if you're really honest about all of this, when I came into broking,

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NAB and CBA would not allow us to introduce business to them, okay? So, the upfront and trail payments were in place then; it was later on - - -

MR HARRIS: I see your point. So, even though the payments were there, you weren't able to do this.

MS RIGONI: Yes, and even - - -

MR HARRIS: So, that couldn't be a rationale.

MS RIGONI: Even that, a couple of weeks ago a client rang me and said, "Maria, the address on my statement is still going to my old home," and I rang the lender and said, you know, "You haven't changed the address," and they said, "Well, we're not supposed to be talking to you about this client because the client hasn't signed a Privacy Act form."

So, how am I responsible for what happens to the loan? You know, I am not the loan processing centre for the banks; I am a person that my aggregator has commissioned me to go and find clients that lenders on their panel want to lend money to - - -

MR HARRIS: Yes.

MS RIGONI: - - - and the borrower wants to accept.

MS ABRAMSON: A number of witnesses have said to us previously, or at least in meetings, that the banks do their own due diligence on the loans.

MS RIGONI: So, annual reviews and all the rest of it. I mean, yes. And a lot of clients - I mean, sometimes a client will ring you about something or ask you about something and you find out what their interest rate is and you say to them, "Look, that interest rate is getting a bit pricey, do you want me to look at what else is in the market?" " Oh no, it's okay. Leave it, I'm quite happy where I am." So, I can suggest and recommend.

Some of the other things that you were asking about are comparative rates?

MR HARRIS: Comparison rates.

MS RIGONI: Comparison rates.

MR HARRIS: Yes.

MS RIGONI: Comparison rates were useless when they brought them in, and they're still useless now.

MR HARRIS: Oh, hallelujah. Hallelujah.

MS RIGONI: Comparison rates; and what they've done is, one of the fees that was included in the comparison rate was application fees, and you'll find now that most lenders don't charge

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an application fee because that affects the comparison rate.

MR HARRIS: Yes. You know, we've been told that these - I was calling in to somebody the other day; they are ghost policies: they were considered good once, and they keep going on like ghost nets do, drifting around the fishing grounds because no-one's there to pick them up and put them in, and take them away.

MS RIGONI: Yes. And you know what would be handy for clients, if you really want them to be aware of what their interest rate is on their home loan is, the first thing you see when you open up a loan statement is their interest rate in big, bold - - -

MR HARRIS: But otherwise, normally you have to go looking for it.

MS RIGONI: Go looking in the middle for it.

MR HARRIS: And on the electronic sites, it's often about three or four pages, separated, and you can't backtrack on an electronic site without losing the link and having to log in again. Oh, it's very interesting. Anyway, we're not sure we can solve all of that, but thank you for making that particular comment.

MS RIGONI: Yes. And I'll just say, that soft dollar thing they all go on about, soft dollar benefits of brokers being wined and dined and whatever; that's not necessarily true. And even if you're an accredited broker, you don't always get invited to what the lenders, like their professional development days and things like that; they select different brokers to invite to those things, so it's not an across the board thing that all brokers are trained by that particular lender about updates and that. You might get an email, but you don't necessarily go to the training day.

DR KING: So, are these training days effectively rewards that they give, or you know, to run parallel in the medicine industry, it's well known that a few years ago pharmaceutical companies often used to offer educational programs on nice places like Hayman Island; is that what we're talking about here, or?

MS RIGONI: No, no, no, I'm talking about just recently, a lender in one of the lender magazines they said they were doing PD days and I thought, "I didn't get an invite," so I sent a message to my BDM, "I didn't get an invite." "Oh no, that's only for our gold and platinum brokers, you don't get one." So, if they were really fair dinkum about training and making sure brokers were up to speed - - -

MR HARRIS: They'd train everyone.

MS RIGONI: - - - they'd train everyone.

MR HARRIS: They'd train everyone. But if, in fact, it is a rewards system under a different name.

MS RIGONI: Yes. And the other thing with reward systems and the preferred broker model

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is that consumers - like, if I'm not one of those high volume brokers, which I'm not, I'm not a high volume broker - so if I'm not one of those high volume brokers and give a certain amount of business, my clients get sent to the end of the queue for assessment, so they might not be picked up for four days. And I say, "What has my client done to deserve that?"

And you know, I can't understand why they think that's okay under the NCCP, when they've got a general obligation to be fair, honest, and efficient.

MR HARRIS: We should note that for the NCCP, okay.

MS RIGONI: And with the Combined Industry Forum, you know, I'm going to be really blunt about this: I just believe that that's an attempt by the lenders to collude and change the broker model into something more that they want, without - like, we've already seen the standard commissions are all pretty much now the same, so where there was variation before, and - like, if a lender wanted to hone in on clients of high value, you know, they've had a loan to value ratio of 60 per cent or less, they might say, "Well, find us these clients and we'll give you an extra little bit of money."

Those sorts of things are all disappearing now, and we're just getting a standard commission down the thing. And with the trailing commissions; you talked about the incentive to stop churn. It used to be that trail was the same level, straight across the board, that was it, you know? It was either 0.22 or 0.27 and that's inclusive of GST. Since about 2008, they've changed so that you start off with a lower trail component and then it builds up after year four or year five. But that wouldn't stop a lot of brokers from moving clients if it was - - -

MR HARRIS: Yes.

MS RIGONI: - - - easy to clients.

MR HARRIS: You can see why that might be.

MS RIGONI: But we didn't introduce that, the lenders did.

MR HARRIS: Okay.

MS RIGONI: And with advice, you're talking about no advice and general advice and personal advice; that's relative to the FRSA right, but it's not relative to brokers.

MS ABRAMSON: We're interested in what you say, but we were very interested in that because we were looking at insurance products and financial services products other than mortgages and loans. So that's why we were quite interested, because we've received submissions that the whole term "general advice" was misleading to consumers because they think the word "advice" means it's about them, but all of us who work in the area know, personal advice is the advice that's measured to your needs.

So that's the reason we were raising it in that context. I mean, I'm interested in views on that, yes.

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MS RIGONI: I understand exactly what you're talking about, and I do think it is an issue for consumers.

MR HARRIS: I'd like to thank you for coming along today; your comments have been refreshing and interesting.

MS ABRAMSON: Thank you very much.

MR HARRIS: It's been very useful for us.

MS RIGONI: Okay, thank you.

MR HARRIS: Now, I think unless anybody in the room is looking to make further comments? No, there's no-one, excellent. So, we're going to suspend the hearing until tomorrow morning, where we'll start again at I don't know what hour.

MS ABRAMSON: It's 10 something.

MR HARRIS: 9.15.

MS ABRAMSON: No, no. Someone else just registered for that first slot, so we're here at 9.15.

MR HARRIS: So, we're on at 9.15 again, so we're starting tomorrow morning at 9.15, for those who want to watch us on Facebook. Okay, in the meantime, we're suspended.

ADJOURNED AT 3.31 PM UNTIL
TUESDAY, 6 MARCH 2018 AT 9.15 AM

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Australian Government
Productivity Commission

PRODUCTIVITY COMMISSION

INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

MR P HARRIS, Presiding Commissioner
DR S KING, Commissioner
MS J ABRAMSON, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT 530 COLLINS STREET, MELBOURNE
ON TUESDAY, 6 MARCH 2018 AT 9.38 AM

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INDEX

	Page
MONEYQUEST AUSTRALIA MR MICHAEL RUSSELL	**265-282**
ANZ MR SHAYNE ELLIOTT MR FRED OHLSSON MR RICHARD YETSENGA	**282-306**
AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION MR GREG KIRK MR MICHAEL SADAAT	**306-322**
ME BANK MR JAMIE MCPHEE MR TONY BECK	**322-336**

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MR HARRIS: Okay. I think we're going to start roughly on time. Can I check sound is okay? Checking sound. TV's okay? Excellent, TV's okay.

So we're going to resume the hearings in the competition and financial system inquiry. I'm Peter Harris, chairman of the Productivity Commission. I have with me Mr Stephen King and Julie Abramson, who are the other commissioners on this inquiry.

I'll just run through the basics from yesterday for people's benefit, who weren't here. So in the nature of this inquiry, we run it pretty informally. Social media is allowed, but taking photographs or broadcasting needs prior permission from us. Witnesses who turn up and offer evidence are encouraged strongly to be truthful, that includes by our Act and not just us. We also encourage people to attempt not to be defamatory because this is being broadcast.

There are exit signs in the corridors, should the alarms sound, which for the first time ever in history it did sound yesterday which was quite a shock to all of us, and there'll be floor wardens to direct you for the evacuation procedures and the assembly point is Enterprise Park down by the Yarra. But I'm sure, most people will probably find something better to do with your time than to assemble. Nevertheless, that's what the OH&S procedures …(inaudible)…

I think our first witness this morning is present. Can you identify yourself please for the record?

MR RUSSELL: Yes, I'm Michael Russell, managing director of MoneyQuest Australia. We're a franchise mortgage broking group that is an ACL holder.

MR HARRIS: Michael, do you have some opening comments you'd like to make?

MR RUSSELL: Yes. Look, firstly, I do want to thank the Commission for allowing me to appear today at short notice. We have submitted a formal submission and, I guess, why I wanted to appear today is I thought it was important to, first of all, put a face behind the submission; and secondly, I really would like to flesh out a little bit and put some context around six items in the submission, particularly. And, if you don't mind, I'd like to, perhaps, go through those six items very quickly.

By way of background, I have been involved in retail financial services most of my life, over a decade employed in banks writing home loans, and for almost two decades working within the mortgage broking industry. I have been at the coal face throughout lots of reforms, starting with the exciting deregulation that took place in the '80s and had the opportunity to move from a main stream four pillar bank to a new foreign bank and saw how exciting that was to really innovate in customer service and product innovation. I've seen a lot of great things occur and a lot of not great things occur. I thought it was important I appear today to give you a real sense of what's going on in the coal face.

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So there's six items I want to talk about today. I want to put into perspective the $2.4 billion that has been raised a number of times in terms of the total lender commissions paid annually to brokers. There has been a little bit of commentary about the fact that it appears large and warrants some sort of public analysis. I want to put this into perspective. I think it's important.

I then want to talk about who is paying for it right now, because I think the Commission is grappling with that and I want to remove any clouds or uncertainty around who is paying for that and why.

Number 3, I want to talk about your draft finding 8.1, pertaining to the fact that mortgage brokers have only originated their loans at slightly lower interest rates than bank first party channels, and just explain what that means.

I want to talk about, number 4, fee for service. This has come up over the years and I really want to knock this on the head and demonstrate, in practical terms, why it is very anticompetitive and very unfair in terms of blocking people that are presently able to access very affordable mortgage credit advice. And I want to bring into context, what happened with FOFA and how we all know FOFA's primary purpose was to make financial advice accessible and affordable for all Australians and bringing your fee for service in for mortgage brokers doesn't seem consistent with what we're doing with financial services reforms.

I want to talk about switching, because much of the Commission's report focused on "switching" and I would really ask the Commission to stop using that word and I'll explain why. "Switching" denotes to people not familiar with the industry that it is easy to switch home loans as it is easy to switch utilities or health insurance. But you can't switch a home loan easily, given that individuals need to go through a full credit assessment over again. It is a refinance. It necessitates a full credit application. And I think "switching" is actually a really misleading term when it comes to home loans and I'll explain why in a minute.

I want to demystify trail commissions a little bit, because in my close to two decades trail commissions were initially put into the economic equation for a very definitive reason. And we, who have worked in the industry, worked hard for our trail commission. and I'll explain why. Unfortunately, those within the lender community that put trail commissions in are no longer with us. But they were put in with a set of obligations that we have to fulfil throughout the life of the loan and I'd like to actually address that and demystify a little bit of the argument going around about trail commission.

And finally, I would just like to close with a couple of closing comments. I've been fortunate to, over the journey, have worked with ASIC and Reserve Bank in particular. And, from time to time, there's a real misunderstanding around the relationship brokers have with our lenders and our involvement in credit policy and credit decisioning in these sorts of things and I just want to make absolutely certain that everybody is fully aware of what a mortgage broker can control and what we can't control and the job that we do. So

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if you're okay with that, I'd like to start. But I'm assuming you're going to interrupt me and ask questions as we go, which is fine.

MR HARRIS: No, no.

MS ABRAMSON: No, no.

MR HARRIS: We're going to ask you though to make sure that you keep your answers as succinct as you can.

MR RUSSELL: Yes.

MR HARRIS: Because we have another speaker coming on at 10.

MR RUSSELL: Yes.

MR HARRIS: And one or two people have appeared here imagining that they have unlimited time.

MR RUSSELL: Yes.

MR HARRIS: There isn't, unfortunately, unlimited time for all people to occupy as much space as they want to. So try and keep it succinct, if we could.

MR RUSSELL: Certainly. Look the first point I want to make with respect to the $2.4 billion, which is apparently the number paid in terms of lender commissions annually to mortgage brokers. And I just want to say a couple of things, because since the report came out, there have been a couple of headlines suggesting that "Hey, this in isolation wants public analysis". And over the years I've learned that, you know, numbers and statistics are always very persuasive and generally contain a bit of bias by the people by the people using them. But the facts are that they can be misleading in isolation.

Our industry's been, unfortunately, plagued, you know — the villains of misleading information at the moment appear to be UBS. If you draw numbers in isolation are very dangerous. I just want to make a point that if you look at home loan arrears at the moment, - they're running at about 1.2 per cent, very low in terms of historical averages. And if you think about that you'd think, that would seem to suggest a healthy mortgage market and good credit control.

But if I were to give you that number, 1.2 per cent in actual dollars as it represents of a $1.7 trillion home loan market, you'd probably look at that number and think, gee, that's an extraordinarily high number. So I'm always concerned when I do see headline numbers and then inferences made that this is a dangerous thing. And I want to put it in perspective that your number is very consistent with the MFAA's Intelligence Survey recently last year that there's around about 16,000 mortgage brokers operating in the market. And if you just

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do a very quick calculation, you'll see that the average revenue per mortgage broker is about $150,000.

That is a revenue number, not a net number. When you remove from that the fee that the mortgage broker pays to their franchise aggregator, the MFAA have recently reported that the net revenue number per broker is $133,000. I'd like the Commission to again, not be focused on that number and think, that's a high salary number. That is a net earnings number. Anecdotally, about 50 per cent of a broker's net earnings is their net take home pay. Brokers incur normal sorts of business costs, such as occupancy costs, administration staff, compliance costs, IT costs, marketing costs.

So when you break that down and you look at a net number of about $67,000, it's certainly not an offensive number by any means, and I just wanted to just spend a couple of minutes, and I thank you for allowing me to just make that point.

The second point, moving on as quickly as I can, the draft report raised in the question well, who's paying for this, and there was an inference, "Well, the consumer's paying for it all. The shareholders are paying for it," and I'd, just again, like to be very clear. We are an outsourcer. That $2.4 billion a year is a variable cost spread across all of our bank and non-bank lenders. It's a variable cost and yes, the banks and non-bank lenders are paying for it and then that flows through to the shareholders, who are absorbing it. But I need to again, just to be - - -

MR HARRIS: Sorry, sorry, let me stop you there.

MR RUSSELL: Yes.

MR HARRIS: Because you have just merged two thoughts into one and without any evidence.

MR RUSSELL: Yes.

MR HARRIS: So you've said, and I said it my speech last week, so you can certainly go to that speech if you want to, and you will see, common sense tells you it is either a shareholder or a customer who is paying for it unless the cost is covered entirely by some cost saving, and that's the analysis that we've been trying to perform, not, I might point out to you.

MR RUSSELL: Sure.

MR HARRIS: Not simply a question of whether $2.4 billion is big or small, it is big enough to warrant analysis, that is a self-evident point, it is a rather large amount of money regardless of how many trillions you want to throw around, $2.4 billion isn't just nothing. But you've just made the leap from "it could be shareholders or customers", to "its shareholders". So since you are on this point, unpack that a little bit for me.

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MR RUSSELL: Yes.

MR HARRIS: Prove to me that customers aren't paying.

MR RUSSELL: Yes. Well, we all know that as a cost of origination and servicing, and I will get to the servicing because brokers are paid an up-front commission to originate the loan and a trail commission to provide the ongoing service, and I will touch on that in a minute. Rolled up, those costs are absorbed by our bank and non-bank lenders. Now, whether some of that costs are passed on to consumers in terms of premiums on home loan rates or anything for that matter, ultimately the net result flows through to shareholders.

What the point needs to be made is that there's always been a debate about, you know, which channel is more efficient. The point I want to make is, it presently costs the bank and non-bank lenders $2.4 billion a year to deliver around about $200 billion a year in processing in new originations a year. The point is not which channel is more cost efficient, the point is could the banks and non-bank lenders actually originate and service those loans at a cheaper amount than $2.4 billion and I can categorically let the Commission know that no, they could not because where a variable cost working on success only if the lenders, who are not ...(indistinct)...

So if the banks or non-banks were to move that $200 billion of origination and servicing into their environment, just have a think about it logically, could they do that for better than $2.4 billion, given that we are only paid on success. So the notion that they wouldn't have to bring up a significant buffering because if they have to bring footprints in and FTE in, they would have to build in a buffer.

MR HARRIS: So in the alternative, we know that online sales of mortgages are developing. They are small but they're developing quite significantly. So it isn't just a binary calculation. It might once have been a binary calculation, floor space versus a broker to do the services, as you say, a variable cost.

MR RUSSELL: Yes.

MR HARRIS: There's actually a third party in there. And we did ask the banks, who ought to know this, for data, and we didn't get a good response. I think one institution gave us some information but not sufficient to make a calculation across all of the institutions. So do you have any data to support or is there any study that you have seen that would enable us to move beyond the "he said/she said" version of this to, you know, something that would justify the calculation of whether there is a benefit to match this cost?

In other words, we can see the cost. We can see the prospective benefit. As you pointed out in one of your other comments, that benefit is shrinking, I mean in terms of the size and differentiation between the interest rates that a broker can get versus the interest rate you can get by going into the branch, it is still there but it is shrinking. And so we wanted to unpack that, which is the standard approach a Commission would take to a question like this.

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MR RUSSELL: So the answer is no, I haven't got any definitive evidence, other than anecdotally and logically to suggest that mortgage brokers have been operating 25 years now and have become extremely professional, sophisticated and embraced technology in the way we process our mortgage loans and the way we run our businesses. We have become extremely efficient.

To suggest that banks could originate and service what we do more efficiently is an argument for debate because there's no - yes, there's no definitive study that has been done on that. I can just draw anecdotally and I can - over the years having worked in banks, with banks, the mortgage broking businesses are extremely efficient.

In terms of, Peter, what you mentioned about digital online services, I've been in this industry almost two decades and I've seen them come and go. The fact of the matter - and I thought Anthony Kale was very succinct yesterday that mortgages in Australia and mortgages throughout the world are still being consumed largely face to face, and you know, to draw on something that UBS said recently which was very inflammatory and untrue, that mortgages are nothing more than a commodity that be consumed with robo advice, it just shows a complete ignorance and lack of understanding.

Mortgages are a commodity, but human beings are not, and we see it all the time that no single borrower or joint borrowers are ever the same. Their circumstances are inherently different when it comes to their employment, their change in employment, their change in residency, their family situation. They've recently had children. They're about to have children. Matching individual needs with commodities needs to be done at this point in time face to face. And it doesn't matter what I think. Consumers have had plenty of options over the last two decades to try to fulfil some of their mortgages on line. They don't want to. They just don't want to. They want to do it face to face. They want a professional to validate a lot of the questions and concerns that they have.

I think the notion - I'm not saying it won't happen - but the notion that home buyers can be seen as commodities wrapped up in robo advice, we're a long way away from that, and it's not only us. Throughout the world, mortgages are still consumed face to face. So I understand yes, it its available, but given that mortgages are now consumed the old fashion way, still using technology to lodge our applications and these sorts of things, I think that the analysis of whether lenders can originate $200 billion a year themselves and continue to communicate to clients as we do throughout the life of a loan, yes, it is an interesting one, that there is no definitive study but having worked on both sides of the ledger, I would cast some doubt that 25 years of building the efficiency in our businesses could be readily picked up and absorbed within our banks and non-bank lenders at this point in time, but I accept there's no definitive - - -

MR HARRIS: Just before we get off this question of who's paying for it. So these costs cover roughly 50 per cent of loans originated each year because that's the broker channel.

MR RUSSELL: Yes.

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MR HARRIS: So roughly 50 per cent of parties are going directly to branch. They're not creating any costs associated with mortgage brokerages but they're not getting any advantage. Do you see that as an inherently unfair position for a consumer to be placed in? If you go to the branch apparently you save the banks money. Now, this is apparently because, of course, as we know, branches are being paid for by somebody.

MR RUSSELL: Yes.

MR HARRIS: This whole proposition are they being paid for by shareholders, you know, generously or are they being paid for partially by customers. Well, clearly, at some point, the customer is going to be paying for the cost of branches. But this is also very unclear from any data. So before you leave the topic of who's paying for it, do you know, at least, of any data from your experience previously in the financial system that says banks have made calculations on the cost of branches and the business that goes through a branch in a decision-making process as to whether or not to keep a branch as a place where you can originate a home loan.

I mean it is asserted that this analysis has happened. But again the data is not readily available.

MR RUSSELL: I would be certain the banks would have that sort of data. The banks would absolutely know their costs of originating and servicing mortgages. Because the thing about mortgages that's often misunderstood. Mortgages are not a set and forget product and a lot of people that don't work in the industry just can't grasp that. This might be interesting for you to know that we've recently - and again, anecdotally I've known for a long time, but we've recently surveyed - our mortgage brokers have been in existence longer than five years keeping it in context that the average mortgage loan's about five years, and we asked them that over the life of a mortgage loan, what percentage of your mortgage customers would you do an annual review, a regular annual review for, and would you do a variation for?

Mortgage brokers do a lot of variations for no remuneration. That's why we get paid trail, but I'll touch on that later. We do a lot of variations. Whether it's a variation of fixed to variable. Whether it's a variation of variable to fixed. Whether it's an interest only rollover. We do a lot of variations to loans and a lot of annual reviews.

Now, the number came back at 71 per cent. So 71 per cent of all mortgage clients throughout the duration of their loan would utilise our services for a review or variation during the loan, and that's a really key statistic. They are not set and forget. So when - again to your question, when banks make the calculation it's not only the origination cost that needs to come into the calculation. It's the ongoing management of that mortgage client.

It is very important we conduct annual reviews of our mortgage customers because they are new innovations continuing to go on, but there's also a sense of apprehensiveness

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amongst mortgage customers when they see certain products and interest rates advertised. So we do conduct annual reviews and loan variations are a very big part of our business, and we do not get paid for that.

MR HARRIS: That 71 per cent. What size group was that?

MR RUSSELL: So we surveyed our mortgage brokers that have had more than five years' experience in the industry because that's important. If you survey a group under five years and they wouldn't have had the complete exposure to an average loan life, and around 71 per cent - - -

MR HARRIS: But how many brokers?

MR RUSSELL: Oh, in our network, I think there was about 25. We're a relatively small - - -

MR HARRIS: Out of about 18 brokers.

MR RUSSELL: I beg your pardon.

MR HARRIS: About 18 brokers - - -

MR RUSSELL: Yes, yes, we're about - you know, we're a network - we're a relatively new franchise, but we have around 25 brokers that have been operating five years or longer.

MR HARRIS: Okay. That's all - - -

MR RUSSELL: I've also - and in addition to that, I went outside to - just to stress test that. I went outside to about a dozen Mortgage Choice brokers where I used to work and the numbers lined up exact, and anecdotally, that's about what I know anyway.

MR HARRIS: We should keep going in time so.

DR KING: Just get onto trail commissions.

MR HARRIS: I'm going through this list. I'm taking the notes. Your next one in order was 8.1 and this question about why brokerages are developing less of a benefit than they were in 2012.

MR RUSSELL: Okay. So I'd ask the Commission not to see that finding in a negative light, but rather take comfort that in a very low interest rate environment, mortgage brokers are still able to negotiate rates better than what the lenders are offering through their first party. So yes, the rates, the differential, has come down a little as rates have come down, but the fact of the matter is that mortgage brokers can't impact fixed interest rates, basic variable interest rates. The only rates we can possibly negotiate for our clients better than maybe what they will be to access through first party is variable interest rates.

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So to me I look at this and I can say, that's great because our proposition is not all about pricing, but the fact that we are still delivering a lower price than our first party competitors it shows that we're still doing our job, but our job is more so one of providing peace of mind to customers that - you know, we're providing them choice and convenience that no single bank can offer. We're also providing people peace of mind that, you know, should a consumer go to a bank and get a home loan, you know, the question is always "Could a third party have negotiated a slightly better rate" and that's why one of the reasons you join, you know, you access a mortgage broker. I don't want the Commission to see that one in a negative light at all.

MR HARRIS: But hang on before we depart your wish to not see it in a negative light, it does suggest that either - and I think you've just answered this but I want you to answer it a little more clearly if you could.

MR RUSSELL: Sure.

MR HARRIS: It says either the banks are offering less in terms of the breadth of a potential discount against - yes, you know we have a criticism of concepts like the standard variable rate.

MR RUSSELL: Yes.

MR HARRIS: And the greyness of the apparent discounts that are available.

MR RUSSELL: Yes.

MR HARRIS: It does suggest, your comment and the data itself does suggest, either the bank are offering less by way of potentially negotiable discounts for brokers to get access to, or it suggests you're less effective. One or the other.

MR RUSSELL: Yes. So I think it's necessarily either. I think that what mortgage brokers have done over the last 20 odd years is keep banks and non-bank lenders very accountable to delivering competitive products and that's - this is one of the things that started in the revolution in the '80s was, you know, when the foreign banks and mortgage brokers arrived, it delivered a level of competition that hopefully we can all say in 20 years' time in 2018, banks and non-bank lenders through first and third parties, the pricing differential has narrowed significantly, and that's actually what we've achieved.

And you are right, you've identified it and that was the objective 20 years ago, and it's only through competition, really good healthy competition that that has arrived, so I don't see that as a negative. I see that as a terrific outcome in promoting a really healthy mortgage market where consumers have choice. Consumers have the choice whether they want to go and approach the bank direct, or whether they want a mortgage broker to scan the market and see if there is a slightly more suitable product from other competitors. So I don't see that as a negative.

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MR HARRIS: All right. I think your next comment was on fee for service and the FOFA.

MR RUSSELL: Yes. So fee for service online, I'm particularly bullish on. I haven't liked the notion for a long, long time. I was really pleased in my previous role when FOFA reforms were rolled out at the same time as we launched the a financial planning business, and you know, the concepts of FOFA have been very familiar with a lot of us in mortgage broking for a long, long time. You know it's the obligation upon all of us to make the availability of financial advice accessible and affordable for everybody.

At the moment mortgage consumers have this magnificent pricing parity across first and third parties. They're able to access mortgage brokers or go to banks direct without fear, favour or pricing discrepancy. The mere notion of providing a fee impost or a tax if you use a broker, I find offensive. I find it is discriminatory for a lot of people that really need mortgage brokers to assist them.

I think it is anti-competitive and I just don't see any reason why anybody could suggest we'd impose this impost upon individuals. So there's two points. One I think it's grossly unfair. The second point is, is the outcome of directing more consumers that can't afford the fee for service back to first party. Is that outcome in any way in the consumer's best interest? Is that outcome in any way a positive thing to be promoting competition in the lender market? I just don't see it.

Mortgage brokers for better or worse, have been the whipping boy since day one, and I can tell you that the mortgage brokers comprise wonderful small business people that invest heavily into their business and are very passionate about delivering home loans for consumers and I still remember myself, the very first home loan I wrote in 1984 and the joy I got in communicating that to my customer. It hasn't changed my love of that business and I - you know, I'm digressing but I'm very passionate about why somebody would be promoting to create a disparity in pricing between first and third parties.

MR HARRIS: So fee for service, at least says there's a fixed amount of money that a broker would get, whereas a commission is a percentage. So there is a natural incentive to have the largest loan possible because a broker will earn the most and yet the costs to the broker do not appear to vary very much as a result of the size of the loan.

The effort from a broker to put together a $350,000 loan is probably pretty much the same as a $700,000 loan.

MR RUSSELL: Correct.

MR HARRIS: The commission is different.

MR RUSSELL: Correct.

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MR HARRIS: So that seems to be against somebody's interest if you were going to price according to cost.

MR RUSSELL: Yes.

MR HARRIS: Now, not every price in the economy is determined by the cost obviously. Many of them logically are and should be determined by demand. But it does argue somewhat counter to your proposition, I think, and presumably explains why consumer advocates appear to be in favour of fee for service. In other words, when you say this is anti-competitive, I'm not sure how it becomes anti-competitive. We can discuss that a little.

MR RUSSELL: Yes.

MR HARRIS: But it certainly doesn't seem to be in the consumers' interest which is a different thing slightly to competition, so the consumer itself is being charged or the shareholder is being charged or somebody is being charged, a percentage when the amount of effort doesn't vary but the percentage may result in quite a variable increase in payment. So can you explain that a bit?

MR RUSSELL: Largely what you've said is factual and correct, and ASIC in their report last year correctly drew out, very forensically, drew out that - there are a number of conflicts pertaining to upfront commission when paid on loan size, and we don't dispute that. If we look at - what you're saying is again correct, the amount of work that goes into originating a mortgage loan irrespective of loan size, is roughly the same.

But that's a separate argument. If we look at that and say, you know, well possibly we need to remove the conflict and maybe, you know, narrow the gap in terms of what that upfront payment the lender makes is. That's one issue, and I'm happy to talk about that issue, but that's very different to what we're talking about in terms of levying a charge on the consumer because the conflicts around upfront commission and loan size, can't be disputed, and the industry through the combined industry forum has already, I think, arrived at a very sensible juncture there to - - -

MR HARRIS: We understand that those changes have yet to be implemented. That's evidence that we've received both from brokers and from other parties.

MR RUSSELL: Largely they are being implemented right now.

MR HARRIS: Are being implemented?

MR RUSSELL: Yes. So a lot of the soft dollar - the soft dollar issues in particular have been completely eradicated from the industry. In terms of the upfront commissions, most, if not all of the lenders, have rolled out changes to the way they remunerate for lines of credit to make sure that they again, recognise the conflict and only pay a mortgage broker

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based on what is actually drawn down at settlement, and not the, you know, the unused line of credit.

There's clearly a conflict that was correctly addressed and been dealt with but, you know, my point is that you can't charge a consumer, you can't create an imbalance between first and third party. You can certainly address the upfront commission paid by lenders because that's not being paid directly by a consumer, and exactly what you have just raised then, I don't disagree with in terms of conflicts around upfront commission, but I just think the industry has been such a windfall for consumers over the last 20 years. It's not broken. The remuneration correctly weights the broker to get rewarded reasonably for a originating the loan, and one point I'd like to make is, you know, again, there's a lot of commentary around the level of upfront commissions, and I'd like the Commission to know that on average it takes around 20 man hours to originate a home loan. That will vary but it's around 20 man hours and increasing.

DR KING: So doesn't come down though to a very simple question of who are you working for?

MR RUSSELL: Yes.

DR KING: If you're paid by the banks, you're working for the banks. If you're paid by the customer, you're working for the customer. You won't expect a real estate agent to act for the buyers. They act for the sellers and they're paid by the sellers. That's why you have buyers' advocates . Aren't brokers who only receive funds from the banks for remuneration they're working for the banks?

MR RUSSELL: Yes. So again, I understand the rationale behind that. I completely disagree. We work for our customers first and foremost. We are not incentivised by the banks to sell more - we're not incentivised more or less to sell certain products. We're paid the same rate of commission irrespective of the product we sell. We work first and foremost for our customers.

DR KING: Why do you work first and foremost for the party that's not paying you, rather than the party that is paying you?

MR RUSSELL: Because - - -

DR KING: I mean, you say there's no incentive to not - - -

MR RUSSELL: Yes. We work along the notion of trying to aspire for clients for life because ultimately a happy client, a satisfied client, the consequences of that is we get remunerated. We don't lend for - we're not an employee of the bank, we don't - yes, the banks do pay us.

MR HARRIS: So you're not an employee, but 70 per cent of broking is employed by banks.

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MR RUSSELL: Yes. We're not employed by the banks.

MR HARRIS: So you're saying independent brokers, that's - - -

DR KING: Rather than bank becoming - - -

MR RUSSELL: I think to draw the analogy that because we are remunerated by the bank, we work for the bank is just not accurate. Our customers, our customers are our customers and our customers are everything to our business. Without our customers we do not have a business. We built our businesses putting the customer at everything that we do to create customers for life. We place our customers to the lenders that present the most suitable options for our clients. We're not, in any way, influenced in any way by lender. ASIC, you know, hundreds and thousands of line items of commission data, trying to draw or looking to draw some sort of correlation between are brokers influenced by lenders paying higher rates of commission, and there is no correlation at all.

Brokers, there is a correlation between the lender offering the most competitive pricing, credit policy and service, yes. So I understand what you're saying but that is not how it works at the coal face.

MR HARRIS: So you - sorry, I know Julie wants to ask a question, but I just need to finish off that statement that you just made. So then that would logically indicate to me that you would not have a problem with our recommendation that brokers, not just bank owned brokers, but actually independent brokers, which you've assured us work primarily for the customer, then you shouldn't have a problem at all with our recommendation which says a duty of care should be imposed upon, you know, more than just bank owned brokers, it should be imposed on all brokers.

MR RUSSELL: Yes.

MR HARRIS: Good.

MR RUSSELL: Yes. And one of the - again, whilst I understand the perceived conflict that people might look at when looking at the bank owned mortgage brokers and thinking that they may be working under a position of conflict, I can assure the Commission that these independently owned mortgage brokers that just so happened to be sitting within aggregation businesses owned by banks, they are not swayed, influenced at all, by the lenders that just so happen to own their aggregation businesses.

MS ABRAMSON: Can I just ask, Michael, about claw back?

MR RUSSELL: Yes.

MS ABRAMSON: We've had some submissions and one of the associations …...(indistinct)..... Commission yesterday so interested in your view.

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MR RUSSELL: Yes. So claw backs and I've read the report and I would like - maybe I'll move into switching because that's relevant to claw back. So, you know, our claw backs generally run 18 to 24 months. Some banks are at 18, some banks are at 24 months, and as the report correctly pointed out, they do present mortgage brokers with a zero sum gain financially if we do refinance a client during the claw back period, the initial claw back period of the loan. We will claw back our up front commission from lender one and be paid that identical commission from lender two. So there is a lot of work for a zero sum gain.

That said, there are a couple of points to make - there's two points to make. Nowadays, there is a lot more work done in packaging up and putting a home loan to lenders than ever before, and that workload is exacerbating as we move into a much more regulatory risk diverse environment. But the work is not only work that we undertake, its work that the consumers have to undertake as well in terms of providing all of the documentation to verify their living expenses and certainly verify their income. There is a lot more forensic analysis undertaken now, particularly around living expenses, and that creates an impost on the client when they go and apply for the mortgage loan. And it's not an impost that can be under-estimated.

So what we find at the coal face is that certainly the first year or two of a home loan consumers are quite reluctant to even entertain the notion of going through that process all over again. They really will only go through that process in the first two years if there are significantly monthly savings and they need to be significant. If they're only marginal savings, a lot of consumers - and we can point out that there can be, you know a marginal saving in their monthly repayments and a reduction in the overall repayment on their home loan. If that saving is only marginal, which tends to happen more often than not in a low interest rate environment, inertia kicks in and the desire not to go through that process again.

So we don't - we actually don't refinance a lot of loans during the claw back period anyway, so it's kind of moot.

MS ABRAMSON: Can I just pick you up on one point, Michael?

MR RUSSELL: Yes.

MS ABRAMSON: You said before that 71 per cent of customers would have loan revisions during the five years, but what you're just amplifying now is that that is not within the - usually within the claw back period.

MR RUSSELL: Yes. So that's a good point. The first review we undertake is around the five week mark, and we contact our clients, either over the phone or we ask them to come in, and that is very important because we make sure that they're direct debits and they're off-set accounts have been correctly linked. So professional mortgage brokers do that

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because mortgage loans can - the relationship can go very sour in that first five weeks if the first mortgage payment is not made or offset. So we do that first review.

We then do the next review at 12 months. And at 12 months it's really just checking in, seeing how mortgage clients are coping with their loan repayments. Just assessing whether or not or trying to understand whether or not anything might have changed in their own personal circumstances, and generally there's not a high demand to consider a refinance, you know, at that 12 month mark.

So there is work done but we don't do a lot of refinancing during that claw back period. When we move on - so if we look at the average loan life of five years and we move beyond the claw back to the balance of the three years, that's when we do, as I said, 71 per cent of clients we have high touch points. That's when possibly clients are more open to looking at refinance options. They're personal circumstances have changed. They might want to make - put in a request to rollover their interest only period. They may look at interest rates and the movement and might want to fix all or part of their mortgage, so we are quite active in that period.

But claw backs were initially bought in as part of the economic calculation of the Lending Commission. They were bought in initially to combat churn and that's what happened, and the industry did a couple of decades ago, you know, have some problems with churn. We've routed all these people out, but the system has actually helped stop churn because, you know, putting a mortgage loan application in requires a lot of work from both broker and client. You know, if there are any brokers left that think that they could go out and churn a client, they're certainly underestimating the desire of any clients to participate in that.

MR HARRIS: It's a funny thing through because we did get the same testimony yesterday and yet if not the same people were saying only two weeks ago in response to our report that the payment was actually about ceasing churn. So you can see how easy it is for us to be confused when we read public statements.

MR RUSSELL: Yes.

MR HARRIS: Quite aggressively made in some cases that the purpose of these follow on arrangements, both trailing conditions and claw backs, was (a) to manage the customer which is an interesting relationship issue, but we can accept at face value perhaps that's a positive one, but (b) to cease churn, and we think, as we know publicly, that might well be in the banks' interest, perhaps it's in the brokers' interests since they're getting paid for it, but it's not always in the customers' interest. Indicative rates have varied quite recently.

MR RUSSELL: Again, I initially started working when home loan interest rates were 15.5, 16 per cent. What I can assure you now is that in this low interest rate environment with mortgage applications having a lot of work, the notion of churn, it just does not exist now, and it would be a very foolhardy broker that would think for a minute that there's an opportunity to engage in churn because - - -

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MR HARRIS: We're just at the end of time, but our next person isn't here yet and I think we've got trail commissions to go.

MS ABRAMSON: I think they are here.

MR HARRIS: They are outside, okay. Did you want to ask something about trail commissions?

DR KING: Look, really just - you mentioned claw back. It's really - you say that trail commissions are a payment for the ongoing management of the client. In the contracts that you have with the lenders, is there any explicit obligation, so is there anything in the contracts that says trail commissions are so that you will be able to do X, Y and Z? And let me supplement that with a similar sort of thing. Is there any performance obligation upon you? In other words, does the trail commission cease getting paid if you haven't reported back to the bank that you've made contact with the customer and done a review every 12 months, and you'll see the parallel with what I'm asking with the review arrangements that have been put in place with wealth management.

MR RUSSELL: Yes.

DR KING: What we appear to have here is a payment that has been asserted as being in the customer's interest and about managing them where there appears to be some plausibility of the thought that the customer could benefit from a review. But is there any obligation in the contractual arrangements between you and the banks to ensure that that customer does get a review?

MR RUSSELL: So there's not. Initially, as I said, when trail commissions were part of the outset of mortgage broking, we had very strong leaders within the lender third party businesses that made it very clear for those of us from the outset that we are paid trail commission to be the first port of call for any client enquiries during the life of their mortgage. There was an expectation that we would do the variations and just so you know, quite often most of the variations require a full credit review, a full application sorry. We then - - -

DR KING: Sorry, that's even if you're refinancing within the same bank?

MR RUSSELL: Within the same lender and it can be even for an interest-only rollover, for an application that moves from variable to fixed rate. We can often be asked to do full applications now to make sure circumstances have not changed with clients - - -

MS ABRAMSON: That would be the legal obligations.

MR RUSSELL: That's exactly right, and what then happens is, we then print the loan documents. These can run quite thick and then arrange to meet the clients. There's a lot of work undertaken then, and we were expected to have to do that and we've taken that on,

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and we've run with that to the point now that professional mortgage brokers that have got successful businesses see that management of the client throughout that trail commission duration as why they get paid their trail commission, and if you look at the that the bank and non-bank lenders have now - you know, if you look at their infrastructures, they don't have the infrastructures to manage mortgage holder expectations throughout the life of the loan.

So to your question. No, there is nothing particularly stipulated. The industry took the guidance or the obligations very seriously when we were paid trail commission. We've invested sizeable amounts into our customer relationship management programs. We invested a lot in the training of our mortgage brokers. What they need to do when they do an annual review.

And I was really heartened when I picked up a little bit of what Anthony Cahill said yesterday when he said that NAB were actually looking to hard code some KPI expectations around what brokers need to do to be entitled to receive trail commissions because we wouldn't have a problem in the world stepping up to those obligations.

DR KING: So just on that, do you think it would be a good idea, so that, you know, the better brokers who are providing the service anyway, there's a direct link back to the contractual obligations and the trail commissions and those brokers who aren't providing those services who are still getting the trail commissions miss out? Do you think that would be good?

MR RUSSELL: I think it is high time that happened because, as I said, mortgage brokers have been the whipping boys for a long time with respect to trail commissions and misinformation about what we do for the trail commission and the fact of the matter is, we work very hard with our clients through the life of their loan for that trail commission.

MR HARRIS: And so the logic would be that if there was a duty of care imposed, this would become the evidence on an ongoing basis that says a duty of care has been discharged.

MR RUSSELL: Yes.

MR HARRIS: Pretty much as it is in wealth management, as we understand it.

MR RUSSELL: Yes, well, look, FOFA - - -

MR HARRIS: I'm not aiming for all the positives and negatives of FOFA, but just sticking with this - the logic flow of saying duty of care and evidence that duty of care is being discharged, would be, you know, supported presumably by such an arrangement.

MR RUSSELL: That would be supported by the vast majority of professional mortgage brokers who would not have a problem with that because they're discharging those obligations now. As FOFA requires a two year opting, you know, really trying to

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encourage professional financial planners to do these reviews and justify their service fees that they earn, mortgage brokers would not have a problem, you know, working the KPIs and justifying the commissions.

One final point re switching that I didn't make. I'd like the Commission to understand why I don't like the term "switching". As you probably know, there has been a real tightening in credit standards in recent times, and one of the consequences across all banks is that the serviceability, the maximum borrowing amounts have come down considerably, and to give you an example, someone that may have qualified, based on their living, their income and living expenses 12 months ago for circa $800,000 today would probably qualify for around $600,000.

So one of the things I'd really like the Commission to understand is that the notion of suggesting to consumers that they can switch, has a misleading element there because it is a full refinance application and I was only talking to some of our brokers last week and they are saying that they have a backlog of refinance requests, but these clients that have perfect repayment records - repayment records now amount for nothing. Zero. You know, when I first started in lending it was all about repayment records and character and capacity.

Now, it has changed such that we unfortunately have a lot of clients that have the perfect repayment records that would like to switch to a product that provides them with a financial benefit each month but they no longer qualify for that same amount.

MR HARRIS: Thanks for your time today, Michael, and for the testimony you have given. Some of it is actually quite useful and we may be back in touch with you to quantify a few other points before we do finals. So we appreciate that.

MR RUSSELL: Thank you.

MR HARRIS: But I am going to move on.

MR RUSSELL: Thank you for the opportunity.

MR HARRIS: Thanks a lot.

Could you identify yourselves, please, for the record?

MR ELLIOTT: Sure. So I'm Shayne Elliott, the Chief Executive of ANZ.

MR OHLSSON: I'm Fred Ohlsson. I'm the group executive of ANZ here in Australia.

MR YETSENGA: I am Richard Yetsenga. Chief economist at ANZ.

MR HARRIS: Do you have opening comments you would like to make?

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MR ELLIOTT: Yes, a few comments. So thank you for the opportunity to speak with you this morning. As a bank with roughly 15 per cent market share, we have welcomed inquiries into the competitiveness of the Australian banking system. Evidence based policies that support contestability offer us, and others, the best chance to win customers through price and service.

We agree with the Commission that lower barriers to entry and open data promise more competition. Open data will allow us to innovate and win customers with better services. It also opens the doors for our competitors, large and small, new and existing. Each day we work hard to serve the 15 per cent of customers who bank with us, and to convince the 85 per cent who don't, that we can offer them a better price and service.

We understand that policy makers must balance stability with competition, and as we've seen overseas, if you get that balance wrong, consumer wellbeing and economic stability can suffer through poor practices, bank collapses and financial crises.

Australians benefit from financial systems stability through economic growth and the confidence that deposits will be repaid. It is true that deposits are backed by the taxpayer up to a point, but bank stability means that this backing is easier for taxpayers to provide.

Over a 22 year period from 1995, key return matrix for ANZ have all trended down despite Australia's long run of economic growth. Our return on equity is down 36 per cent over that period and from its high point in 2002, the decline is 51 per cent.

If you look at revenue per dollar of average interest earning assets, which effectively looks at what we earn and fees and interest on our lending to customers, that's down 49 per cent, and similarly, net interest margin, which measures the difference between what we pay in interests costs and what we receive in interest revenue, is down 41 per cent. While bank returns have trended down, consumers have benefitted from innovations such as internet banking and new ways of paying.

With the pressure on returns, our strategy in the Australian retail market is to be the best bank for people who want to buy and own a home or start to run a small business, and as a result, we are focusing on the owner occupied home loan market, and through a mixture of pricing, service and underwriting policies, we've grown our market share in this market significantly from 15.8 per cent to nearly 16.3 in the two years to December, and those figures include loans which have been securitised.

Now, to achieve this increase, we've had to consistently win business from others who are trying to do the same thing and in some periods, we've managed to expand one and a half times faster than the system as a whole, while at other times we've only expanded at half system growth and that means the market is fluid and competitive.

In the market, consumers have won, with increased discounts delivering lower rates. Consumers are refinancing both within and between banks to capture lower rates driven by that competition. And as you know, part of the story with home loans are of course brokers.

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Consumers use brokers to understand the market, to help with the loan paperwork and to negotiate a better deal. We're happy to help customers whether they choose to use a broker, our branch network or our mobile lenders. About half of our mortgages originate from brokers and as such, while we don't own a broker network, we believe the integrity of the channel is critical. In addition to helping our customers, brokers also help those banks without branch networks compete.

The Productivity Commission has made some recommendations concerning brokers and we see merit in enhancing the consumer protections in this space. A best interest duty could support the existing law to promote consumer interests when receiving help from a broker. Finalisation of the Commission's recommendations on this topic, in our view, should take into account the need for trust in brokers as advisors, whether consumers are willing to pay for loan help and brokers' role in levelling the playing field for banks without branches.

And lastly, in relation to the new payments platform, we believe it is too early to reach a conclusion on whether a mandated access regime is required. NPP is open by design and it will succeed for its 80-odd shareholders if innovative overlay services have access to the platform and these services will make it more attractive to consumers and this will drive volume that will benefit the shareholders. So thank you for your time and I and my colleagues welcome your questions.

MR HARRIS: I appreciate your opening statement and succinct comments because it gives us time for quite a few questions if that is okay. Can I just take one point of your presentation there? You did suggest that there are increased discounts on offer. We've just had a discussion with a broker and we have data in the report which suggests that the broker channel, in any event, has delivered in relatively recent times, less of an advantage. Still an advantage over branches, but less.

We were comparing 2012, I think to 2015 and the apparent comments, although I'm not going to quote anybody in this kind of forum, you know, as giving us answers that are anything more than a sort of general perception.

MR ELLIOTT: Yes.

MR HARRIS: Does that appear to be right. There has been a shrinking of discount capacity in relatively recent times. Your comment says an increase in discount capacity, so do you know any reason why a confusion might persist?

MR ELLIOTT: So I will ask Fred to give a bit more detail, but I mean, I think it's probably - I'm guessing because I don't know what it was - - -

MR HARRIS: No, no.

MR ELLIOTT: I'm guessing it is to do with the timeframe. So if you look over the long timeframe and I've said, you know, since I've been in Australia since '09 and looking at

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discounts, they've absolutely trended up. However, in the very short term, so looking over perhaps the last year, they got to an extreme high, probably 18 months ago.

MR OHLSSON: Mid-2016.

MR ELLIOTT: Yes. They got to a very extreme high and they hadn't moderated since then, but even today, they're still elevated compared to where they were three, four, five years ago. That would be our view.

MR OHLSSON: Yes, absolutely, I would support that and I think when we look at the flow though and discounting, ebb and flow a bit, so at a given point, you know, it might feel or there might be an impression that discounting is lower at the time and you know, any given quarter, in any given month, but over the last three, four years the feeling is certainly to overall, over time, an increase in the amount of discounts.

MR HARRIS: Well, isn't that curious because the data clearly shows that, just comparing 12 to 15, the success of the broker in negotiating discounts has been to negotiate a lesser discount, in other words, whilst they have negotiated some discount, it's been shrinking. So can you explain why the broker generally otherwise is growing and you know, everybody's into it and consumers, I think, are being encouraged by a complexity to go there. Not encouraged in the sense of being forced at gun point, but certainly encouraged to go there and yet there's a lesser level of success now than there was even three years ago.

MR OHLSSON: What I would say is that in absolute terms, the discount levels today are higher than three years ago. That's what our data definitely points to. It might have been a reference to, I guess the broker channels success of providing discounts compared to other channels, and the way we think about this as Shayne said, you know being - as Shayne pointed out in the opening statement, being a bank and 15 per cent market share, it is very important for us when we serve our customers, both to maintain them and acquire new ones, is that we compete well through every channel, not just through brokers. There might be a perception of, at this point, maybe that it's more competitive through the other channels so maybe the advantage of going through a broker has decreased over the last two or three years.

For us it is very important the way we think about it, you know, it is important for us to, I guess, keep our share and win share and it's very important for us that we compete well and very, very similarly and across all channels. If that's through our proprietary branch channel, if that's through online acquisition servicing, if it's through mobile lenders or through brokers.

MR HARRIS: Yes. No, it's easier - it's possibly explained by precisely that. If you are being more generous at the branch in 2015 than you were in 2012, it could have been - - -

MR ELLIOTT: What I would say though, the way we do this at ANZ, is that we - that is important for us as we are, you know, equally competitive because for us, you know, we

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want to make sure we show up well in any channel. It's important that we show up well and give customers choice regardless of what channel they have their preference for.

DR KING: A number of potential explanations, one fairly obvious one, I just want to make sure we're not doing, how do you measure discounts internally? So when you say discounts, discounts compared to what? Is that standard variable rate?

MR ELLIOTT: Yes.

MR OHLSSON: Yes.

DR KING: Just wanted to make sure - - -

MR OHLSSON: The way we think about discounts, that's the starting point is the SVR.

DR KING: Yes.

MR YETSENGA: Sorry, I was just going to round that off. I mean, the others used the expression more generous at the branch. I mean, the other alternative may be that the other information channels that consumers have to get information about the products available are becoming more effective, whether it is comparison websites or other sources, or even gleaning information through informal avenues like social medial and other things probably has become more important over that period. So brokers are competing in that segment, I suppose, rather than being the only way that consumers distil the information.

MR HARRIS: There's multiple factors involved and that's accepted. We can't be absolute about these things, but what we can say is the data suggests that that channel is less successful now than it was and our interest in that is primarily, I guess, driven by the fact that it's quite an expensive channel or so it appears. Now, we've had disputes over how expensive the broker channel actually is, and moreover we've had a dispute about who's paying. So we find assertions that a customer isn't paying to be, you know, counterintuitive, and the responses that we've got to date are ones which suggest that - at best they're anecdotally based.

Now, you are doing the paying. Tell me what the view of the ANZ is about who's actually paying for this service and therefore who should expect to get something in return for that payment.

MR ELLIOTT: Well, at the end of the day, the customer, the consumers are paying for almost everything that we do, whether - they're also paying for the branch network, and they're paying for internet banking and they're paying for everything. I get, you know, obviously as you know, it's not necessarily always transparent, the customer in that case that what the brokerage or what that fee is and they're not writing a cheque for it, so it's less visible to them, and we know that, you know, the mere fact of writing a cheque or paying something, changes people's behaviour so it's slightly, you know, it's less

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transparent, but ultimately yes, the customer pays. We build it into our model when we're thinking about pricing.

MR HARRIS: So we were having this discussion in the context of should a broker be under a duty of care to act in a customer's best interest and that's step 1. If the customer through whatever mechanism is actually paying for and would have a reasonable expectation that the service is being provided to them, in our draft report, as I'm sure you know, we have recommended that a duty of care might be imposed on bank owned brokerages, but this morning we've heard and I think we've heard a little bit of testimony as well last week as well, to the effect that high quality independent brokers apparently wouldn't mind if a duty of care was imposed upon them as well.

So those two notions do fit quite neatly together. If the customer is paying they would have a reasonable expectation then they should have an assurance. The question is how do they get that assurance.

MR ELLIOTT: Yes.

MR HARRIS: It could be done through regulation. It could be done through contract as well. But there seems to be a lot less resistance now to the notion that a duty of care would be a reasonable thing and possibly more a question of its design as to how we go about doing this because we have learned perhaps from financial advice on design issues. Would that be - again, I'm putting words in your mouth, but that's the way we try and do this because we're trying to get you to debate with us - - -

MR ELLIOTT: So I think it's important to go and ask consumers. Let's find out. But my guess, and I've done a bunch of focus groups when I first took on the job and listened to people and issues, I imagine that a lot of people think that the broker does have a duty of care to them. I imagine that when mums and dads walk into a broker, they assume that that is the case. You may even go as far to say they have a best interest duty as well. I don't know, but I think there is an expectation and I think FOFA and others have probably raised that expectation. People would say well, if that's the rule for a financial planner, I assume it is for a broker. But I think it is important to go and ask consumers and their representatives to see what they would expect. Yes, I would agree with your statement, it's certainly not unreasonable.

MR OHLSSON: I think that's the similar aspect in regards to, I guess, the commission and what you were alluding to, I think Peter, in regards to a fee potentially, and paying for the fee of that advice or that conversation that support that guidance from the broker. I think that's - there are examples all over the world of that taking place, as opposed to it being, I guess, not the fee. Not the disclosed fee, and I think that's another thing that would be important to check with consumers what they would prefer.

MR ELLIOTT: And our understanding there are brokers in Australia who do charge customers directly. I'm not sure how prevalent that is or how big a part of the market, but there are certainly brokers who go out and offer and get paid by the borrower directly.

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MR HARRIS: Yes. Well, we should probably separate these into the question of a fee versus a commission, which is a percentage-based value where again I have the impression, without actually having it crystallised into decision-making as I understand it within the industry, I get the impression that perhaps a fee is a better proposition. The question might be should it be paid by the customer or should it still be paid by the bank. But they're different things. I don't know whether you have an impression that perhaps there is any movement going on in this area.

MR ELLIOTT: A fee versus commission?

MR HARRIS: A fee versus commission and the incentive effects that can be created by percentages.

MR ELLIOTT: So look, I think, you know, as part of the Sedgwick review there was some referral to and the industry is looking at the whole area of broker commissions and the way that they get paid. As Fred said, I know - our experience looking around the world, there are the markets that have a kind of fixed fee rather than a volume based type thing. There's absolutely merit in looking at it. The reality is today in that kind of openly highly competitive market that it's taking us down a commission-based structure, and there's - I guess it's understandable logic to that because, you know, given there's an alignment between the commission and the revenue and the volume obviously driving revenue for the bank, there's an alignment of interest there, but I think there is merit in looking at a fee based structure.

I can't imagine myself that will evolve naturally. That would require some intervention either as an industry or through regulation, would be my guess.

DR KING: ANZ is in a slightly odd position though in the broker space. So you don't own any aggregators as I understand it. But you do have that franchise network which is mobile lenders.

MR ELLIOTT: Mobile lenders, yes.

DR KING: Mobile lenders, yes. Which I'd assume and I'd be interested if I've got this wrong, but I'd assume you've added being a broker competitor if I can put it that way.

MR ELLIOTT: Sort of, yeah. So I guess, ...(indistinct)... position is odd, but as a good one, it's a decision we've made. I think the mobile lenders do differentiate themselves from a broker. It's got ANZ all over it.

DR KING: Yes, it's - - -

MR ELLIOTT: You know it's ANZ. You're right. I guess the compensation model is different than if they're our own employees and that attracts certain types of people to that

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industry who like to work in kind of a small business. If you look that's essentially what they are, small business operators.

MR OHLSSON: We work very closely too with our branches because as Shayne pointed out they are ANZ franchises and they - you work very closely with our branches making sure if we have customers they want to be served out of hours and then, you know, we provide that convenient solution.

DR KING: Yes, it was more for when you were talking, "Well, perhaps it would be better to have fixed rather than a variable payment." I wondered had you tried any of that with your own franchises? Have you tried varying them, taking them away from the broker.

MR OHLSSON: No, we haven't. We haven't. We find, you know, the way we do today with our mobile lenders that works really well.

MR ELLIOTT: You know, they were quite small just to put their numbers in, so what this is about ten per cent of our - - -

MR OHLSSON: Ten per cent - well, ten, fifteen per cent of up flow depending on, you know - - -

MR ELLIOTT: The broker is a path.

DR KING: It was more if you had tried experimenting with them, it would be fantastic.

MR ELLIOTT: No, no, we don't do that, no.

MR HARRIS: It's hard to go one out, isn't it, in a commercial sense?

MR ELLIOTT: It is. It is.

MR HARRIS: In order to work this, you might well lose them with a preference of - - -

MR ELLIOTT: Going to a broker.

MR HARRIS: While still maintaining a percentage arrangement as a proper broker - - -

MS ABRAMSON: Can I ask a question which is related sort of in the wealth management and also the mortgage broking? One of the things that we're looking at was introducing competition by allowing wealth management or financial planners to actually advise on loans. And some of the reaction that we've got is - and I do understand the legal background to this, is but they're such fundamentally different products. But when you think about it your home loan for most people is going to be the biggest financial product that they take out, and I've been thinking about this from a sort of licensing point of view and the range of licences that you hold. So just interested in your views.

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MR ELLIOTT: So yes, I read about that. I mean, so if I stand back - there's nothing stopping people doing that today. So if I'm - have a financial planner myself, I can go and get a broking licence and there's nothing prohibiting that, but for some reason that has not evolved.

Our view, from experience and looking at the products, they are different and people, our customers think about them in a very different way. You know, there's that old adage that you know, the wealth products are sold and mortgages are bought. You know, people think about them very differently. They think about who they go to for that advice, so there doesn't - experience would suggest there isn't quite the natural fit that there might otherwise be. But as I said there's nothing stopping in particular a financial planner getting a broker's licence. It's interesting - - -

MR OHLSSON: Well, sometimes what we say is that financial planning, I guess, houses, they work closely with broker firms so there's kind of like an alliance.

MR ELLIOTT: Yes, if you come into an ANZ, you'll find that our home loan managers who are authorised, sit next to the financial planners and they do - share clients and talk together and kind of tag team with their own specialisations.

MR HARRIS: Yes, inside branches, we could probably see it. It was a question really - this is a competition inquiry and we're thinking of competition from four parties in the industry and we were thinking - and it appears the data to support this - that it's interesting the regulatory structure doesn't support the notion that a potential source of competition for brokering, which are financial planners - it doesn't envisage that that might be the case. And so we were thinking perhaps we can clean up a regulatory anomaly and at the same time, perhaps we can introduce some form of competition that might affect this apparently quite large price that's paid for broking, and attached to that was the fact that it appears that financial planning, at least in its basic form, doesn't cost as much as broking alone.

Now, we've had that disputed and we're going to try and find some better data, although given our access to data arrangements haven't worked as well as perhaps it might have - I might put on the record here, if you're able to offer us some information about financial planning charges for the equivalent of the average loan being $350,000 nationally, placing $350,000 in an investment arrangement, we'd be very interested in knowing whether there is a significant differential there that might suggest that the competition could drive prices down towards, you know, perhaps a happier mean. Anyway, that's the notion.

Competition in the industry doesn't just involve competition as it were, at the supply and there can also be competition amongst the facilitators and so we were interested in those areas.

Can I turn - if that's okay with my fellow commissioners - can I turn to the big structural issue in this which is macroprudential and the idea of a competition champion particularly in those forums where necessarily behind doors, macroprudential issues are discussed and debated and then intervention occurs. We have concluded in draft form that

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macroprudential intervention is likely to persist. Whether we believe it's likely to persist simply because central banks have been somewhat constrained in their ability to use cash rates in the post-GFC environment which eventually will regularise itself, or whether it's simply because once a tool is discovered there's temptation to use it, particularly if it can be finely tuned, it seemed a wise thing to maintain that for either source.

Now, we did note in ANZ comments in an online blog that you're suggesting that on this sort of general area of whether macroprudential interventions are going to persist, that we might be right in the short and mid-term but not in the long term and I thought, "That's a curious comment. I'll be interested in knowing why".

MR ELLIOTT: I don't know who wrote that blog.

MR HARRIS: Okay. Well, anyway, maybe you can just have a look at it and we will see - our group will determine where we saw it - - -

MR ELLIOTT: I think, you know, the reality is macroprudential, you are quite right, is a new trend. It's an emerging trend and in efforts to kind of, you know, tweak and clip the edges around the business, you know, and I think it's a recognition that the traditional tools have had some gaps in them and so, you know - and obviously people are concerned about the inflation in house prices, the rapid growth of investors, et cetera, et cetera, and so these are a blunt tool.

Whether they will always be thus, I would tend to think that they - we're probably through a bit of a cycle. They'll be popular for a period of time. They'll achieve their aims and then probably will recede, but you know - - -

MR HARRIS: That's inconsistent with this sort of statement but I guess from our perspective, if you looked at it in almost the entirely opposite way. I mean if the choice is between using shifting cash rates which are a broad swing across the economy and do, in almost all circumstances, damage entities that were not the target but necessarily that's what a cash rate does, versus a quite selective intervention at a particular point via the macroprudential regulator, it does seem that these macroprudential tools are capable of refinement and increasing precision, and could therefore be desirable, versus shift in the cash rate unless for a very big monetary policy reason, like obviously a shift in the cash rate ...(indistinct)... so it happens.

MR ELLIOTT: Although they do expose, they have their own weaknesses as you know because they always sound simple, but in the execution they raise all sorts of complexity.

MR HARRIS: Correct.

MR ELLIOTT: For example, the obvious one recently being, you know, when we say "Oh, we should put a cap on investors", well, let's define what an investment property is. Is a holiday home an investment property? Is it not? People do actually live in more than one home increasingly. What does that mean? So we start getting into complexity of

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definitions, and therefore we end up having potentially regulatory arbitrage. Now, I don't - it's early days and I'm not suggesting that that's happening, but history will suggest - - -

MR HARRIS: Yes, people will take advantage of that. We don't have any malicious presumption here. People will take advantage of it because it's a market.

MR ELLIOTT: Yes.

MR HARRIS: In a market, this is the activity that we expect to happen. You know, you see an advantage, you will price according to the advantage and things will change as a consequence of that. Anyway, we're interested in this question of would it persist? Because clearly if macroprudential interventions disappear as a tool, then we possibly need to worry less about it than we have been.

But it is an important part of our contention that a competition champion in those sorts of forums would be desirable because otherwise the macroprudential regulator in APRA must all balance necessarily towards stability. It must favour that.

MR ELLIOTT: Sure.

MR HARRIS: It may be able to take into account, have regard to competition. Whenever it is a finely balanced judgment, the balance is going to fall towards stability, thus - the question is could an alternative party be making an argument in those forums for considering competition, achieving a slightly different outcome or achieving it via a slightly different methodology.

And that little homily is supported, I think, by the fact that we've noted that in the UK, and I mentioned this last week so you're probably in observing these hearings and therefore you know, the UK itself, even though it had quite a difficult global financial crisis by comparison with us, nevertheless the lid might have gone on too far in favouring stability and changed its remit to its prudential regulator to create this secondary objective of favouring competition, so a more explicit direction than simply have regard to competition.

We haven't done the same thing here. We had a better global financial crisis than they did, but we're apparently less worried about competition.

MR ELLIOTT: Well, I mean, in one - we didn't have a financial crisis essentially. You know, consumers didn't have a crisis. There were no runs on banks. There were no failed institutions. There was no cost to the tax payer in terms of bail outs so I think in Australia, the system here, the regulatory system, the stability framework, worked incredibly well and Australia and Australians are better off for it.

Now, you can argue that it was, you know - the arguments it was too stable perhaps, but I think it became a great benefit to the economy.

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MR HARRIS: That's right, but would you simply - do you offer any support for the idea there should be a competition champion at the macroprudential level?

MR ELLIOTT: I don't know. I mean, I take it for granted that - and maybe I am wrong - but I've taken it for granted that the Council of Financial Regulators do consider competition in terms of their setting. That it's not just stability because if it was my view, we'd have a very different system today. If they were solely functioning on stability and they had no regard for competition, we wouldn't be living in the world we are today, and I think the government itself has actually moved pretty pro-competition in terms of making it easier for people to form banks, lowering the capital requirements. Making it easier to put bank in your name. You know, putting together regulatory sandpits for start-ups et cetera.

All of those are pro-competition and they have been actually the thrust of most recent changes in the system.

MR HARRIS: That's right, and as we observe in our report, none of those have induced any significant competitive change and they might prospectively do that, but entry itself into the banking industry - well, we've got the numbers, they're in the report, it hasn't been the competitive threat that a text book might make out.

MR ELLIOTT: Well, that's true although there's still a large number of ADIs in the country and there's certainly a large number of non-banking financial institutions. All one has to do is turn on the radio on the way to work and hear all the adverts for financing opportunities for small businesses et cetera. So there's a wide arrange of options available for people more so than before.

MR HARRIS: Well, there's an analysis in the report and that's why we think this question of the overall level of intervention which clearly has an impact on competition and it necessarily does.

MR ELLIOTT: Yes.

MR HARRIS: It has in those examples we've used, constrained competitive response from those very institutions including to the non-bank sector which you mentioned apparently.

MR ELLIOTT: Although can I make a comment. I mean, I think - I get that and I understand it and yes, by definition there are some various entries in the system and therefore there will be less competition as a result and that's undoubtedly true. However, the barriers are not such that there are a wide range of financial institutions globally who have had every ability and it's not that difficult to come and get a licence and set up a bank in Australia and compete and some have.

But some may have chosen not to, I put it to you, not because of the regulatory barriers, because it's hard. Because it's competitive, because returns are low, because there are

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some scaled requirements in terms of being in an effective competitor in the market. Now, that may change with fintech and open data. We'll have to wait and see.

MR YETSENGA: Can I make - sorry, just two final comments. I mean, there's conventional monetary policy that also has competitive impacts. I mean, countries that have had very low interest rates, and one and a half sounds low but countries that have gone closer to zero, banks that can access wholesale funding have a substantial competitive advantage over banks that primarily rely on deposit funding.

So I think to think about macroprudential as being fundamentally different from a conventional monetary policy, I'm not sure that there's a clear dividing line there. I think they both have competitive implications and just, I guess, to pick up your phraseology a bit, fine tuning, and I guess for me, I think if there's a presumption that the market with a large number of players and with reasonable information will generally do a reasonable job of allocating things efficiently and we should let the market do its role, I guess I get nervous about that conjunction of events because, you know, history may well look backwards on this period and say actually at the risk of trying to fix what happened to other countries during the crisis, we became very involved in the financial system in lots of different ways, and the effects of that will only become clear over time.

So if there was as shift back to conventional monetary policy on balance, I suspect that would be a good thing rather than - - -

MR HARRIS: Yes, I don't think I'm saying - I mean, I have a sense of what's desirable; I'm merely saying it appears to be a mechanism that is under increasing use at the moment.

MR ELLIOTT: True.

MR HARRIS: Yes, it has that ongoing attraction of being precise in its targeting versus a cash rate; it has costs by being precise in its targeting because, as you pointed out, arbitrage opportunities were a dividing line. And I guess that's why our solution has been as subtle as it is, which you know, to suggest that an entity is stated as being the competition champion in the closed-door forums that debate these kinds of things, and that a statement of expectations is varied for the other participants to say, "We expect you to pay attention to the competition champion," you know, it's a pretty subtle and nuanced change.

Those in the industry who are steeped in this do accept that such subtle nuanced change can be of significance, but it is still pretty subtle and nuanced, and hardly, I think, an endorsement of the idea that one mechanism is preferential to another. We wouldn't disagree with your broad statement that says it would be far preferential for the market to be open the allocations here, as far as possible.

Stephen, you're last.

DR KING: I wanted to change directions slightly, and get onto risk rates generally and then I think Julie, you wanted to do the SMEs in particular?

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There's been a recent history in banking in Australia of - it appears, and I'd be interested in your views of this - of playing down, if I can put it that way, the differences between the IRB banks and the standardised banks. There have been recommendations that this is relevant to competition and you've seen our comments on those recommendations. And you'll be aware obviously, that the APRA discussion papers came out a couple of weeks ago.

From your perspective as one of the five IRB banks, is the value of being an IRB bank being eroded by the prudentials changing and essentially saying, "Well, fine, you can have your internal risk rates but we're starting to floor them; never going to raise the floors on them," so they start looking very much like a standardised rate.

I mean, you know, for want of a better way, did you guys do your dough when you put in all of those systems for the IRB to become an IRB bank, the sort of investment that you made was substantial; you were expecting a return on that, or it was quite reasonable for you to - - -

MR ELLIOTT: So, no, we didn't do our dough. And you know, being an IRB bank is a good thing; forget the regulation. Being more granular and being more thoughtful about how we manage risk is a good thing; it's in our interest to do so. So we haven't done our dough; it's been good for us and we are a better risk-managed institution as a result of what we've learnt and continue to invest in that.

Your question about has the value diminished over time? Mostly certainly, because the return on that investment was, you know, essentially, one way of thinking about it, and it's only one, is well, what was the RWA advantage it gave you after versus standardised? It wasn't that long ago that difference was almost 20 per cent difference, you know, on a home loan for example. And today, it's more like 10. So, yes, the value of it has diminished but it's still worthwhile.

I mean, as I said, it's a good thing to be on an advanced system and to be using better analytics to understand our risk: how can it help me?

DR KING: Do you see the direction that APRA has gone in the discussion papers, which are looking at a more nuanced, standardised risk, for example, residential property, as being a desirable thing?

MR ELLIOTT: At the end of the day, I guess there's two objectives here; one is to make sure that the playing field is as level as it can be, reflecting that it can't be totally level because you know, we are investing in different systems and amounts, and in terms of being better risk managed, there should be a reward and a benefit for being better at risk management, right? So there should be that benefit.

So we've got to get that because if we eliminate it all, then the incentive for us is not to invest in risk management systems, and how that is to the benefit of Australian consumers or shareholders or the economy is not clear to me; so, there's that point.

But on the other hand, the nuances in terms of refinement, of understanding various differences in risk, you know, I think is a good direction. So understanding that there is a difference

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between potentially an owner occupier and an investor; there is a difference between small businesses, you know, and the nature of those small businesses, you can't just categorise them as all the same and therefore all be equally risk weighted.

DR KING: The term "level the playing field" gets used all the time here, so "level the playing field" between the standardised and the IRB bank.

MR ELLIOTT: Yes.

DR KING: And I don't understand it. I mean, it strikes me as being a bizarre concept in many ways. If a company invests in a new IT system or new factory, that means that if they were to produce a better product and the others who haven't invested go out of business because they can't compete, we'd normally say that is a good thing for the economy.

MR ELLIOTT: I agree.

DR KING: So in what sense does level - - -

MR ELLIOTT: I agree with you: it is generally the smaller players - those on standardised - who say that they are somehow at a disadvantage, and our answer to that is, "Well, you can become an advanced bank. It requires investment and scale, and system and technology, but you can achieve it. There's no rule that says you can't have it."

And you know, Macquarie is a very good example, you know, one of the non-big four who made the investment to go and be an advanced bank in terms of their models, so I agree with you. And that's what I'm saying, there should be a benefit if you make those investments.

DR KING: So would you view the APRA moves to essentially move away from the IRB rates and push up those IRB rates to standardised rates as anti-competitive?

MR ELLIOTT: I don't think I would use those terms. I mean, I think globally, in the Basel committee there was a view that perhaps the models need some kind of speed limit, overriders, whatever you want to call it, to kind of give them more ballast, right? Maybe we became too reliant on just pure models and they need some ballast in them just to kind of make them a bit more even; that has inevitably led to a shrinkage of that advantage that you're talking about, yes.

MS ABRAMSON: It's kind of a comment really, because I think this is where you're going: we've made some recommendations about APRA being more granular around the risk weighting for SMEs, so I take it, Mr Elliott, from what you're saying, that that would be a move that you would be supporting?

MR ELLIOTT: Sure, yes.

MS ABRAMSON: Yes.

MR HARRIS: You have a new payments system as a point, and I think you may be - anyway,

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you've given promise to it, I'm not sure that many people have. If I take your presentation directly, I don't think you're disagreeing with our view that this is going to be fundamental infrastructure for the future, for people to be able to compete - - -

MR ELLIOTT: Agree.

MR HARRIS: - - - in one area of the finance system. Your proposition is, I think, it's too early to impose an access obligation upon the payments board, I guess, that's going to run this. I'd appreciate your view on this: we found when we were enquiring into this that it was quite difficult to determine what the arrangements were likely to be, beyond the initial participants who had, obviously, funded this.

And I think the reason we were attracted to an access obligation is, it tends to be a mechanism which enables you to crystallise how you're going to go about allowing participants, who weren't original investors, to play without having to, I guess, justify almost, to their competitors, that they should be allowed to play.

This is an area that has come up in a number of regulated industries, and I think it'd be fair to say, access agreements aren't that popular. But that's their benefit: their benefit is, it crystallises your thinking about how this might happen; do you have a reaction to that at all?

MR ELLIOTT: So, look, I try to think about this as simply as I can, you know, which is going to your point earlier: there needs to be an incentive for the investment to create such benefits. So we spent, as an industry, a huge amount of money, hundreds and hundreds of millions of dollars, to create this, and there needs to be the incentive that says, "Hey, if you go and spend on new infrastructure, there's a benefit to the investors." And they don't take that - hopefully - for granted.

Hang on, but when I think about their openness - so there's nothing to suggest in the discussions or the documentation today that it is not viewed as going to be open, in terms of open access. What we're saying is, we've only just - actually we hadn't even launched the system yet; it's being tried out at the moment, so it's really hard to - - -

DR KING: Really early days.

MR ELLIOTT: It's really early days, literally weeks in. I mean, we haven't even turned it on at this point, so it's a bit early to say.

Having said that, I think about these new networked worlds we live in, whether it's a Google world or whatever, or whether it's the credit card networks; the value of these networks increases in terms of the more users and more access to them.

So in terms of a shareholder in this, it's in my interest to have more access, more users, more volume going through that platform, you know? Realities in our world, we have a history of closed-loop networks failing miserably, and there are some in the cards business and other payments around the world.

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Openness is an asset to the owners of that infrastructure and will continue to be so. So I think it's actually a total alignment of interest to say, "We want more and more people on the new payments platform," because the utility of it will increase. If I say to my own customers, "It only works between certain kinds of banks and you can't do these," that will limit its utility, so it's in my interest.

DR KING: Have you also seen these platforms - and obviously it's a concern for competition regulators around the world – that the first mover advantage is particularly important, but often we may see a slew of overlay services initially; it's likely that one or two will end up dominating the market.

Isn't the problem here that whilst there may be a preference for open access, as you've mentioned, unless it's actually formally stated, unless it is, in a sense, governed by the RBA, we might find in five years' time that well, it wasn't quite so easy to get access to build overlay services, and by that stage it's too late, it's whoever has won the competition, they've got the market share and the competition is gone by that stage.

MR ELLIOTT: Look, my reaction about that is based on a whole bunch of assumptions: if this, maybe that, possibly in the future; I mean, none of those things we know, right? So there is no evidence to suggest any of that is the case, it's all ifs and possibilities.

You know, which overlay services are we talking about?

DR KING: I'm just thinking of ...(indistinct)... Google - - - we can run through the platforms that are now dominated by a single player.

MR ELLIOTT: Right.

DR KING: And what's to stop that happening on the NPP?

MR ELLIOTT: Well, you know, again, that's a theoretical discussion I'm sure we can debate; I don't know.

DR KING: Well - - -

MR ELLIOTT: But in saying that, I don't see any incentive at - there's a slight difference here, and again, I'm not an expert in this field, but you know, NPP is not run by ANZ, where world domination is my goal and I want 90 per cent share. It is run by a consortium, and say, Google isn't run by consortia, Facebook isn't run by a consortia of industry players, you know.

Maybe cards is an interesting one to look at: where you've got a Visa and MasterCard you know, both open platforms, you know, thousands and thousands of bank members who fight really hard to have more openness in their networks and compete very, very heavily; maybe that's a better model to look at in comparison?

MR YETSENGA: I think that is the problem about technology dominance, though - allowing open access doesn't do anything to affect that, does it? If it's a market and a system in which

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some sort of natural monopoly exists, then it still exists, regardless of how much access you allow. It might take you longer to get to the single dominant entity, but it shouldn't change the - - -

DR KING: Or allow competition on the platform from day one, rather than finding out in five years' time that really, it wasn't open from day one.

MR YETSENGA: There's a dozen institutions I think, on the platform now. I mean, it strikes me as pretty competitive to start something from scratch.

MR HARRIS: I don't think we doubt that the original investors themselves have plans to deal with this, in terms of their own cross-competitive outcomes. I don't think we doubt that; you'd have to be mugs to put the amount of money in that's gone in, without having - - -

MR YETSENGA: Yes.

MR HARRIS: - - - some idea of how you plan to utilise it in a competitive sense.

No, our question is really the one I posed at the outset: there does not appear to have been any crystallisation of our thinking about the other entities. And those other entities - I think you referred to this Shayne in your opening address - are innovators using data to create overlays that would benefit from direct access to the new payment system.

The question is, how do they get access? And in our investigation, going around the multiple parties, that originally we thought were responsible for this and finally getting through the complex labyrinth - this actually involved us going to the wrong meeting in the wrong building at one point.

MR YETSENGA: Right.

MR HARRIS: Well, we thought we'd found the right party and we weren't. But having got there, we asked this question, how do they get access? And I won't say people were uncooperative, I just think they hadn't conceived of necessarily having a structured format in which we could say, "If you want to be - have not been ...(indistinct)... you want to deliver a service that potentially needs to use this, this is how you're going to go about doing it, this is the cost, this is the bona fide issue you'll need to establish, this is the safety of data."

Access arrangement could establish that and we considered that would be a support to innovation; in other words, it becomes convenient to plan how I might put an overlay service through this, that was all. We didn't think it was there.

MR ELLIOTT: Right, so it's more like - - -

MR HARRIS: It's sort of like an - - -

MR ELLIOTT: ...(indistinct)...

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MR HARRIS: - - - explanation is, it's early days, that's the explanation.

MR ELLIOTT: Yes, that's more like the open day, that regime, "How do I - yes.

MR HARRIS: Yes, how do we get there? Anyway, we think it's important and since you raised it I thought I would make something of it, and maybe if you've got a submission that comes following this, you - - -

MR ELLIOTT: Sure.

MR HARRIS: - - - might want to give us a little bit further advice on that. I realise, as I've said, that access regimes are not necessarily the most popular mechanisms for dealing with major strategic infrastructure, but the concept behind them seems to be an advisable one when you start out, knowing how you're going to do that.

LMI, I have taken you past your time - - -

MR ELLIOTT: That's all right, okay. LMI.

MR HARRIS: Lenders mortgage insurance has become, from being a sort of slow moving element of this inquiry, become quite a significant one in the course of these hearings, and we may come back and ask you for some data on LMI - - -

MR ELLIOTT: Yes.

MR HARRIS: - - - and how we - you - go about engaging with the industry that provides the insurance: could we start there? It's been an interesting revelation that there's not competitive tendering of what is quite a large chunk of money for quite a large group; in fact, it's surprising to me that the degree of home owner utilisation of lenders mortgage insurance, you know, 20-odd per cent has to take out LMI.

It's quite a big chunk of money; it's generally capitalised into the loan; it seems quite an odd arrangement. Now, not to say there's anything wrong with that, but the particular aspect that we asked people about so far and that no-one's been able to offer us any good explanation for why it isn't the case of re-tendering of this from time to time, if there is a preferred provider. But why doesn't re-tendering occur with LMI - - -

MR ELLIOTT: Do you mean from the bank?

MR HARRIS: Yes, the bank - - -

MR ELLIOTT: So you're saying ANZ, being - - -

MR HARRIS: Well, you're ensuring your loan, so you're - - -

MR ELLIOTT: We don't disregard re-tendering, we consider whether we are the best provider of that insurance - because at ANZ it's an in-house arrangement - or are we better to

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go to an external provider? The problem you get into with external providers, frankly, in a small - we do - we can reinsure a little bit. In a smaller market like Australia, it's a concentration risk: if everybody insures with the same provider for that insurance, when things go bad, that insurance is worthless.

And so we have to consider those risks, and that's actually much more important than a few basis points or a bit of cost here and there in terms of the tendering. And again, we all know that in our daily life, if you're going to insure your house, insure it with somebody who's going to be around when you need them, and that's really important. And what we know about housing when there's a problem it'll be cyclical, it'll be lots and lots of people having problems, all at the same time.

MR HARRIS: But aside from - and I can debate the in-house nature of it, therefore the fact that you're absorbing that risk - - -

MR ELLIOTT: Yes.

MR HARRIS: - - - so, you know, in a sense if there was a meltdown, you know, you're a slightly riskier proposition as a consequence; that might be a counter-argument.

But my point was really, there are two large external providers, and there's you internally. It's a standard of economics to say, occasionally we test the market and say, "can they do a better job than us?" And particularly in this case where you're not paying for it, your customers are paying for it.

MR ELLIOTT: Yes, but our customers don't have to bank with us, they don't have to borrow the money from us; it's a competitive market. If they want to go to somebody else, they can. We're transparent about it, the cost is transparent; they know what it is. And as I said, it's not about - with all due respect - it's not as simple as that cost issue.

The most fundamental issue for us is that the insurance is good when we're going to make a claim, and you know, the reality is, there are a small number of providers who are massively concentrated in terms of their exposures.

MR HARRIS: Yes.

MR ELLIOTT: You might suggest that - you know, one thing that I - self-insuring, ANZ is a large, massively diversified organisation with a significant amount of capital base, and we capitalise our LMI appropriately. We're still regulated, it's a regulated entity; we capitalise it, but we have diversification which a lot of the independent providers don't have.

MR HARRIS: Right. But we're a competition inquiry, so - - -

MR ELLIOTT: Sure.

MR HARRIS: - - - we're looking at this as a sub-market, which is the way we approach the whole of how do you boil down competition in the finance system to areas where competition

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might need some kind of policy response? This one appears to be quite an unusual market in the sense that the actual purchaser is not in charge of the price but has to accept it as a consequence of buying a larger commodity; that is, a home loan.

Has to accept that, or as you say, could go elsewhere, but it's late in the transaction; they've invested quite a lot of time. And the degree of competition in this market isn't the kind of competition you would say might be traditional: that is, someone would be out there testing my in-house product versus my external supplier.

Now, I can understand your point about risk, don't get me wrong.

MR ELLIOTT: Yes.

MR HARRIS: I mean, it's an entirely rational commercial judgement, but from our perspective the question is, this means that the market looks like it isn't functioning.

MR ELLIOTT: And again, maybe this is a completely inappropriate analogy, but it's a little bit like buying a car: I don't go through and say, "I understand who all the possible providers of the airbags are, and I'll pick from you. And I'd like to know who are the possible providers of the steering wheel and the seats, and all those bits and pieces?" It's a package.

And our package of our product, if you want a highly-geared mortgage, there's a package. You get it, it's ANZ, and we tell you what's in it, and the LMI is part of that package and if you don't want the LMI, you can't have the loan; it goes together.

MR HARRIS: Gives you access to - - -

MR ELLIOTT: So the idea that we should slice and dice all the features and functions and we compete on an individual - I don't think it's reasonable for us to provide that.

Your point about should we tender it out and make sure we're getting the best price; we do, but what I'm saying is, we go through the analysis quite regularly. And you know, I was the CFO, I've been through it, we do go through that analysis to decide should we keep this in-house, or should we go outside? And it's not just a thing we go through as a routine and tick a box; we do give it serious thought; we are engaged with those other providers, we talk to them, we engage quite heavily.

It's not quite as simple as just tendering out, but we do engage with it, formally.

MR HARRIS: I'm trying to use the form of language which - - -

MR ELLIOTT: Yes, no, no, I understand - - -

MR HARRIS: - - - means we can have a discussion, rather than - - -

MR ELLIOTT: But we do consider it.

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MR HARRIS: Yes, all right.

DR KING: Just one small matter. So under the IRB weights at the moment - - -

MR ELLIOTT: Yes.

DR KING: - - - there seems to be very little benefit for the IRB banks to actually have LMI insurance in terms of capital savings, and it's paid for by the customer. In your case, it's kept internal because you have your own LMI provider. To an outsider like me, this seems like something where it's a nice way to put a little bit of an extra impost on the customer, you know, perhaps an extra $10,000 if they're a 90 per cent LVR, with no cost saving from your perspective. I mean, you know - - -

MR ELLIOTT: Well, so the difference is, I think you would agree that if you walk in - and looking at an assumption - if you have a half a million-dollar house and you borrowed $450,000, that is more risky than if you come in and borrow $100,000. And therefore, if it's more risky, you would expect to pay more, and the way that people are paying more in this case, is by taking up the insurance. And so, it's a way of price differentiating for risk.

Because the sole driver of LMI is a risk one: high loan-to-value, or not? And as I said, it's not secret, it's completely transparent, and that is a way of reflecting the risk. It's got nothing to do with the risk weightings; forget whatever the risk weightings are. I mean, we don't run the bank just based on what regulators ask us to do; we run it prudently, based on our understanding and our imagining of that risk, and so we have to price for the risk that we take.

So in New Zealand, slightly different, we do it differently. It isn't through an LMI, it's through what we call a low equity premium, so kind of the same outcome: people with low equity or people with high loan to value pay a little bit more because it is riskier. But they pay it in a different way than through a formal insurance arrangement.

MR HARRIS: Does that mean here that they don't pay a premium as well as LMI? Can you guarantee that that is the case?

MR ELLIOTT: Well, when you say guarantee, you know - - -

MR HARRIS: You've got banking policy, so - - -

MR ELLIOTT: Yes.

MR HARRIS: - - - you know, whatever the policy is, is it your policy that if a customer is required to take out LMI, their interest rate does not then need to reflect their loan to valuation ratio circumstances?

MR ELLIOTT: Well, yes, in theory. The problem with that argument is that it assumes that it's a binary decision that is a two-factor problem, you know, that the price is only LMI or not LMI; the price is all the same. And as we know, it's not. The pricing is a many, many factored issue to do with that person's income, their credit history, their household expenses, the loan

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to value, where the house is, what it's made of; all those other things go into that pricing decision, so it's not quite as simple as that.

I'm sure we could find people, absolutely, that are paying LMI who, on the face of it, are not getting the discount rate that somebody else might be getting, who is almost similar, because as I said, you know, we have a million mortgages on our books; there are so many factors that go into pricing.

MR HARRIS: Yes. No, we did have a sort of conclusion that rested on the word "probably" but did say, "It's probably a case that you're paying twice if you're paying LMI." Your suggestion is probably the case that you're not, but - - -

MR ELLIOTT: Well, there might be cases where people are - when you say paying twice, again, it's a package, right?

MR HARRIS: Sure.

MR ELLIOTT: And how they're paying for their loan might be in the rate, it might be through LMI, but it is transparent what the customer is buying; they know what they are paying; it's easy to compare with anybody else at any time, and make a decision whether they want to, you know, choose our package or go somewhere else.

MR OHLSSON: I think APRA came out quite recently, saying that they are looking at LMI and the consideration of it and the like, and LMI and the risk weights, you know. So it is something that's - - -

MR ELLIOTT: And it would be a logical - - -

MR OHLSSON: - - - being considered.

MR ELLIOTT: There would be a lot of logic in that.

MR OHLSSON: Mm.

MR HARRIS: Okay. I was thinking of wrapping up now, because we've - - -

MR ELLIOTT: Okay.

MR HARRIS: - - - taken you over time.

MR ELLIOTT: That's all right.

MR HARRIS: But thank you very much for your generosity with the time. Is there anything that we haven't asked you that you'd like to put on the record at all, or anything you'd like to correct a misapprehension that I made, or anything - - -

MR ELLIOTT: I mean, look, thanks for the opportunity to come and have a chat about it.

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We have obviously gone through your ...(indistinct)... in some level of detail. What we thought we'd do is just kind of focus on well, we had a point of view that might be a little bit different than - we've been monitoring the things that you've had a look at, but I'm just repeating stuff.

MR HARRIS: Yes, it's good this, isn't it? Yes.

MR ELLIOTT: Yes, so it's fine. And now we've obviously got the opportunity to put through our formal written submission which we'll do, and we'll take some of the leads you gave us today on areas that are of interest, where we can provide a bit of data on it, and a bit more of our insights, perhaps.

MR HARRIS: Thank you very much for your time.

MR ELLIOTT: Thank you.

MR HARRIS: For everybody's benefit, there is the possibility - it's probably now cold - of a cup of coffee outside. And we're back in 10 minutes' time. Thanks.

MR ELLIOTT: Appreciate your time.

MS ABRAMSON: Thank you very much.

ADJOURNED **[11.42 am]**

RESUMED **[11.52 am]**

MR HARRIS: So let's restart; I think ASIC is coming up to the table. And once you guys have settled and if you want a glass of water, pour it now so that it doesn't go over the sound system and deafen everybody. But once you've done that, could you introduce yourselves please, for the record?

MR KIRK: Yes, my name is Greg Kirk. I'm the Senior Executive Leader of Strategy at ASIC.

MR SADAAT: My name is Michael Sadaat. I'm the Senior Executive Leader for Deposit Takers, Credit and Insurers at ASIC.

MR HARRIS: Okay. I'm just going to check with the sound guys if those microphones are in slightly the wrong places, we'll just wave if the sound isn't as good as we need it to be.

MR SADAAT: No worries.

MR HARRIS: But I think currently it's okay for everybody. Opening statement needed from ASIC?

MR KIRK: We do have a short, I think, statement.

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MR HARRIS: Go for it.

MR KIRK: Well, first of all, we thank you for the opportunity to appear today, and we welcome the Commission's draft report and the attention it has drawn to competition in Australia's financial system.

A key priority for ASIC is to identify where the failure of competition to operate effectively results in poor conduct and consumer harm. The draft report includes a number of findings and recommendations that are relevant to ASICs work and mandate, and we'll respond to each of those recommendations in our written submission.

I just wanted to focus some opening remarks on three issues: improving consumer outcomes, data and transparency, and regulatory settings.

Firstly, on improving consumer outcomes: as noted in our first submission, poor consumer outcomes can be a sign of competition not working as effectively as it could be. In our experience, in many cases the practices involved do not breach competition laws and may not breach conduct laws. These types of failures often require a tailored regulatory response.

ASIC has worked to address some of these competition problems in financial markets, with effective results. A good example is our work on add-on insurance and flex-commissions in car yards. There, we've obtained refunds of over $120 million for consumers in a market which is characterised by excessive supply side or "reverse" competition. That is, vigorous competition by lenders and insurance for access to the car dealership intermediaries, rather than to the consumers themselves.

And in that context, we welcome the Commission's support for ASIC to proceed with our proposal to mandate a deferred sales model for add-on insurance through car dealerships, and for the Government to consider extending this to other parts of add-on insurance products.

Next, I'd like to discuss data and transparency. We welcome the Commission's strong focus on data and harnessing new technologies to facilitate consumer understanding. Like the Productivity Commission, we support the proposed open banking regime. We think, with appropriate regulatory settings, increasing consumers' access to their own data has the potential to empower decision making and stimulate competition and innovation within the financial services sector.

We agree with the Commission that a significant component of consumer choice is providing consumers with the right sort of information, at the right time. While we think there has been too much focus in the past on the provision of individual contractual disclosure on "terms and conditions", there has been too little focus on providing consumers with meaningful information on performance - that is, how the product the consumer is considering and the entity providing it performs in practice, and how what the consumer is being offered compares to what is being offered in the market more generally.

In appropriate cases, we are working to make that "performance" type information available.

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For example, to improve public trust and consumer understanding in life insurance, there was a clear need for better quality, more transparent and more consistent data on claims. ASIC has been working with APRA on establishing a new public reporting regime for claims data, and for outcomes in the life insurance industry.

However, we also know that the complexity of financial products and services and consumer decision making means simply providing more information may not necessarily improve competition and consumer outcomes. It's important to ensure that any additional information and data provided to consumers is actually beneficial through, for example, consumer testing.

Finally, I'd like to discuss regulatory settings to promote competition. Competition in financial markets is dynamic and evolving. Ensuring effective competition in the Australian financial system is an ongoing process. Each regulator has a role to play. As a starting point, each regulator needs the right mandate and regulatory toolkit to promote effective competition.

We support the Productivity Commission's recognition of the importance of ASIC having a broad, proactive competition mandate to undertake our role effectively. An appropriately broad mandate would allow us to factor and appropriately balance competition into our regulatory decision making, and address market failure as a driver of misconduct or poor consumer outcomes.

We also support regulators working together to consider competition issues in the financial system, and to learn from each other's expertise and perspectives, whatever mechanism is ultimately chosen to achieve this.

We look forward to continuing our work with the Productivity Commission in this inquiry, and we're happy to take any questions.

MR HARRIS: Thanks very much, Greg. I could start off, I think. In the case of deferred sales models, ASIC has been pretty clear about the car dealership insurance product being separated and having a clear, separated, decision making framework for choosing whether you enter into the insurance product as well as purchase the car.

We went further and suggested that most of these add-on insurance products appeared to involve the same kind of impact on a consumer, that is, the skewed encouragement to purchase a product that you didn't necessarily come there to purchase, but has been conveniently included, and it doesn't give you the opportunity to determine whether you're getting value for money, or indeed, a product that you really need at all.

Now, we'd suggested that in a manner which attempted to encourage the industry itself to review these products as much as the regulator to do so. So we haven't received much feedback to date on that. Have you received any feedback to date on that, or do you have a view on whether that should be the case?

MR SADAAT: Well, we would agree that the concerns around the sale of add-on insurance are not confined to the car dealership channel. We have seen some significant concerns in that channel, which is why that's been an area of focus for us, but we also have done work looking

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at the distribution of add-on insurance products through other channels, including through banks themselves.

And to that end, we've recently been working with the banking industry as part of the update to their code of banking practice, and the banking industry is proposing to introduce a deferred sales model for the sale of consumer credit insurance that is sold with credit cards in branches, and over the telephone, where there's a face to face or telephone interaction with the customer. And that will result in a four-day delay between the sale of the credit card and the sale of the add-on insurance, the consumer credit insurance.

We think that's a good step, and it's an example of the industry self-regulating, but that doesn't cover the field in terms of the types of add-on insurance products that banks themselves will sell. We think there is probably quite a strong case for the sale of consumer credit insurance with personal loans to also be brought within a deferred sales framework. So far, the industry hasn't proposed that. And one thing we will look to do is monitor the market to understand how that is evolving, including how the deferred sales model for credit cards works in practice.

But certainly, it is a positive step, but we think there could be more work to do there.

MS ABRAMSON: Can I just ask a follow up question, Michael? You mentioned, I think, the industry standard of four days Do you have a view at ASIC about what is a reasonable period of time, or what you'd be thinking there?

MR SADAAT: We don't think there's a magic number. Four days is the same amount of time that the UK has gone with - - -

MS ABRAMSON: Yes.

MR SADAAT: - - - as part of their implementation of the deferred sales model for gap insurance sold through car dealerships. I think the key point is that there needs to be a separation in terms of the sale of the underlying product with the sale of the insurance; enough time for the consumer to think about what product they're being offered, particularly when it's a product that they hadn't at all thought about before walking into the bank or walking into the car dealership. So enough time to review any disclosure material, think about their needs, think about whether the product could be purchased elsewhere for a better cost.

So our view is that a couple of days is probably the minimum you would think of, in terms of, you know, introducing a deferred sales model. It's something we're going to be canvassing as part of the second round of consultation for our deferred sales model for car yard add-on insurance. We haven't arrived at a view as to whether it should be four days, but we don't have any concerns with four days, as it were.

MS ABRAMSON: The Insurance Contracts Act - I mean, I can't quite remember - but it does have, like, a cooling off period for some insurance products, doesn't it? You can take it on notice, you don't have to respond now.

MR SADAAT: I think that's right, and it may be for consumer credit insurance, but it's not

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a deferred sale, it's a cooling off so that - - -

MS ABRAMSON: Yes.

MR SADAAT: - - - you make the decision on the day - - -

MS ABRAMSON: And then you can change your mind.

MR SADAAT: You can change it, I think, in the next 14 days.

MS ABRAMSON: Yes.

MR SADAAT: But the general history - and I think that's probably true in a number of jurisdictions with those sort of cooling off periods - is that people - the people who are unaware that they've even got the product are certainly unaware that they also have the right to cool off from getting it. And that the uptake of that is relatively low, and people are not very conscious of it. People are not spending their time immediately after this major transaction where they might've bought a car and finance insurance, reviewing it all and working out whether - they're out driving their car.

MR HARRIS: Can I ask it from the alternative perspective - and this is not a question of how ASIC views insurance products per se - so, this is a product that the insurance industry collectively at least has to endorse, in order for it to be offered to consumers: it's not just a question that a car dealer or a financial institution, or indeed, a whitegoods warehouse offers an insurance product along with a major purchase. The insurance industry has to be conscious and willing and supportive of the transaction.

So is it normal for ASIC, rather than to look at the individual product, the bundled insurance with the car or the bundled insurance with a credit card, is it normal or even plausible for ASIC to invert it and say, "You know, we see enough of a pattern here to instead call in the insurance industry and ask the question, 'Why are you so willing and cooperative to offer a product which clearly has such a poor rate of claims history, or certainly, is being offered in a circumstance where consumers are unable to access sufficient information to judge whether it's a good deal or not?'"

In other words, can we consider that this could be inverted to become a debate between the regulator and the insurance industry, or is that outside your either normal operating remit or indeed, outside your legislative remit, to do that?

MR SADAAT: I think in fact, that's the approach we've been taking to these issues. We've been focusing on the conduct of the insurance companies, because they're the firms and entities that we regulate directly - they're licensed by ASIC, and they've got obligations to ensure that, you know, the products that they're selling through these channels are creating good consumer outcomes.

So our engagement has primarily been with the insurance companies in understanding the impact of these products. We've done significant data collection from the insurers to

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understand how many products they're selling; the claims ratios and performance of the products; and we have, as I said, done extensive engagement with the insurers to understand how they go about overseeing these distribution channels to ensure that good consumer outcomes are occurring.

If we proceed with a deferred sales model, it will be through modifying the obligations that insurers have in distributing these products, rather than any new obligations on the distributors themselves, because in some cases - actually in many cases - the distributors themselves are authorised by the insurers to distribute these products, they're not separately licensed by ASIC. So our focus is very much on the product manufacturer, as it were, which is the insurance company.

And with the Government's proposals around issuer - - -

MS ABRAMSON: The new distribution - - -

MR SADAAT: The new distribution obligations, design and distribution obligations, that will really strengthen our toolkit when it comes to sheeting home responsibility to the product manufacturer so that the product manufacturer can't turn a blind eye to how their products are being distributed.

MR HARRIS: So it's plausible then that, although your priority currently is in motor vehicles, we could see a solution which is to turn all add-on insurance on its head and say, it must be a separated product?

MR SADAAT: Yes, that's theoretically possible, yes. Certainly, what we're doing at the moment is, you know, we're doing it with reference to the powers that we have, and you know, we don't have unlimited powers for example, to implement deferred sales across the board; we would have to consider that carefully.

And so, your recommendation that Treasury lead that work is, we think, the right one, because it is a question of policy around how these products are sold.

MR HARRIS: Yes, yes. and there's a markets group now in Treasury that could do that, but it doesn't necessarily have to be undertaken by a brand-new entity.

We've also had this proposition, we put forward what we considered to be a structural proposition about the idea of having, at the highest levels within the industry, an entity charged by the Treasurer with becoming competition champion: the advocate for competition in a circumstance where regulation, in whatever form it's in, including macroprudential intervention - the specific example we were using in that report.

But regulation is being applied in support of stability, and perhaps competition is being not as thoroughly analysed for potential adverse impacts that might occur from that intervention. So we put forward the proposition that it could be either ASIC or the ACCC. Do you have a view explicitly as to whether or not in those forums, you'd be a better advocate than the ACCC, or are you happy to leave that to the Government to decide, or…?

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MR KIRK: I think we're still working through the implications of it internally, so certainly today, we don't have a settled position. I think we would have to put one in our written submission to you.

We have been advocating for some time, including through the Financial System Inquiry, that we do have a bigger role in competition, whether we have a mandate. But that has been conceived up until now as very much focused on our own work in relation to conduct, not a broader immediate relation to other regulatory measures taken by other regulators.

So it would be an additional step, as conceived in the report, for us to take on that role. And as I said, we're still working through the implications of that.

MR HARRIS: Yes.

MR KIRK: I hope to have a settled position for you in the - - -

MR HARRIS: Yes, you definitely went beyond what Murray was proposing; indeed, I think he's commented to that effect as well, so we're happy to accept that level of responsibility.

Anyway, that's fine, if you don't have a settled view today, I'm not going to pursue it further, but we would appreciate knowing - even if you don't, in the submission, come to a final conclusion - the factors that influence your judgement: it might well be relevant. Anyway, whatever benefit you can offer us in the submission, that would be great.

MS ABRAMSON: Can I ask about mortgage brokers and the best interests duty? I think it's fair to say, at least from the people that we've had before us, that there doesn't seem to be a great degree of concern about a best interests duty, because some of the industry players have said, "Well, we're looking after the client, we'd be acting in their best interests."

But one of the things I'm interested in, firstly, your view on it, but also bearing in mind the report that ASIC released into the financial planning industry in terms of the performance of a number of the people that you looked at; if you support a best interests duty, what type of things also might need to go with it to make it actually be something that's happening in the marketplace.

MR KIRK: I think broadly, our view is that there is scope to increase the standard expected of mortgage brokers, and I think when mortgage brokers were first regulated, when credit regulations became national in 2010, it was a big step forward to bring in standards around responsible lending, and that included standards around meeting the needs and objectives of the customer.

But at that point, the standard that was set was the same for the product issuer. If you went into the bank and asked for a loan, the standard was in exactly the same terms as for a mortgage broker, and it does seem that a mortgage broker is seeking to offer customers something more in terms of work helping navigate people across the marketplace, than is offered by a particular loan issuer.

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So there does seem to us to be scope to raise the standard. Whether just adopting the best interests duty from the Corporations Act, as applicable in the financial services, is the best solution to that, we're not sure. It may be better to start with the obligation that's on them now and to work in some more specific requirements.

The two elements now of responsible lending are that the loan has to be repayable by the consumer, given their financial circumstances, without undue hardship, but it also has to meet their needs and objectives. And I think often at the moment, the needs and objectives are only explored in very broad terms. So, you know, the main need is to buy a house, "I need a home loan to buy a house," rather than more detailed needs and objectives about you know, looking for the most competitive loan I can get, the best price right across the market.

And so, something more explicit about what they should be canvassing and addressing in meeting consumers' needs and objectives may be a more direct way to get to the sort of solution that we're talking about.

MS ABRAMSON: And would your thinking - and I'm not trying to put you on the spot because I realise that this is a process and there's a policy decision upfront about what that "duty" might be - would that be something that you would do under the standards, or at least your regulatory powers, or your regulation guides about what type of skills you have to have to do certain things?

MR SADAAT: So I think raising the standard that brokers need to meet - because that standard is currently in the law - - -

MS ABRAMSON: Yes.

MR SADAAT: - - - it would require a change to the law to raise that standard. We currently have regulatory guidance around competence levels that need to be met.

MS ABRAMSON: Yes, yes.

MR SADAAT: So that's something that ASIC could look at, but I don't think we've got a view that raising competence standards would necessarily change the outcomes for consumers, if that was the only thing to get - you know, if there's a concern around whether consumers are being provided with quality advice, there could be a number of drivers of poor quality advice, including what the legal standard is, the remuneration structures, ownership structures, competency standards - it could be, you know, all of those things put together.

But, you know, I think we would need to think that through I think, before we were sort of confident that there was a clear need, for example, to raise competency standards in that sector. In reviewing the remuneration models as part of that work we did, where the report was published at the beginning of last year, we noted that a number of things could be done to improve remuneration models; we didn't go as far as to say that commissions should be abolished, but we did say that the standard commission model could be improved.

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The industry has come together and proposed a number of improvements to that standard model, and we think they're positive suggestions. I suppose one thing to consider is whether you wait for the impact of those to flow through to the market and then assess whether further change is required, or whether there's enough evidence now to say that, you know, more fundamental change is required to those commission arrangements.

And you know, for our own purpose, I don't think we've landed on that position.

MS ABRAMSON: Just a follow up question, I guess: we're looking through the competition lens, so one of the things we've been thinking about is whether wealth management advisers should be able to also advise on loans. And one of the things a number of people have said to us is, "Ah, but they're fundamentally different. Credit is entirely different from financial services, or wealth management products," and we've got two regulatory regimes. So I'm just interested in your views on that as well.

MR KIRK: Again, maybe going back to the history for a moment; again, when the credit regime was being established federally for the 2010 regime, the representatives of financial planners had quite a strong voice in the consultations on that, because they wanted to make sure that nothing in the regime was a barrier to financial planners providing mortgage advice.

And it was expected at the time that there would be - certainly they were suggesting - that there would be, maybe, financial planners who would want to do both. I think we agree with your observation that hasn't turned out to be true.

At the moment we're going through some of our databases to try and get you some data that would cross over, but - - -

MS ABRAMSON: That would be really helpful.

MR KIRK: - - - as a broad indicator, it looked to be about 4 per cent of licensees have a dual licence, and maybe a little bit higher when you get into the number of representatives they have - - -

MS ABRAMSON: Yes, yes.

MR KIRK: - - - as a percentage of the market. But still, not significantly higher. We'll try and get you some data on that.

In terms of what the causes of that are, we will also try and address what are the regulatory barriers to it, and some of them, you know, you do have to get separate licences, but if you've already got the one licence and you've been operating well, that would get you a fair way along the path on the assessment. Slightly different training requirements: both have to be in ADR, both have to have PI insurance cover.

So they're relatively similar, so some additional costs, but we'll work that through.

MR HARRIS: We had a concept, you know, 20-odd years ago, pioneered at COAG when

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once COAG was taking a great deal of interest in structural reform and red tape, and that was called "mutual recognition" and it seems a bit odd here that we couldn't have a mutual recognition arrangement within the one regulatory entity, for dealing with this.

What's the impediment to saying one party currently licensed can offer the products that the other licensed party can, as long as they meet these regulated standards? In other words, why can't you create - - -

MS ABRAMSON: It's a hybrid licence.

MR HARRIS: - - - a common regime?

MR KIRK: I think that would definitely - - -

MR HARRIS: And then offer it to people.

MR KIRK: Yes. That would definitely require legislative change.

MR HARRIS: Quite. But leaving aside the mechanics, the concept, you know? We can manage mutual recognition between, you know, entities that were trained in different - I think even New Zealand qualifies for this - so training in different countries for slightly different regulatory standards for, I don't know, being surveyors and being whatever. It seems weird we can't do it inside the one organisation.

MR KIRK: Conceptually, you could do that. That said, it may not be the case that the regulatory system is the only barrier there, in the sense that - - -

MR HARRIS: No, it - - -

MR KIRK: - - - even from some of the people who've come and answered questions before you, there seems to be a strong sense of almost a cultural divide, you know - - -

MR HARRIS: Quite.

MR KIRK: - - - "We're this," or, "We're that, but we're not both." And to some extent, you also - because financial advisers can and do provide advice on credit now, and they're permitted to, and in fact, our regulatory guidance encourages them to in some circumstances; the difficulty they have is providing advice on particular credit contracts. So ...(indistinct)... - - -

MR HARRIS: Well, if they're being paid for them - - -

MR KIRK: - - - loan and being - well, I'll get to the being paid for it. So they're able to do that now, up to a certain point, but unless they have the credit licence they can't set up the loan. But other barriers for them being able to do that may include the sorts of industry structures, having to be accredited with an aggregator, having to be part of a particular industry body; that type of thing. And they, in fact, may be more significant than the regulatory hurdles.

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Certainly, historically, if you're only doing that sort of work, setting up mortgages on a relatively sporadic basis as part of a practice which is more focused on investment advice, some of the costs of participating through an aggregator and having arrangements with all these lenders may either not be available to you, or may be less economic - - -

MR HARRIS: This is a competition inquiry; we're talking about competition in the advisory space here, so these are potential competitors. If there are barriers that are created by industry practice, that too can be dealt with by the competition regulator itself, if it had to. I mean, I'm not sure this is literally a matter that the ACCC would care to look at, but clearly, if regulation amends and allows a party to offer both the products in an advisory sense and then we find some industry association prevents them from so doing, by some particular standard, well, that's a substantial lessening of competition, in principle.

So, you know, people would have to be a little careful here about how far we took industry practice to prevent competition in the advisory space, wouldn't they?

MR KIRK: Yes. That said, there may be legitimate reasons for some of them.

MR HARRIS: There may well, in which case the investigation would presumably demonstrate that.

MR KIRK: I would accept that. And just on your point about they can't be paid for it, certainly our work on commissions discovered a separate category of people who were paid commissions, who don't arrange the loan but just refer the borrower to the lender. And it seems to be that professionals, lawyers, accountants and financial advisers, are reasonably prominent amongst people who are acting as referrers.

And the strange one in there was that the commission they were paid for just doing the referral was almost as large as the commission the mortgage broker was paid for doing all the extra work in responsible lending, meeting the laws and setting up the loan.

So, yes, again, some industry structures that possibly are worthy of examination.

DR KING: Sorry. I did notice in some of the discussions we've had with mortgage brokers that yes, their contracts include that there may be a payment to another party possible, but the payment you're talking about here is direct referral: a lawyer referring a particular client to a bank directly to write a mortgage?

MR SADAAT: Yes, there's an exemption within the law for referrers.

DR KING: Yes.

MR SADAAT: And if they operate within the exemption, they're not required to be licensed by ASIC, or authorised by another licensee. And there is now a fairly large industry of referrers, comprising professionals, lawyers, accountants, advisers, who do directly refer consumers to a particular lender. And as long as they disclose to the consumer that they're receiving a commission and they don't do anything to help the consumer arrange the loan, then

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they can fall within that exemption and they'll be paid by the lender, a commission.

You know, as we reported on in our report, those commissions can be quite significant. In some cases, you know, as close to the commissions that are paid to mortgage brokers, who are doing more work than a referrer is supposed to be doing.

DR KING: So when you say "assist" the consumer in actually getting the loan, does that mean filling out paperwork, providing information about that consumer to the bank so that - - -

MR KIRK: Getting together the documents around their financial position?

DR KING: Yes. But they could be aware or discuss the consumer's financial position and then say, "Well, you should be eligible for a loan." I mean, I'm just wondering where the boundary there is.

MR SADAAT: Well, what they can do under the law is quite limited. I guess, there's a risk that some might be going beyond what they're allowed to do under the exemption, and that risk is potentially exacerbated by the incentives that are provided by banks. And we have seen cases where misconduct has occurred by so-called referrers, and ASIC has taken action against those.

But yes, it is a feature of the law, and as a result, there is now an industry of referrers that includes financial advisers, and therefore they're paid for that referral activity.

DR KING: Just a final one on this: you said referrers to a particular bank. Do you know referrers who will have, you know, say multiple banks, and they will decide, "Well, actually, you'd be best off with the ANZ." Or, "No, you'd be best off with St George," and so they - rather than just having an arrangement with one bank for referrals?

MR SADAAT: I think I'll have to take that on notice. It's possible, but certainly, to the consumer they can't give the impression that they've considered the consumer's circumstances and you know, picked a particular - - -

DR KING: ...(indistinct)... it starts getting very grey.

MR SADAAT: Yes, yes.

MS ABRAMSON: They would be giving advice.

DR KING: Yes, okay.

MR HARRIS: I'd like to ask about your regulatory sandbox, and innovation. You mentioned data and your support for open banking, and obviously ours too, and that seems to be progressing. ASIC operates a regulatory sandbox arrangement where you can allow a new entrant to a market that you regulate to experiment, as it were, with a product and potentially test that in the market without breaching some regulatory standards.

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How does this go with participants in the financial markets who have products that are regulated, not just by you, but potentially by, you know, one of your fellow regulators, without being terribly specific. Although I could be, I have a particular case in mind, but it appears that there are - and logically, this would be the case - that boundaries in financial products overlap a little. How do you go about offering the benefits of the regulatory sandbox to a party who is in that position?

I mean, for example, in all the payments arrangements, you know, so the RBA is interested in payment arrangements, at the margin APRA, always interested in payment arrangements. You also are interested in payment arrangements. So, just in that area, how do you go about running a regulatory sandbox?

MR KIRK: Certainly, our regulatory sandbox is limited to what's within our mandate. And we don't authorise products, so the thing that we're exempting people from is from the entity getting a licence, but we're doing that because they've got a new product idea, they want to test it, but all the costs of getting that licence and setting up just to test whether there's a market for this product, are a discouragement to them going ahead.

But we can only give relief through the sandbox from the obligations that they owe under the laws that we administer, so it doesn't help them with other entities. Though we obviously try and cooperate and coordinate and make sure people are aware of other obligations and we can refer them on, but we can't address through that sandbox, obligations that they owe elsewhere.

MR HARRIS: Right. Well, you can't in some legal sense, because you don't own the regulatory barrier. But had you considered entering into agreements with fellow regulators who have said, "We're interested in this party getting to market, but there are regulatory barriers to them experimenting with their product."

Although I hate the term, because it's so regularly misused in the public sector, but "memoranda of understanding" kind of arrangements that effectively provide a pathway to market for possibly new competitive products, which is why we're interested in this area. I mean, the sandbox idea appears to have been, you know, almost ASIC-owned kind of territory, but the industry itself is regulated in multiple fashions, so for a sandbox to properly work you would assume that is one of your interests, or perhaps is it the Treasury's interest, or, shouldn't somebody be looking at this question of products that do enter into other market territory as well as yours, in the finance industry?

MR KIRK: Yes, I might have to take it on notice, partly because of the things that we're authorising in our regulatory sandbox are small in scale, generally. I mean, both the size of the activity and how many transactions they're going enter into as a result, and also the amount of money at stake for any particular consumer, I think in general they won't trigger requirements of regulators that are more focused on either systemic stability or the stability of a particular entity. And they're not deposit taking entities, they're not insurers, so that doesn't come up.

MR HARRIS: Let's take the payments area. So we've got this Payments Board - it's not necessarily a regulator but it certainly controls access to the payment system. Would you consider that to be an area that you'd have any - if there's a product in that area, would you

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have any role in allowing, I don't know, this sandbox concept, the possibility of experimenting with utilisation, would it go that far?

MR KIRK: I think it may be better for us to explore this in our written submission, in the sense that - - -

MR HARRIS: Yes, I'd be interested - - -

MR KIRK: - - - I would like to check whether there are entities that are small enough to satisfy the requirements of our sandbox and their activities small enough, who would, nevertheless, be subject to regulations administered by the - - -

MR HARRIS: Yes. Because - - -

MR KIRK: - - - parameters of the Board. And I think I would need to check that before I - - -

MR HARRIS: But you can see, going on out there in the marketplace, there are lots of overlay entities wo are floating and might be relevant to this, and might not.

MR SADAAT: So on payments specifically - - -

MR HARRIS: No-one seems to own them, and yet the government is clearly interested in this; after all, it asked you to set up the regulatory sandbox, and yet the finance system is a system, it's not just an ASIC-regulated set of products, is it? So the question is, is the sandbox designed to allow entry? And we're a competition inquiry, we're interested in entry.

MR SADAAT: And on payments specifically, the framework for the regulation of payments for both conduct-related and prudential issues is a fairly graduated framework right now. So there are exemptions that ASIC has put in place that mean you can do quite a lot with payments without necessarily needing a licence.

So, for example, if you operate low value payments, you may not need a licence from ASIC, and you can scale up your business to a point before any prudential regulation kicks in as well. So, on payments specifically, I think we would say that the framework is fairly graduated, and the Murray inquiry has recommended that it be made more graduated, and that's something that we've been talking to Treasury and APRA about, so there could be more scope for accommodating innovative business models there.

But the framework is quite flexible at the moment, and we do, when it comes to the bits that we're responsible for, consider whether further relief or exemptions are required on a case by case basis, for the innovative providers.

MR HARRIS: Yes. I guess what I'm feeling for - and this is relating in a sense to a competition champion, in other words, who would you go to if you were looking for someone to, as it were, champion your competitive entry here? And the answer in the system appears to be, well, it all depends on, you know, who owns the black letter law.

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And yet, the black letter law doesn't necessarily envisage all of these kind of overlay activities that can be triggered. The ...(indistinct)... payment system is an example of this; there appear to be a lot of opportunities there. Anyway, we're interested in that; if you've got any comments in your submission, I wouldn't mind seeing that, if you can address it.

DR KING: Just one other: we haven't mentioned the mortgage data proposal that we've got, where ASIC would have a role in publishing the relevant data, although it's expected it would be collected by APRA. Do you have any views on that? Is that a useful way forward, or do you see problems with that? Just interested in your views.

MR KIRK: I think broadly, we would agree with you that that pricing and comparative pricing of mortgages is somewhat opaque at the moment, partly because the standard variable rate is not what a lot of people get, and it's hard to know whether the discount you're getting is the same as the discount other people are getting.

So the more data, and the more public data, that enable people to have a real idea of what the price of the loan they're getting is, relative to what's being offered in the marketplace generally at the moment, would be very good. I think we also think if we were going to embark on that, we'd want to sort of consumer test what is our most useful information, and what's the best way to present it.

I've certainly had it suggested to me that if you just gave the median, maybe the median then becomes the anchor and maybe that's not a good thing, so I think some of that would need to be unpacked and explored, and consumer testing would be important. But broadly, we would be in favour of it.

MR HARRIS: Yes. Well, we haven't a clear interest in that; we don't want to go to the point of being totally prescriptive in the design, but we could easily see how the design could ensure that consumers weren't better informed, which is why I think the median was chosen in the first place: it's harder to play games with a median.

But anyway, we're quite interested in the design proposition, so if you have any views on that? I mean, we take your point and I don't think we were going to rule out consumer testing at all; obviously, the implementation of it is deeply desirable, but the question is, I think we need a proposition that doesn't go in the first place, to be easily gamed.

MR SADAAT: And the trouble with the current comparison rate that's required to be disclosed in advertising is that it's built on assumptions around the size of the loan and the term of the loan, and those assumptions are not necessarily reflective of what people are actually borrowing these days.

But moreover, the comparison rate is based on the advertised rate, not on the rate that people get when they either talk to a broker or a lender. So again, it's not a very good guide as to whether the rate you are being offered is a good rate. It also doesn't include other things that, you know, affect the cost of the loan like LMI, because the requirement is that a comparison rate include mandatory fees, but not contingent fees, and LMI, being a contingent fee is not

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included within the comparison rate.

So there is certainly scope for better public disclosure of home loan rates because at the moment, consumers only really have anecdotal information about that.

MR HARRIS: Well, you particularly would consider something called a comparison rate. Yes, standard variable rate; it's an interesting nomenclature, but you know, expectations are not raised by that, but something called a comparison rate, you would expect that one of the key inputs to it is something like the median for the last month, so that it is continuously being updated.

Now, last month where, a good question, and that's why we've addressed that in our recommendation. But nevertheless, the comparison rate, the use of that term, does condition the expectation of a potential borrower - whether it was deliberately designed to do that or not, it must, because it says, "Here's the comparator."

And so, having some, as it were, truth in advertising here would seem to be deeply desirable so that consumers aren't conditioned to imagine they aren't entitled to a better rate if they pushed a little harder. Now, that's a debate that can be had in a competitive market: what does push a little bit harder mean, but the bottom line is, I don't think you should start out with a rate that says it's a comparator if it isn't a comparator, based around real time data; it just seems to be very unusual.

And us trying to get to the bottom of this has been quite frustrating, so that contributor to how a comparison number is built up is quite important, almost in any market where you might expect the consumer to be able to look after themselves to some degree. Even if they have a broker, they should still be able to look after themselves to some degree, because separately, it was demonstrated brokers' allegiances are - notwithstanding their intent to be as loyal as they can to their customers, the payment arrangements are a little skewed, to say the least.

Okay, that's prices. Anything else? Nothing else? I haven't got anything else here. Other issues that we've failed to draw out from you that you would like to go on record?

MR KIRK: No, I don't think so. Anything else, we'll make sure it's in our submission.

MR HARRIS: Okay.

MS ABRAMSON: Sorry, Peter, one thing. The insurance; we've made some proposals about the type of disclosure that would go with the insurance - - -

MR KIRK: Yes.

MS ABRAMSON: So that's about disclosing what the increase is in the policy; obtaining any views you have on that would be quite useful. Happy to have it in your written submission.

MR KIRK: Right ...(indistinct)... sorry.

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MR HARRIS: No problem. Okay, thanks very much for your time today.

MR KIRK: Thank you.

MR HARRIS: I think we have ME Bank next. Once you guys have settled yourselves, could you please identify yourselves, for the record?

MR MCPHEE: Jamie McPhee; ME Bank.

MR BECK: Tony Beck, a consultant for ME Bank.

MR HARRIS: Jamie, do you have a little opening statement that you'd like to make?

MR MCPHEE: Yes, I do, thank you. And so, what I thought I might do is make a few short comments at the opening, but I think probably the real value is in the discussion, so I'll keep them relatively brief. But before I do, I'd just like to acknowledge the quality of the draft report, and all of the work for the commissioners; it's something that we've obviously read in detail. I think it's a very good piece of work.

So we do appreciate the opportunity to appear before the Productivity Commission to reflect on and contribute to the public discussion regarding the draft report. As I've said, I believe the draft report is an excellent public policy contribution document in relation to improving the competition in financial services, and particularly in retail banking. The regional banks do intend to make a further submission to the Productivity Commission, responding to the report in more detail.

I'd just like to start with a little context, if I may? It's just that ME is a small bank with a unique business model, due to our ownership structure of the industry super funds. ME was set up to help all Australians get ahead and achieve dignity in retirement, and that still remains, absolutely, our core purpose today.

As a small bank, ME is heavily dependent on the policy settings that promote competitive neutrality. We've made regular submissions over recent years to the various inquiries, including the Financial systems Inquiry, the Productivity Commission, and the Senate Economics Committee, and we continue actively engaged in the public debate concerning competition and pressing the need to level the playing field.

It is our view, until the GFC, a relatively level playing field existed for banks, credit unions, building societies and non-ADIs, however, post-GFC, regulation has tilted the playing field materially in the favour of the larger banks by reducing the capital requirements and lowering their relative funding costs due to their "too big to fail" status.

As identified in the Productivity Commission's draft report, 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 GFC, promoting the concept of an unquestionably strong financial system.

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We view this as a critical finding, as an attempt to rebalance the regulatory setting somewhat towards competition. ME believes it is now the time to identify, acknowledge and discuss the issues of competitive neutrality in a constructive way, with a view to improving the system for the future.

Consequently, ME supports the concept that competition become part of the responsibility of the regulators when setting policy. Competitive neutrality is about ensuring all service providers compete on an equal footing and that the regulatory arrangements do not favour some service providers over others.

On this point, all we're really asking for is a fair go, not a subsidy or a handout, just an opportunity to compete fairly, and we don't believe that to be an unreasonable request.

As the commissioners are aware, ME has been advocating for some time for the following issues to be addressed: one, reducing the gap in mortgage risk weights between advanced model banks and standard model banks. Two, addressing the too big to fail funding advantage of the major banks. Three, reducing overall compliance burden of the smaller ADIs. Four, implementing requirements for mortgage brokers to disclose ownership interests. Five, the removal or redesign of macroprudential restrictions that have the effect of locking in the market share status quo.

On this last issue, it's been pleasing to read Wayne Byres' comments recently that the 10 per cent limit on investor loans may have served its purpose and be ready to be removed because it was never really intended to be permanent policy. These initiatives ensure a more level playing field and put the industry in a stronger position to implement other reforms such as open data, which will ultimately be in the consumers' best interest.

In relation to risk weights, ME notes the Productivity Commission's draft report findings that larger institutions have a cost advantage through lower risk weights, compared to smaller banks. It's pleasing to see that the Productivity Commission's draft report - or since the Productivity Commission's draft report was released - APRA has published a discussion paper which is mostly consistent with the Productivity Commission's findings.

A major focus of the proposals is adjusting the risk weight outcomes in the residential mortgage asset class. ME will engage closely with APRA on this consultation with a clear focus on how the newly proposed risk weights will impact on the competitive position of standardised banks versus IRB banks. It's too early to fully assess the impact of APRA's proposed changes but we note that APRA has made the standardised risk weight system more reflective of the underlying risks including the proposal to set 20 per cent as the minimum risk weight compared to 35 per cent today.

In relation to too big to fail, ME also welcomes the draft finding that larger ADIs benefit from lower costs of funding compared to smaller institutions, in part reflecting the expectation of government support. This is a key issue for the regional banks because the cost of funding is the major competitive distortion between small and large banks.

Having said that, we acknowledge the difficulty in finding a solution, and note the Productivity

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Commission has not made any explicit draft recommendations which would directly address this issue. We recognise that the Productivity Commission has formed a view that the major bank levy does not improve competitive outcomes as it does not reduce the cost to smaller banks, however we do believe it is pro-competition because it partly offsets a funding cost subsidy to the major banks.

In relation to disclosure of mortgage broker ownership, which is also key to creating a level playing field, it's noted in the draft report that smaller banks are dependent on the broker industry to overcome scale and geographical disadvantages. We see the growth in the mortgage broker industry as a testament to improving customer service, as broker loans now account for 56 per cent of all new loans originated. The main issue for the regional banks is ensuring that the customers of mortgage brokers know the identity of the broker's owner so the consumer can factor in this information into their decision making.

So, look, I'm going to leave my opening comments there. Just before I do, I'd like to again commend the draft report and acknowledge the consultative approach and we greatly appreciate the opportunity to contribute and we also look forward to making a further submission in which we will continue to prosecute the case for a level playing field in the five key areas that I previously mentioned.

So with that, happy to open up to take any questions.

MR HARRIS: Thanks Jamie. Can I deal with the one where you said we have obviously identified an issue in relation to too big to fail, and the market benefit that that conveys to the larger financial institutions when they go into wholesale markets to raise money.

MR MCPHEE: Yes.

MR HARRIS: Yesterday, I think Suncorp said to us, "Look, there's a three notch rating difference that remains there" and you know - actually very few people didn't notice our comment on the levy and I'm not sure whether I'm happy or unhappy about that because I don't think we did it in order to garner controversy but we certainly thought it was a relevant consideration.

But a crucial point there surely is if these shifts in risk weighting or in application and levies do nothing to shift ratings agencies' perceptions, then that three notches is going to remain.

MR MCPHEE: Yes.

MR HARRIS: And all we end up doing is - unless the risk weighting is needed to be made tighter because they were misjudged, and then I leave that aside, it's entirely a matter for you guys and the regulators between you to work out. But if it is driven by this perception of the big banks have an advantage, yet the ratings agencies just shrug their shoulders, it says we're adding cost to the industry without actually addressing this core problem.

I can't remember in the end - I look at the team here and they're going to shake their heads and think, "How can the Chairman not remember this?" but I can't remember if we actually

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concluded anything in relation to the ratings agencies, but the logical position is, they determine this, and - - -

MR MCPHEE: Yes.

MR HARRIS: - - - for a regulator or a government to pursue that differential, possibly is going on a fool's errand, isn't it, if in fact the ratings agencies are going to not vary that three notch differential.

MR MCPHEE: So, I think you talked about two quite separate issues, right? So, one is the risk weights which is the difference, obviously, between standard banks and an IRB - - -

MR HARRIS: Yes.

MR MCPHEE: - - - or an advanced model bank. But bring it back to the cost of funding, to your point, absolutely, it's the rating agencies which provide the rating notch upgrade, because of their belief that the government will bail them out. So, that's then what has to be addressed; it has to address that belief, because if that's not changed - and how we do that I think is quite complex because we want to absolutely ensure the stability of the system, but offshore there's all these bail instruments and the like.

But exactly to your point, as long as there's a subset of the banking sector where the rating agencies believe that too big to fail or government support will be provided, but not to the others, then that differential exists, which will always accrue the advantage to the major banks.

MR HARRIS: The logic of that position suggests that it could only be addressed - and that's a 'could' - only be addressed if it were addressed directly; that is, too big to fail just doesn't apply to the four, it applies to a much larger group. But that, in itself, brings on a substantial, well, if nothing else, a moral hazard for government - - -

MR MCPHEE: Right.

MR HARRIS: - - - but also other implications. But aside from addressing it directly, you know, this is the question; to the extent governments or regulators are interested in addressing this differential, aren't they on a fool's errand?

MR MCPHEE: Well, there's one other way you could address it. So, absolutely that one is that everyone's all in, or all out. So, that does deal with it from exactly the way that you described.

Another one could be that if it's acknowledged that there is a benefit accruing to the major banks - I think it's factual - I think it would be hard to acknowledge anything other than that, is it possible to conduct a calculation by an independent body that determines what that value is that's accruing? Is that value accruing really being accrued by the taxpayer? Because in effect, that's the person that's providing this implicit guarantee via the government.

And then on an annual basis, that then becomes, where should that benefit accrue to? Should

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that accrue to the people that, in effect, provide the benefit, which is the general public, and therefore it'll either be applied and adjusted on an annual basis, to simply level the playing field; that's the other way it could be done.

MR HARRIS: Yes, I see. In our report, we did notice the RBA had done calculations of premium that might be applied here, and if I recall rightly - this bit I can remember - the suggestion was that at some point it could actually reduce to zero, this differential.

MR MCPHEE: Right.

MR HARRIS: Which I found a little surprising, because I look at this more commercially and say, well, ratings agencies are paid to find differences between banks because otherwise - - -

MR MCPHEE: Yes.

MR HARRIS: - - - why is every capital raising treated exactly the same? So, it may be, in principle, possible to suggest it should be driven down to a relatively low amount at the time of stability in a financial system, but it seems unlikely there will ever be no differentiation. So, even if you were to calculate some model that does that, is it likely - I guess I'm really saying, aren't the ratings agencies in exactly the same position really, as quasi-regulators? They're crystallising a judgement about risk in the market, and they're going to do it, regardless of what anybody does.

MR MCPHEE: Yes. So, then there's the two mechanisms that we just talked about. The one is all in or all out, so - - -

MR HARRIS: All in, all out, I appreciate.

MR MCPHEE: And the second one, as I said, so it can change over time, because the RBA also had a report that shows the benefit accruing was between 20 to 40 basis points, so the point that you're making is, it actually, obviously, varies with time.

So that's all my point is that if you actually set the levy on an annual basis, whatever you're doing actually then should reflect the current market conditions, and again, create a level playing field. Because it's not actually hard to determine if you issue this amount of wholesale funding at this rating, this is the price that you pay. If you issue the same amount of wholesale funding at a three notch lower rating, this is the price you pay.

And then it just becomes a mathematical equation, and so therefore I think that's quite discoverable, and so therefore, should that benefit - and our belief is that that benefit because it's about government support - therefore that benefit has been ultimately provided by the taxpayer, the community, then shouldn't that benefit accrue back to the people who are providing it?

All I can tell you is that I don't have any insurance policies where I haven't had to pay a premium. No-one is giving me free insurance, so isn't that analogous to what's happening here? That's a proposition that we have put forward previously.

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MR HARRIS: Sorry, one last thing, just to - - -

MR MCPHEE: Does that make sense?

MR HARRIS: No, I understand what you're saying; just with this supplementation. The party doing the analysis would have to be a pretty credible party, wouldn't they - - -

MR MCPHEE: Yes.

MR HARRIS: - - - for this to be accepted, as you say, an insurance premium versus some of the other claims that are occasionally made against - without being terribly specific, are you tap dancing around the edges of various things?

MR MCPHEE: That would be absolutely critical, wouldn't it? If you think about - and it's not really sort of for me to suggest who that may be, but the RBA, you know, ultimately sets the cash rate, so again, that's a pretty important decision which a lot of information is taken to make that decision. So, there are many very credible bodies that could do that.

And to be honest with you, the amount of calculations that the financial sector is making all the time, and some of them are relatively complex, I actually don't think this one, in comparison, is actually all that complex, and is quite discoverable, would be our proposition.

DR KING: Just the rating agencies, and pretty much, upgrade, obviously affects the wholesale funding. Should we be asking, do you see the same issues on deposit side? So, do you see the major banks being able to offer lower returns to depositors because they are viewed as safer than say, an ME Bank?

MR MCPHEE: Well, the way that that's been dealt with - I think to some degree banks, and our costs and our cost structure should reflect the businesses that we've built up; I mean, that's our obligation: to make sure that we're running safe, secure and efficient businesses.

Where that issue has been solved up to $250,000, of course the financial - - -

DR KING: Having ...(indistinct)... the guarantee.

MR MCPHEE: Yes, that's right. And to be honest with you, I'm actually not sure exactly what percentage of the population that covers, but that covers obviously the lion's share, so I think that issue in the retail space has already been dealt with. Does that make sense?

DR KING: No, no, I thought that would be the range, I just wanted to make sure - - -

MR MCPHEE: Yes.

DR KING: - - - it was on the record.

MR MCPHEE: Our cost of retail deposits is higher than the major banks, but I think in that

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context, we're just looking for a level playing field; I mean, we can't sit here asking for a subsidy or anything else, so it's our responsibility to make sure that depositors feel comfortable depositing their funds with ME Bank, and I think that sits with us.

MR HARRIS: You commented in your opening remarks too, about the strong predisposition of regulators towards an unquestionably strong system, and you suggested that an increase in regulatory arrangements in favour of competition would be desirable. We put forward this, we think quite subtle proposition, about the appointment of a competition champion - - -

MR MCPHEE: Yes.

MR HARRIS: - - - and a revised statement of expectations, to the parties that are involved in regulating activity here in favour of them recognising the competition champion and in particular ...(indistinct)... of financial regulators taking some account of an analysis put forward by this entity.

And you noted, I'm sure, in our report we had two choices, in ASIC or the ACCC; do you have a preference, or would you be prepared - or a group of banks that you often appeared here with, would they be prepared to have a view on what should be a desirable party here?

MR MCPHEE: So, my view is that I actually think it was a suggestion we completely agree with, and to have stability in the system, you know, and no focus on competition will ultimately drives to the ...(indistinct)... type behaviour too, down the track.

In relation to exactly who that should be, we actually haven't had that discussion yet as a group of banks, but that is absolutely something that we will address in our follow up report.

MR HARRIS: Thank you for that, we'll look forward to seeing it. The point from our perspective, in putting this up is, they're both well-recognised entities in the market place, they're not really entities that would fail to understand the sensitivity of what we're discussing, you know, our - - -

MR MCPHEE: Yes.

MR HARRIS: - - - prudential intervention being the requisite example we used; it's a very sensitive tool. So, don't think we've taken anything other than a subtle approach to this. There have been suggestions I think - not made to this inquiry but to other inquiries - that varying legislation would be a desirable alternative approach; you don't have a view on whether you know, legislation for example, if it was legislation, should be varied?

MR MCPHEE: I think - - -

MR HARRIS: UK has varied its regulators - - -

MR MCPHEE: Yes, yes.

MR HARRIS: - - - legislation, but we didn't go down that path.

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MR MCPHEE: I think the critical thing is what we're trying to solve for here and I think that's absolutely spot on. In relation to the mechanism of the organisations you've put forward, they're both credible, you can make it as part of the remit of sort of, other regulators. To be honest with you, I think all of them are workable solutions; I think it's actually the intent, that people actually want to genuinely achieve both stability - and no-one's going to argue against, we need a strong financial system, but also a competitive one.

So the only way that I'd answer is, I think there's a number of credible solutions and I think for the success or otherwise we'd be the intent that actually sits behind that. I think, you know, you callout the example of macroprudential policy that came in, and to some degree we feel stifled competition, sort of almost put status quo as the rhythm or the measurement going forward.

We are completely supportive of what the macroprudential policy is trying to achieve. When you think about, you know, from running a healthy economy, you know, monetary policy and then what you do to influence your economy through monetary policy when you've got a one and a half per cent cash rate. Then fiscal policy, then of course, you've got both sides of government or main sides of government, saying that they're going to get back into budget balance; there's a level of impact that you can have through that.

So macroprudential policy, I believe, makes complete sense. And you know, we've got high levels of household debt and high house prices. All we're saying is, what we want to make sure is that there's the appropriate consultation time and it's just thought through what those consequences might be, not just through the managing the economy lens - which I think we've all got to sign up for, I mean, that's a very sensible thing that we want our government and regulators to do - but also have a look at what may that do to competition, and then should adjustments be made the way it's applied, to ensure that it doesn't stifle competition going forward.

So really what I want on the record is to make the comment that we agreed with the intent of what's trying to be achieve, it's just how it gets executed and make sure that competition lens is just considered prior to implementation.

MR HARRIS: Quite. Any questions?

MS ABRAMSON: I just wanted to ask about mortgage brokers.

MR MCPHEE: Sure.

MS ABRAMSON: And we've made some comments around how mortgage brokers are paid in terms of commission and trailing fees, and we've also had some evidence from the brokers about clawback, so I'm just interested on your perspective on those issues.

MR MCPHEE: Sure. I think that the way mortgage brokers are paid is transparent, it's fair, and at the end of the day, you need an industry, or any services being provided, to be profitable otherwise it won't be provided. So, from my perspective, the upfront fees quite clearly disclose

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the trail commissions, you know, quite clearly, disclosed.

And if you actually have a look in comparison across the industry, there's not a huge amount of difference about the payments being made. So, if we manage to put the power back in the hands of the consumer, for us probably the issues with mortgage brokers comes down to really understanding their ownership structure and does that influence or have an influence about the advice that's being given?

So we sit here and say that we're not unhappy with the fee structure that underpins that industry, but it's about just being completely transparent about the ownership structure. You think about it like this: why wouldn't we make publicly available, the flows that brokers are putting towards lender? And should there be no advice? No-one should be uncomfortable providing that information.

Now, what happens if each of the aggregator groups, the broker groups, there was more, if you like, the share was skewed towards the owner of that group, now let's say it was different across each of them, then that would be curious. And so, would that then be worthwhile of further investigation?

Now, if that's not happening, then why would anyone have any concern about providing that information? And so that's where we sit; we just believe the consumer has a right to know the ownership of the person that they're talking to and therefore they can make the judgement whether that may or may not skew that person's bias towards one product over another product. Putting the power back in the hands of the consumer is really where we're coming from.

MS ABRAMSON: If you went down that disclosure route, and we've had a bit to say about this, so you have the disclosure of the aggregator's ownership, but if I've understood you correctly, where would you put the obligation to say how much of the percentage of the owner's product, you know, or the bank's product - - -

MR MCPHEE: Yes.

MS ABRAMSON: - - - was actually the mortgages that are written? Because if I understand your proposal, that's where you were going; how would make that disclosure?

MR MCPHEE: Well, banks are disclosing their information all the time, right across the regulatory body; a lot of information that we provide goes to APRA, in terms of the loans we're writing, the bands, the LVR bands, how much investor, how much owner occupied, how much interest only, how much principal interest; this is, to be honest with you, really just another data point that could be very, very easily provided.

Now, where the information was made available, how public that information was that was made available, that would have to be thought through but it would certainly put this issue really to bed once and for all because once a responsible entity has that information, you'll actually just see if there's any anomalies there.

MS ABRAMSON: Sorry, I know I'm pressing you, but - - -

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MR MCPHEE: No, that's fine.

MS ABRAMSON: - - - this is an interesting response. So, what you would be saying is, you're collecting the data that you collect, how many loans are written by a particular aggregator, to that lender?

MR MCPHEE: Yes.

MS ABRAMSON: That's really what you're saying?

MR MCPHEE: Yes, that's right. And let's say we owned an aggregator business and our market share is say, 8 per cent, I don't think anyone has, so I might as well say that our market share is 8 per cent, but we were getting 16 per cent of that business, or we're getting 4 per cent of that business or we're getting 8 per cent of that business.

Now, I'm not saying if we're getting 16 per cent that's necessarily wrong. I mean, it might've been for a period of time that the product that we had in the marketplace, the product, the pricing, the features to service, was superior to what could be got elsewhere and therefore we should get a greater level of market share; we just provide that information so those questions could be asked, that's all.

MR HARRIS: Yes. And we have some numbers, as you know, in our draft report on a couple of examples where there appears to be a disproportionate success rate if you like via owned brokers versus other participation in the broker channel. But you know, we know it's not a perfect conclusion can be drawn from that information; we know that's the case. But it's indicative, potentially - - -

MR MCPHEE: Yes.

MR HARRIS: - - - of some problems. We have had it put to us at some points that a fee for service, that is, a fixed amount of money for the service, might be preferable to a percentage of the loan achieved, as a way of reducing an incentive to take out the largest possible loan. And I'm separating fee for service, because it often conflated; it has been in a number of the comments that we received back. It's often conflated with fee for service and paid by the customer - - -

MR MCPHEE: Yes.

MR HARRIS: Interested in paid by the customer as well, not just missing it, but just on fee for service versus percentage, because I think it's been accepted that there isn't that much variation in the work required to deliver a $700,000 loan versus a $350,000 loan, but you get a higher payment for it.

MR MCPHEE: Yes.

MR HARRIS: So, do you have a view on that?

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MR MCPHEE: Not a strong view, in terms of probably a fee for service feels cleaner if you like, and for the reason that you are doing but I know there are also benefits of doing it on loan sizes as well. I mean, the one thing I would say really, in answer to that is, it all comes back to discharging your obligation about acting in the customer's best interests and responsible lending.

So I tend to probably focus on that as the key issues that we need to make sure that we as banks and brokers and distribution channels are really discharging our obligation. And that's why when I talk about it, I just like the little context around the bank; I mean, I talk about the whole reason the bank was established was to help all Australians get ahead, and that was to actually get better priced mortgages. So, at the end of the day, if you genuinely are sitting there acting in a customer's best interests and genuinely discharging your duties about responsible lending, to be honest with you, I think the fee structure to some degree, is worth debate.

But do I have a strong view on it? No, but I have a strong view that you should be acting in the customer's best interests, and you should be absolutely discharging your duties around responsible lending.

MR HARRIS: Yes, and for those who closely read our report in this area, and it certainly hasn't been the case for everybody who's commented publicly, but we had a firm recommendation on acting in the customer's best interest and a query as to whether or not we should have a view on commissions, and trailing commissions in particular, just because they exemplify some of the skewed incentives that appeared to be obvious.

But our balance probably went, yes, more clearly in the direction of acting in the customer's best interest was pre-emptively logical because it decreases the possibility that a payment arrangement is then used as a rationale - - -

MR MCPHEE: Yes, that's right.

MR HARRIS: - - - to act against the customer's best interests. But it would need to be backed up, wouldn't it? And this came up, I think, with our discussion with the ANZ as well, but it may have been with the brokers too; when you pay a brokerage a trailing commission, it's been asserted that that is primarily about looking after the customer, whatever that means.

MR MCPHEE: Yes.

MR HARRIS: But it appears that you don't subsequently track that behaviour at all; "you" being the industry itself, per se.

MR MCPHEE: Yes.

MR HARRIS: Trailing commission is paid but the contract with the broker, or the agreement with the broker, doesn't require them, for example, to offer the customer once a year, a review of their loan status. Now, in the course of some of our hearings, today in particular, I think it's come up that that might be a deeply desirable thing to do such that the payment was clearly

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tied to the customer at least getting a service.

MR MCPHEE: Yes.

MR HARRIS: Because there is no current obligation upon the broker to offer that service, as we understand it; could you correct my impression if I'm wrong, or otherwise - - -

MR MCPHEE: No. So, your observations as to the way we operate are actually accurate; we don't track that. I mean, one of the things is, that obviously there is an expectation of course that the broker is there, always acting in the customer's best interests, then you'd think from time to time is checking in with that consumer to make sure that their loan and their mortgage is meeting their current requirements, change, you know, et cetera, et cetera.

So again, I think that's an interesting issue for discussion, and I think we should all welcome further discussion and debate around that.

MR HARRIS: Okay, good.

DR KING: One last one. For your mortgage portfolio, do you securitise any?

MR MCPHEE: Yes, we do.

DR KING: And - - -

MR MCPHEE: Actually, we're one of the larger securitisers - it's between 20 to 25 per cent of our sort of liability, is securities, yes.

DR KING: Oh, okay. So, presumably you would need to fund of that short-term funding through warehouse funding, or - - -

MR MCPHEE: Yes, well - - -

DR KING: - - - your - you know - - -

MR HARRIS: Also, because - - -

MR MCPHEE: Actually, going into the GFC, ME Bank was 100 per cent securitised funded which was not a great position to be in. So, since that period of time, we've built a much more balance liability balance sheet. Because of our rating at BBB, and not getting sort of the benefit of the too big to fail three rating notch upgrade, probably rather than issuing so much into the wholesale markets, our default plan is actually issuing into the securitisation markets.

And so if you actually look at our balance sheet, now how then those loans are funded before they're securitised, it's with normal core deposits: retail deposits, business deposits, you know, institutional deposits. And then when you term-out some loans, it's just then part of the ongoing mechanism of how we fund; we're a $27 billion balance sheet, so it's just a mechanism. And we probably securitise - for the last three or four years, it's been once a year at around between

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a billion and a billion and a half.

DR KING: Okay. so, I guess my key interest was on the warehouse funding side, which you don't rely on, so it's - - -

MR MCPHEE: Well, we do have warehouses, so we do have warehouse funding; it's not what I'd call "we rely" - it helps us as a mechanism. So, we do have warehouse funds, it's not that we don't have warehouse funding but that's just one of another source - - -

DR KING: Sources, yes.

MR MCPHEE: - - - that we'll fund. We think about ourselves as having seven different funding pools, which gives us that diversity. So, really, I was just trying to create - the picture I'm trying to paint is, it's just one of seven different funding sources.

DR KING: Yes, so how have you found - obviously the model has changed a lot since the GFC.

MR MCPHEE: Yes.

DR KING: I presume a lot of the pressure to change that model came out of the GFC, but - - -

MR MCPHEE: Yes.

DR KING: - - - it's also come out of some of the regulation that's popped up around securitisation - - -

MR MCPHEE: Yes.

DR KING: - - - since the GFC. Do you have any comments on that? I mean, how is that affecting your business model?

MR MCPHEE: Yes, I do. So, I found the way the securitisation markets have been handled in this country by a whole range of players has been terrific. You know, I was also at Adelaide Bank, I was the Manager at the Adelaide Bank when the GFC hit, which again, had quite a high level of securitisation. And of course, then there was the AOFM, which started buying parts of the securitisation.

The way that market has been built back up, the support by certain regulators or parts of the community, and also the change to what you can securitise or not securitise, and when you get your relief through the different sort of regulations, I think has been well handled and it's a good market out there. I think it's a genuine - should be - one of the funding sources that's available to the banks; I don't think it's a bad funding source. Everybody's sort of got that sort of image through the GFC - - -

DR KING: Got a reputation?

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MR MCPHEE: Yes, it did get that reputation through the GFC. So, I think it works well and I think generally the players, the regulators right through, have done a good job.

DR KING: Okay. Any changes? If you had your wish book open and said, "Well, I could change this," or - - -

MR MCPHEE: If I had the Treasurer sitting here, I might be able to answer that question on a more informed basis. If I can just take that on notice?

DR KING: All right.

MR MCPHEE: But I'm sure he'd have some ideas. But I just want to say, I think it's been well handled. You know, it's fine, we asked for certain things, I mean, we need to acknowledge when things have been well handled, and I'd say that's been well handled.

MR HARRIS: Okay. I think I'm out of things to ask you about; are there things that we've failed to ask you about that you'd like to get on the record? I know that you've got - we could do LMI, I wasn't going to - well, lenders mortgage insurance, it has become quite a topical item in the course of these hearings, versus the process leading up to the draft report.

We're interested in how financial institutions go about pricing the product. Consumers pay for it, obviously, it's generally incorporated into their loan; by the time they're ready to qualify for the loan, they've really got limited choice, unless they push back on the size of it, and probably limited knowledge. It appears to be the case that relatively few financial institutions would go to market to test the price.

Amongst the larger institutions, I guess as a smaller institution you probably would go to market quite often, to get a price for this.

MR MCPHEE: So, our case in point is, we believe that we'd get - so our obligation is to act in the best interests of the customer, right? Because it sits with our core purpose, so we will drive everything from that perspective. And it's not just what I say, it's actually how we act and what we do.

We were exclusively Genworth, and we tender, you know, periodically; I think it would be two years ago we moved from Genworth to QBE. And the reason we did that is, we went out to tender; it was a good competitive tender, and we felt by moving to QBE at that point in time, it was in our customers' better interest to do so.

We don't believe it's in our customers' better interest to have the two, because on one hand if you're big enough you can say, "Well, that creates the competitive tension" and then you can direct the flow as to where you're getting the better value. For us, the better competitive tension is, we go out to tender on a periodic basis, and it gets to more favourable pricing through that way because it actually gives enough flow to get that cheaper pricing; so that's how we deal with that issue.

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DR KING: You just pass the tender price through to the customer?

MR MCPHEE: Yes, and if you actually had a look at the two proposals, what you'll see is, we went for the proposal that ultimately was in the customers' better interest, so there's nothing in it for us other than to make sure we're acting in the customers' best interest.

The fact is, I take the point that by the time the customers talk about LMI, they're a fair way down the track, however, you will find that customers will challenge - not all, of course - but will challenge the LMI and that does become part of the overall decision as to whether they go with lender A or lender B, simply through the mortgage broking space because that's when they get the comparison, "Well, here's the rate, here's the fees, here's the LMI. This LMI is say, $4,000, this LMI is $3,000." Does that thousand dollars difference, when you're taking those other things into consideration, mean that the consumer is better going with lender A rather than lender B? So, also, price tension does happen at some stage during the consumer making the decision.

MR HARRIS: Okay Jamie, thank you very much for your participation.

MR MCPHEE: Thank you.

MR HARRIS: And the round table submission here today; hopefully we'll be back in touch with you again before the completion of this inquiry.

MR MCPHEE: Thank you.

MR HARRIS: Thanks for your time.

MR McPHEE: We will definitely put in another submission with our regional peers. We appreciate your time, and again, we thank you for the quality of the reports, so thank you. And thank you.

MR HARRIS: Okay. So, we are now going to close the public hearings in Melbourne. And for the purpose of this inquiry, I'd like to thank again, through the electronic distribution mechanism, all the participants who've made time to come along and endured our questions. And we'll indicate, once again, that we have a period open for submissions until 20 March; certainly, hoping to get increased participation as a result of the attractiveness of these hearings, and the comments that have been generated.

And, that we expect to have a final report in the Government's hands by 1 July. Otherwise, I declare the hearings closed.

ADJOURNED AT 1.36 PM

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