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Productivity Commission Submission: Competition in the Australian Financial System

Opening Remarks

The Productivity Commission provides the banking and finance industry with a timely and encouraging opportunity to consider the changes we could make to better support Small-to-Medium Enterprises (SME's), the growth outcomes of their businesses and the Australian economy. For this to be achieved we need to support/facilitate competition in the Australian Financial System to address the under-served SME sector and provide them with real alternatives to access the funding they need and deserve.

Now is the time to ask ourselves, if the current trajectory is unchanged, how will entrepreneurs with great business ideas to drive growth, national income and employment prospects ever get started if they can neither acquire a strong equity stake in a property or access affordable finance?

Societal confidence in Australia's major banks has been eroding for several years to a point where it is now at a nadir, a fact publicly acknowledged by several major bank CEO's. The trust gap that has opened-up is not just a matter for the banks, it is a legitimate public policy concern given the unique, privileged and protected position the banks play in our economy and in society.

There are many reasons for this trust gap, but perhaps the major reason is the focus on maximising economic rents in a highly privileged and protected industry structure, which has resulted in an unprecedented market power residing in the four major banks, when it comes to key customer sectors. A concentrated focus on shareholders, often at a cost to other stakeholders, has resulted in the unpalatable situation that prevails today.

The consolidation of banks and departure of foreign banks have heightened the need to encourage and facilitate new entrants. Examples of policy responses in the UK and Singapore that support competition have resulted in material regulatory changes, one example of this is the staged/preliminary ADI process allowing new entrants to collect deposits sooner, deliver a wider product offering to their customer base and compete on a level playing field with the incumbent banks.

As discussed below, Australia's commercial banking system in 2017, is more closely akin to the traditional building societies system, with a bias on property-based lending, rather than the core function of banks to intermediate capital to sectors of the economy to finance expansion in productive assets and economic activity, as well as housing. Great developments in nation building, as was seen in the past in the USA and in Australia, come when the banking system supports innovation and entrepreneurs in building new businesses and creating new frontiers in business models and markets. A banking sector that fails to do this, regardless of its own profitability, is not serving the needs of society.

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Competition in SME Banking

Of all sectors of the economy impacted by the way our banking system operates, none has been affected as much as SMEs, widely regarded as the engine room of our domestic economy, employing ~70% of all private sector employment. Some evidence of the economic cost of a banking system that is unsupportive of SMEs is an estimated ‘credit gap’ in unmet SME credit demand in Australia of c.$50-$70bn.[1] Even if this estimate is overstated by 50%, the economic, including employment, consequences remain material.

SMEs are hugely reliant on banks and the major banks, who account for ~85% of all SME lending. All the evidence suggests, however, that in the absence of meaningful competition, the banks have leveraged their power to maximise profits instead of providing the quality and consistency of service the SME sector would naturally expect and deserve. Consequently, SME satisfaction with the big four banks has deteriorated to a 30-year low and it may never recover. Numerous surveys highlight the poor quality of service and support provided by the major banks to SMEs.

There are several reasons, both policy and practical, why this has developed.

At a policy level, an oligopoly will always act in defending self-interest, unless there is the threat of real competition or political intervention. This is evident, for example, in the pricing decisions on mortgages. To their mutual benefit, the major banks have solved for the ‘prisoners dilemma’ by knowing each other’s incentive to maximise profit, thus pricing decisions can appear to be coordinated, as each bank moves in step, each taking a turn to be the first mover. Rather than providing capital to support SMEs in nation-building activities, our major banks have had an unhealthy bias towards household lending, now at eye-watering levels with household lending around $1.6 trillion, compared to SME lending at ~$250bn (total non-financial institution business lending ~$680bn). Moreover, in the allocation of scarce capital and funding, close to 80% of all housing lending is for the purchase of existing property and close to 60% of all new housing loans are taken by investors for negatively geared property investments. In a banking industry where a “sales” culture is endemic, even the simple rules of mortgage credit assessment can become subordinate to “sales targets”.[2] This bias to property lending has also resulted in ~90% of all SME lending being secured against ‘collateral’ of either commercial or residential property, with little weight now attached to three of the traditional 4C’s of lending (character, cash-flow, capital and collateral). The Australian banking system in 2017 resembles a market dominated by actors modelled more on traditional building societies rather than nation-building commercial banks, allocating capital to support economic growth.

At a practical level, there may be deeper, more complex issues that are fundamentally related to the de-skilling and de-professionalisation of the banking industry, driven in part by the desire of the banks to i) build a product lead “sales-culture” and ii) industrialise operating models to achieve economies of scale, cutting costs and automating services. The long journey of industrialising the operating model within many banks has seen core SME skills lost and a priority given to centralisation, standardisation and automation of credit decisioning, which is the antithesis of relationship banking. SME banking has almost become a world of ‘one size fits all’.

The demise of the banking proposition to SME is highlighted by the Australian Centre for Financial Services in their submission to the Financial System Inquiry:

[1] Macquarie Bank Research, 2015

[2] The Australian, *Banks sitting on $500bn ‘liar loans’*, September 12, 2017

"With the consolidation of banking and drive to reduce costs, there has been a move [by the major banks] toward algorithmic credit assessment, or credit scoring, … [as an] efficient means of processing smaller high volume loans. With the widespread use of such models to assess credit risk, it has been suggested that within Australian banks "there appears to be a shortage of people with the skills required to assess credit-worthiness of SME borrowers." Increased reliance on risk models rather than traditional relationship banking may have … possible adverse consequences for SMEs [including]…. Individual banks … view[ing] SMEs as a segment rather than as heterogeneous businesses with varying risk profiles, leading to reduced business lending to SMEs in the aggregate."

Australian Centre for Financial Studies submission, Lending to Small and Medium Enterprises

What *could* be better, with better policy?

Australia has the most profitable banking market in the world, with aggregate after tax profits of the major banks at ~$30 billion, in an economy of 24m people. The Returns on Equity (RoE) of the major banks are at close to twice their cost of capital, which is a simple but powerful measure of an industry occupying a privileged position and lacking in competition. Defenders of the status quo point to the stability of the system as a strength of our economy – and there is some merit in this argument. The counter, however, should be understood: what are the wider costs to the economy of an essentially oligopolistic industry structure, with undifferentiated actors that all have a bias towards household lending, and with the extraordinary economic rents earned?

The rise in household lending has in part been driven by the banks' constant drive to maximise profit and therefore it's predilection to 'game' the regulations. In this case, shifting capital and funding to mortgage lending where the capital requirements are lower driving higher RoE. This strategy, which is a rationale for individual banks seeking to maximise RoE, has resulted in 'copycat strategies' which create systemic risk. Bank board's take comfort from this approach by asking "are we in the pack" and implicitly seek sanctuary from the insight from Keynes who said: " A 'sound' banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him."[3] Therefore, future regulation needs to consider how it enshrines a broad range societal desired outcomes in a way that forces the banks to balance profit and purpose.

The largest impediment to real competition is the way the banks have used regulation to build barriers around themselves meaning it is both incredibly hard for new entrants to create customer propositions that can match that of the major banks and for customers to switch away even if they could. It has been said it's more likely for an individual to get divorced than change banks and that's not surprising given how entwined people's lives are with their banking facilities and how hard it is to change. The two keys to unlock these barriers are:

- create an industry standard and portable (from the customer's perspective) know-your-customer (KYC) model, similar in design to the new payments platform (NPP) with an independent centralised body to administer
- follow European legislation giving back the ownership of customer data to the customer, forcing the banks to securely digitally publish (with the customer's consent) the data held by the bank for any purpose the customer wants, thereby instantly enabling continuity of experience when simply switching

[3] John Maynard Keynes (1932), *Essential Keynes* by Robert Skidelsky, p156

Fin-tech and working capital cash-flow lenders are some new entrants that are welcomed and have been supported by recent regulatory changes but they fail to address significant business growth, acquisition and expansion plans, or offer the full array of products needed by SMEs.

Policy makers must face into the structural issues that have allowed an oligopoly structure to flourish and encouraged culture and conduct issues that have resulted in costs (often distress) to customers, who feel disempowered in responding to the banks. As ASIC Chairman Greg Medcraft said "there is still a major problem with culture, conduct and accountability at the major banks"[4] that needs to be addressed. The asymmetry of power between bank and customer is a feature of a market lacking competitive tension; this was recently a central feature of the inquiry into small business banking by Small Business Ombudsman Kate Carnell.

Another important public policy consideration is the need for greater innovation in banking. The major banks have limited incentive to innovate in a way that creates greater customer utility, where there is a conflict with the banks' profit objectives. Just as IBM was less known for its innovation than for its ability to bring standardised technology to the mass market, so it is with our major banks. Breakthrough innovation that benefits customers, is most likely to come from new entrants and firms that think like start-ups, such as Apple, Alibaba, Metro Bank and Netflix.

Whilst more regulation is always a tempting course of action, the key is to create an environment which is supportive of greater competition, including the lowering of barriers to entry into the banking sector, particularly SME focused lending. Following policy announcements in the May 2017 Federal Budget on reforms to the regulatory rules governing ADI licencing, the recent discussion paper from APRA on plans to introduce a restricted banking licence category as a bridge to creating more competition in the sector, are all steps in the right direction. The implied policy move is encouraging, but much more must be done to create meaningful competition, without compromising the integrity of our banking system. Creating greater competition, whilst protecting the integrity of the banking system is an 'AND' not an 'OR' proposition i.e. greater competition and a strong banking system.

Concluding Remarks

Whilst there is much legitimate societal disquiet centred on the culture problem within our major banks – which should not be downplayed as this is unlikely to self-correct – culture is only part of and arguably not core to the disillusionment so wide spread. The core problem is a powerful oligopoly industry structure, protected by special privileges, that has seen customer interests become a poor second to their profit maximising goals. It is little surprise that our banks earn the highest economic rents in the global banking market. As former Treasurer, Peter Costello recently commented[4], the major banks are "absolutely immune from market discipline" living in a highly profitable "cocoon" because of government policy. Costello added, "they think all these high returns are from their own brilliance, but what they haven't understood is they have a unique and privileged regulatory system which has delivered this to them."[5]

Given the challenges faced by SMEs and accepting that there is nothing path dependent about the current industry structure, policy makers should see a wonderful opportunity in following economist, John Kay's advice to the British government on its banking sector: "perhaps the most useful initial role of government is to promote the creation of new financial institutions directed to providing the mix of loan and equity finance and advice to help SMEs grow."

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[4] The Australian, *ASIC says bank culture a 'major problem'*, September 12, 2017

[5] The Australian, *Peter Costello's blast at the banks: bring in some competition*, August 19, 2017

There are times when active government intervention to facilitate greater competition is a legitimate policy response and it's encouraging to new entrants like Judo that policy makers are examining leading edge policy and regulatory response to support greater competition and how we could better support SME customers accessing these new alternatives once they become available.

About Judo Capital – 'Banking as it used to be; banking as it should be'

Built by some of Australia's most experienced bankers and modelled in part on the UK Challenger Banks (Aldermore www.aldermore.co.uk, Shawbrook www.shawbrook.co.uk and Oaknorth www.oaknorth.co.uk) Judo Capital is a *purpose-built Challenger* (not a Fintech) focussed solely on the SME market, that has come to market to address the growing dissatisfaction with, and the gaps inherent in the offerings of the incumbent banks. It is Judo Capital's intention to apply for a banking licence in 2018. Details on Judo Capital can be found at www.judocapital.com.au.

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