CUSTOMER OWNED BANKING ASSOCIATION

Submission to Productivity Commission Inquiry into Competition in the Australian Financial System

15 September 2017

About us

The Customer Owned Banking Association (COBA) is the industry advocate for Australia's customer owned banking sector. It is owned by its 72 member institutions: 51 credit unions, 3 building societies, 16 mutual banks and 2 others; and a number of affiliate members.

COBA provides representation and advocacy for its members to:

- federal and state governments
- regulators, such as APRA and ASIC
- the media
- industry and consumer groups, and
- the general public and other stakeholders.

It also provides member institutions with expert advisory and support services, such as fraud & financial crimes and research.

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Executive Summary

A competitive banking market with a diverse range of competitors is important to ensure the best outcomes for consumers in terms of pricing, product & service quality and innovation.

A lack of competition can contribute to inappropriate conduct by firms, and insufficient choice, limited access and poor quality products for consumers.

We have a problem with competition in the Australian banking market.

It is widely accepted that the banking sector is an oligopoly where the major banks have significant market power that they use to protect shareholders from regulatory and market developments.

Major banks benefit from a regulatory framework that has helped to embed their dominant position in the market.

Promoting a more competitive banking market does not require any dilution of financial safety or financial system stability. It is arguable that the high level of concentration in the banking sector has exacerbated the problem of systemic risk in the Australian financial system.

There is evidence that Australia's financial regulators are not immune from the view that accretion of market power can be desirable from standpoint of preserving stability in the financial system.

The prudential regulator APRA's consideration of the impact on competition of its approach to regulation has improved since the Financial System Inquiry but in COBA's view has been inadequate and inconsistent.

Examples of APRA's failure to give due consideration to competition concerns include:

- lack of urgency in addressing the market distortions caused by the unfair funding cost advantage enjoyed by the major banks due to the implicit guarantee
- continuing wide gap in mortgage risk weight settings between the major banks and smaller banking institutions
- implementation of macro-prudential measures affecting investor lending and interest only lending
- lengthy delays in accommodating the customer owned banking sector in the regulatory capital framework, and
- prohibition on credit unions and building societies using the term 'banking' in a registered corporate, business or trading name or internet domain name.

COBA recommends amending APRA's statutory mandate to include an explicit 'secondary competition objective' (SCO). The SCO would remain secondary to APRA's primary responsibilities of financial stability and safety but when making policy in pursuit of these primary objectives APRA would be required to do so in a way that facilitates effective competition, as far as reasonably possible.

The SCO would include reporting obligations to ensure accountability against the objective.

APRA's peer regulator in the UK, the PRA, was given an SCO in 2014 and the outcome is a "material change of gear" where "competition is gaining airtime and traction at all levels" and "there are numerous instances where competition considerations have influenced policy outcomes."

All policymakers and regulators need to better recognise that regulation is an important factor in promoting or suppressing competition. Regulation should be targeted, proportionate, risk-based and, where possible, graduated.

The fixed costs of regulatory compliance fall more heavily on smaller firms. This effect provides yet another advantage to the major banks because they can spread their regulatory compliance costs over a vastly bigger revenue base.

The customer owned banking sector, with its unmatched customer focus and good compliance culture, is being caught up in the backlash against the conduct and culture of major banks. Regulatory responses to problems created by major banks should be targeted at major banks.

Consumers have a critical role in driving competition by their willingness and capacity to switch to a new provider with a better or more suitable product.

Customer owned banking institutions offer the full range of consumer retail banking products and services, including highly competitive home loans, credit cards, personal loans and deposit products. Many of these products are market leading and award winning. The providers of these products strongly support cost-effective measures to empower consumers to switch.

In order to drive competition, consumers must have the awareness to consider it worthwhile to switch, be willing and able to compare products, be willing and able to find the right product, and be willing and able to take action.

Across different products, e.g. home loans, credit cards or transaction accounts, different friction points arise and different factors contribute to customer inertia.

COBA recommends rigorous market studies of retail banking product markets, taking into account consumer behaviour and behavioural biases, to identify the barriers to switching and to design interventions to reduce these barriers in the most cost-effective way.

We welcome the Government's decision to provide resources to the ACCC to establish a dedicated Financial Services Unit to undertake regular in-depth inquiries into competition issues in the financial system. We also support Government's decision to include competition in ASIC's mandate. We recommend clarity of responsibility between these two regulators for carrying out market studies and designing interventions to promote switching.

Recommendations

1. Policymakers and regulators give greater consideration to the impact on competition of the regulatory compliance burden on smaller ADIs and ensure that regulation is targeted, proportionate, risk-based and, where possible, graduated.

2. The Government introduce an explicit 'secondary competition objective' into APRA's legislative mandate, including with an accountability mechanism.

3. Interventions are needed to empower consumers to switch between banking products but interventions to promote switching should be cost-effective and based on rigorous market studies of banking product markets and consumer behaviour.

Sector Overview

Australia's customer-owned banking sector consists of 79 authorised-deposit taking institutions (ADIs) trading as mutual banks, credit unions and building societies. Our sector has $108 billion in total assets, 10 per cent of the household deposits market, 12,000 staff and 4 million customers.

Customer owned banking institutions offer the full range of consumer retail banking products and services, including home loans, credit cards, personal loans, transaction accounts, savings accounts and term deposits. The customer owned sector has an important role to play in the retail banking market because consumers are entitled to genuine choice and competition.

The customer-owned banking model

Customer-owned institutions have a different set of incentives to their investor-owned counterparts. Unlike investor-owned ADIs, customer-owned banking institutions are owned by their customer-members, not separate shareholders, and abide by the principle of "one member, one vote." This ownership structure aligns the incentives of owners with those of the customers. As such, customer-owned banking institutions exist solely to serve their customers and do not face the conflicting priorities of providing quality products and service to customers while maximising returns to shareholders.

Customer-owned banks deliver value to their members by:

- highly competitive pricing, i.e. better rates and fees
- excellent service, and
- reinvesting profits into the company to promote future growth and improve product offerings and into community programs.

The customer-owned banking sector made $487 million in profit after tax in the 2016-17 financial year[1]. While customer-owned institutions generate profits to create capital and to invest in improving products and services, this is not their primary purpose. This distinction is reflected in the Corporations Act[2] which requires that customer owned ADIs are not to be companies run for the purpose of yielding a return to shareholders.

In terms of the 'mutuality dividend', i.e. the benefit provided to members due to better value products, some customer-owned banking institutions commission independent agencies such as CANSTAR to estimate this potential value.

Table 1: Estimates of the 'mutuality dividend'

	Year	Profit	Pricing Benefit
Bank Australia	FY15	$22.6 m	$33.2 m
Teachers Mutual Bank	FY16	$30.3 m	$28.9 m
Heritage Bank	FY16	$33.2 m	$50.0 m
Victoria Teachers	FY15	$15.0 m	$174 per member

Source: Annual and Customer Reports

Customer-owned banking institutions pay company tax like other companies. While customer-owned institutions are 'mutuals', they are not subject to the mutuality tax principle[3] and their income is subject to the corporate tax rate. Our sector paid $187 million

[1] See APRA's Quarterly ADI Performance (QADIP) statistics June 2017 (issued 29 August 2017)
[2] Corporations Act 2001 Schedule 4, 30(4)
[3] Under this principle, 'mutual receipts' are not assessable income. This works on the principle that an organisation cannot derive income from itself and therefore should not be taxed on this income.

in corporate tax in FY 2016-17.[4] The total corporate tax paid by our sector in FY 2014-15 would put the customer owned banking sector within the top 30 companies based on tax paid[5].

Trends in the customer-owned banking sector

The customer owned banking sector continues to perform strongly with housing loans growing at a rate of 8.5 per cent over the last three years. Our assets, deposit and housing loan growth has exceed the broader ADI sector over the last three years. Customer owned banking sector assets now exceed $108 billion.

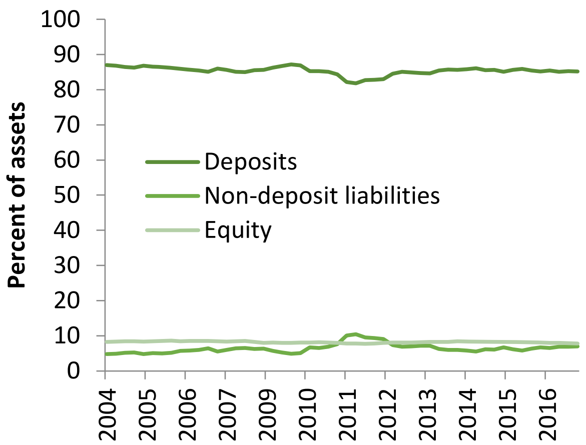
Table 2: Customer-owned banking overview

	Our Sector	3-yr Annual Growth	ADI sector
Assets	$108.2 bn	7.2%	4.7%
Deposits	$92.2 bn	7.0%	6.3%
Housing	$80.6 bn	8.5%	5.3%

Source: APRA QADIP

The customer-owned banking sector remains predominately funded by retail deposits, holding $92.2 billion in deposits in June 2017 (Chart 1)[6]. These deposits are mainly retail deposits. However, many of COBA's larger members access wholesale funding through rated debt issuances, securitisation and negotiable certificates of deposit. Efficient access to a diversity of funding sources for customer-owned banking institutions ADIs remains critical.

Chart 1: Customer-owned banking funding



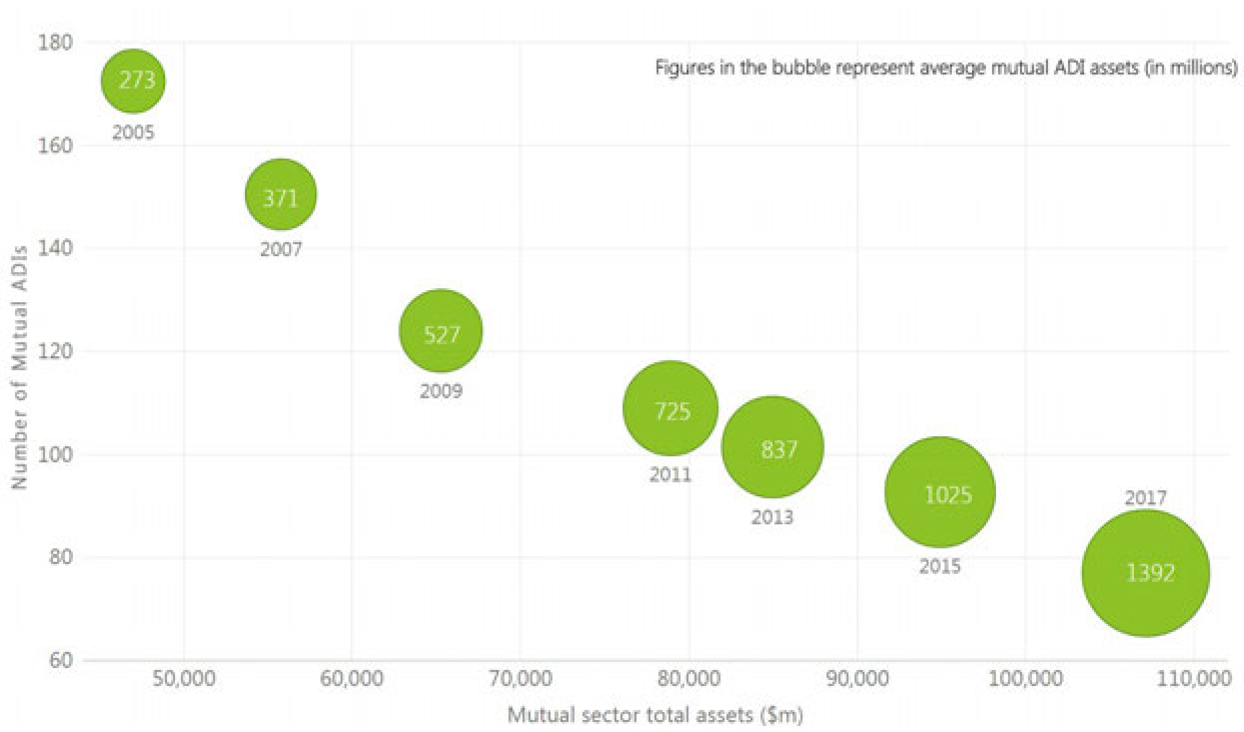
On the assets side, customer-owned banking institutions predominately provide housing loans with around 90 per cent of their lending coming from these products. Asset quality remains high with impaired facilities and past due loans for credit unions and building societies remaining below ADI sector averages.[7]

A long-term trend of consolidation continues to result in fewer but larger customer-owned banking institutions and overall sector growth (Chart 2). The consolidation process is effected by mergers between customer-owned banking institutions, with the largest ten institutions now holding around two-thirds of the sector's assets. This consolidation has seen the average customer-owned banking institution growing to $1.4 billion in assets, up from $273 million in 2005[8]. While there has been a significant amount of consolidation, there are still a large number of smaller customer-owned banking institutions with our sector having a median asset size of $422 million in 2016.

In addition to this 'within' sector consolidation, there have also been a number of customer-owned banking institutions that have become subsidiaries of larger mutuals – Big Sky Building Society in 2012 (Australian Unity), MyLife MyFinance in 2016 (MyLifeMyMoney Superannuation Fund) and QTMB in 2016 (RACQ). These institutions retain their mutual philosophy but with greater ability to take advantage of growth opportunity and to improve broader product offerings for members.

[4] APRA QADIP June 2017
[5] ATO's 2014-15 Corporate Tax Transparency list, https://data.gov.au/dataset/corporate-transparency
[6] Chart 1 is based on data from APRA QADIP June 2017
[7] APRA QADIP June 2017 Table 3d and 4d – note APRA does not provide asset quality for the entire mutual ADI sector.
[8] COBA estimates based on APRA QADIP June 2017

Chart 2: Consolidation in the customer-owned banking sector



Source: COBA estimates based on APRA QADIP June 2017

Emergence of mutual banks

There has been a growing trend since 2010 for credit unions and building societies to rebrand as banks. The customer-owned banking sector now includes 19 mutual banks. The majority of the largest customer-owned institutions have taken the chance to rebrand as banks[9] but three of the four largest customer-owned institutions prefer to continue to trade as credit unions or building societies.[10] While these institutions that have rebranded are now 'banks', this does not dilute their mutual purpose and they remain customer owned and continue to follow the principles of mutuality, serving customer owners rather than maximising profits. The Government's current proposal to reduce the barriers to the use the term 'bank' is likely to increase the number of credit unions and building societies opting to use the term.

The general case for rebranding relates to improved recognition including to: "better explain what it [our bank] does", "clearly explain what we do" and "provide opportunities for growth and recognition in a competitive environment".

Regulation of customer-owned banking

Customer owned banking institutions are Authorised Deposit-taking Institutions (ADIs) and are regulated by APRA under the *Banking Act 1959*. Customer owned banking institutions are subject to the same prudential standards as other ADIs. This means that they are subject to restrictions on leverage through regulatory capital requirements and as well as APRA's lending standards. In terms of APRA's regime, customer-owned institutions are standardised institutions that are subject to APRA's simplified minimum liquidity holdings regime.

As is the case with listed banks, deposits with mutual banks, credit unions and building societies are covered by the Australian Government's Financial Claims Scheme.

[9] APRA policy requires banks to have at least $50 million in capital
[10] These include CUA and People's Choice Credit Union

Customer owned banking institutions are Australian Financial Services Licensees regulated by ASIC under the *Corporations Act 2001* which means they are subject to the same rules as other businesses that conduct financial services businesses.

Customer owned banking institutions are Australian Credit Licensees regulated by ASIC under the *National Consumer Credit Protection Act 2009*. This means they are subject to responsible lending, credit contract and general conduct obligations.

Customer-owned banking institutions are regulated under the Anti-Money Laundering and *Counter-Terrorism Financing Act 2006* and are therefore subject to regulation by AUSTRAC.

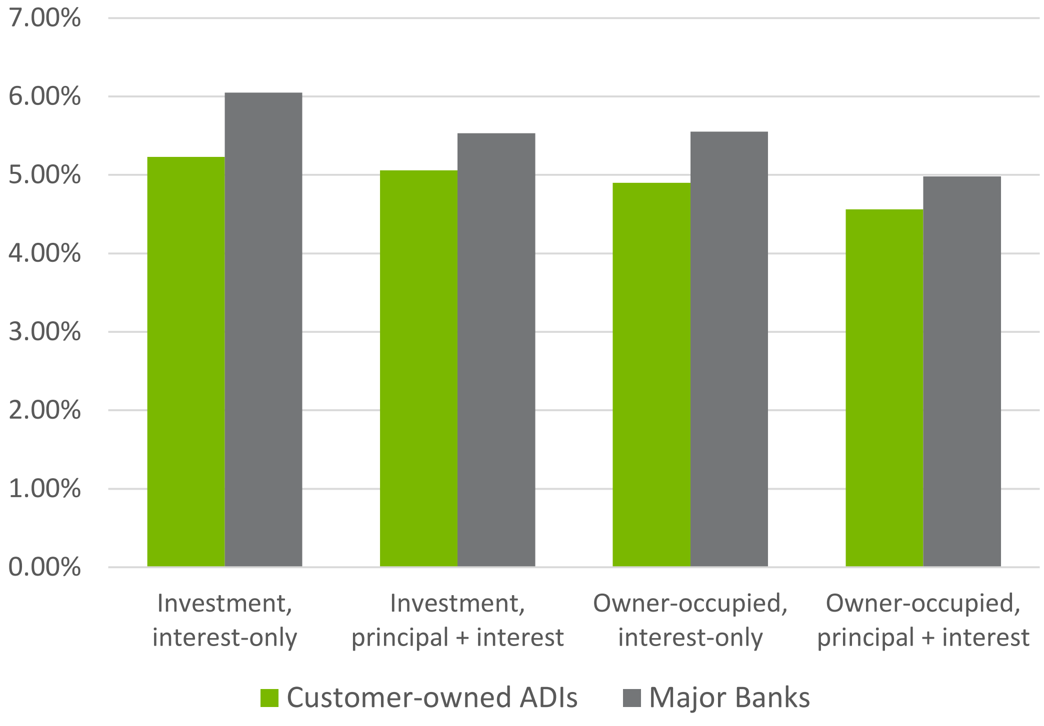
Competitively priced and award winning products

Customer-owned banking institutions offer the full range of retail banking products and services and provide highly competitive pricing on key products such as home loans, credit cards, personal loans and deposits. These award winning products have the same features as more expensive products in the market and provide significant diversity in the market. This provides consumers genuine choice in financial services.

Home loans

Customer-owned institutions provide a complete range of great value home loans, including: investor, package, interest-only and reverse mortgage products. Our sector's products are competitively priced with an average standard variable rate that is 40-80 basis points lower than the major banks' rates (Chart 3).

Chart 3: Average standard variable rate comparison

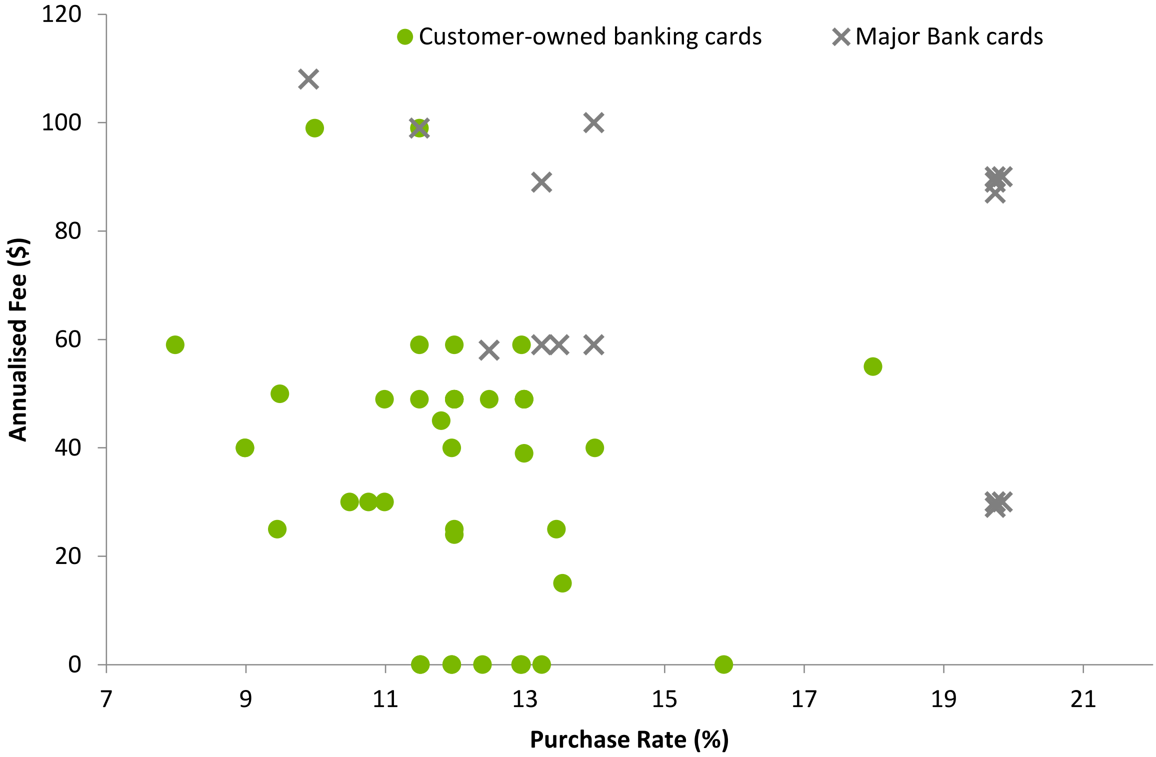


Source: COBA estimates based on CANSTAR data for open, non-package 80% LVR home loan of $400,000 at 13 Sep 2017 – note excludes loans that list a single interest rate for both P+I and IO loans

Credit cards

Customer-owned institutions provide very competitive low rate and low fee credit card options. Chart 4 shows that there are a multitude of customer-owned banking cards that provide lower rates, lower fees or both.

Chart 4: Customer-owned banking contribution to credit card diversity



Source: Based on CANSTAR data for non-rewards credit cards with interest free days at 13 Sep 2017

This combination of lower fees, lower interest and similar features make them highly competitive alternatives to the credit cards offered by the major banks.

Comparison websites have recognised the value and features provided by our sector's products with our sector receiving:

- 12 5-star and 17 4-star ratings in the CANSTAR Low Rate Credit Cards category[11]
- 11 5-star and 8 4-star ratings in the CANSTAR Low Fee Credit Cards category
- 8 of 12 awards for Mozo Expert's Choice Best Low Rate Credit Cards[12]
- 6 of 10 awards for Mozo Expert's Choice Best No Annual Fee Credit Card
- both Money Magazine 2017 Cheapest Credit Card awards for banks and non-banks[13]

Personal loans

Our sector's personal loans have highly competitive rates and fees. Customer-owned institutions provide personal loans for the same purposes as other banks—paying off debt, cars and travel. Some institutions now also provide special loans for 'green' purposes e.g. to purchase solar panels and undertake environmentally friendly improvements. Similar to our sector's other products, customer owned banking personal loans have received strong endorsement:

[11] CANSTAR Credit Card Star Ratings, May 2017
[12] https://mozo.com.au/expertschoice/best-credit-cards
[13] http://moneymag.com.au/best-best-2017-cheapest-credit-cards/

- 11 five-star and 8 four-star ratings for the CANSTAR secured personal loans category
- 9 five-star and 17 four-star ratings for the CANSTAR unsecured personal loans category
- 23 five-star and 45 four-star ratings for the CANSTAR car loans category
- 8 of 13 awards for Mozo Expert's Choice Best New Car Loans[14]
- 12 of 13 awards for Mozo Expert's Choice Best Used Car Loans
- all 4 of 4 awards for Mozo Expert's Choice Best Secured Personal Loans
- 8 of 11 awards for Mozo Expert's Choice Best Unsecured Personal Loans

Table 3: Personal loans comparison

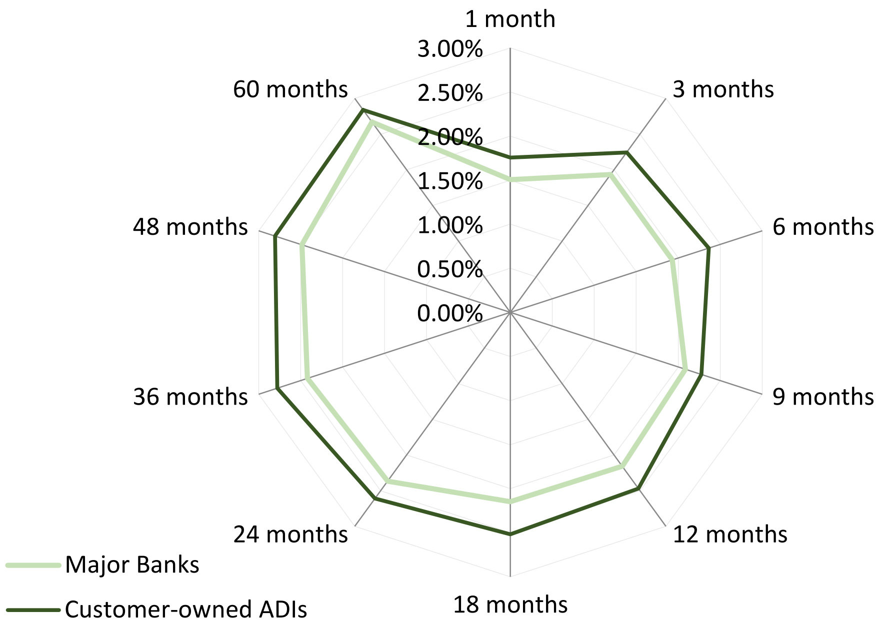
	Minimum Rate	Average Annual Rate (inc. fees)[15]
Major Banks	15.2%	18.3%
Customer-owned ADIs	12.4%	13.7%

Source: COBA estimates based on CANSTAR data at 13 Sep 2017 for unsecured variable rate personal loan of $10,000, excludes personal loans for specific purposes (i.e. funerals and green loans)

Term deposits

Our sector provides very competitive rates on term deposits and holds than $40 billion in term deposits, as at July 2017. This reflects the importance of deposits to our funding model and our model's ethos to return value to members. Chart 5 shows the relative pricing of our term deposits compared to the major banks.

Chart 5: Term deposit average rate comparison[16]



Source: COBA estimates based on CANSTAR term deposit rates for a $10,000 deposit at 13 Sep 2017

[14] https://mozo.com.au/expertschoice/best-personal-loans
[15] CANSTAR calculates this based on a $10,000 loan over 3 years.
[16] Based on CANSTAR term deposit rates for a $10,000 deposit at 13 Sep 2017

High levels of customer satisfaction

The customer owned banking sector has for many years consistently recorded market leading levels of customer satisfaction.

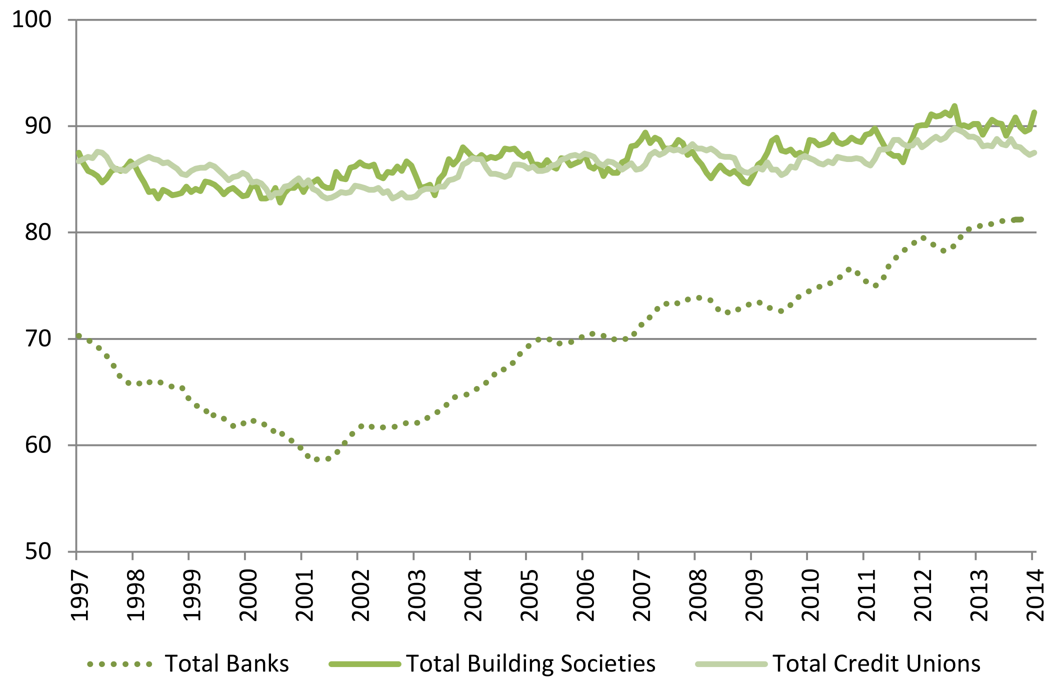
For the last five years, a customer owned banking institution has won Roy Morgan's Bank of the Year Customer Satisfaction award (Victoria Teachers Mutual Bank in 2012 & 2013, P&N Bank in 2014, Teachers Mutual Bank in 2015 and Greater Bank in 2016) beating their major bank and regional bank rivals.

Customer owned banking institutions have also won Canstar Blue's Most Satisfied Customers Challenger Bank award (non-major bank) five times (Heritage Bank in 2012, 2014 & 2016, Police Bank in 2013 and Teachers Mutual Bank in 2015).[17]

According to Roy Morgan Research[18], mutual sector customer satisfaction was 90.1% in July 2017 compared to 79.2% for the major banks. Our strong focus on customer relationships is shown by mutual sector customer satisfaction increasing to 93.6% when we are a customer's main financial institution (MFI). This compares to 81.3% for the major banks. Customer owned institutions hold seven of the top eight highest individual MFI customer satisfaction ratings.[19]

This customer satisfaction gap isn't a fleeting result. Chart 6 shows that the gap in customer satisfaction between our sector and total banks has existed since at least 1997. Mutual banks have similar satisfaction levels to credit unions and building societies.

Chart 6: Customer owned banking satisfaction



Source: Roy Morgan Research, Customer Satisfaction: Consumer Banking in Australia Monthly Report, Australians 14+, 6 month average

[17] Note Canstar Blue does not have an 'all bank' category.
[18] Roy Morgan Research, Customer Satisfaction: Consumer Banking in Australia, Monthly Report July 2017
[19] These seven institutions include four mutual banks, two credit unions and one building society.

Location of customer-owned banking institutions

Customer-owned banking institutions have a proud history of serving both metropolitan and regional communities. The head offices of eight of the 10 largest customer-owned banking institutions are outside Sydney and Melbourne and are important economic and social contributors to their communities. Customer owned banking institutions are well-represented in regional and rural communities across Australia.

Table 4: Head office locations of ten largest COBA members

Institution	Location	Total Employment[20]
CUA	Brisbane	1034
Heritage Bank	Toowoomba	798
People's Choice Credit Union	Adelaide	935
Greater Bank	Newcastle	627
Teachers Mutual Bank	Sydney	468
IMB Bank	Wollongong	442
Beyond Bank Australia	Adelaide	510
Bank Australia	Melbourne	338
P&N Bank	Perth	298
Victoria Teachers Mutual Bank	Melbourne	206

Most customer-owned banking institutions are partners in the rediATM network, giving them access to a national network of more than 3,000 ATMs.[21] This results in our customers having a level of ATM coverage similar to the major banks and gives our customers access to one of the largest direct charge free ATM networks in Australia. Some COBA members also have arrangements for their members to access a major banks' ATM network on a free of direct charge basis.

Our sector has more than 900 branches widely spread throughout Australia, with half in NSW reflecting the geographic spread of our institutions. To operate outside of these branch networks, some COBA members utilise brokers.

Table 5: Customer-owned banking sector locations[22]

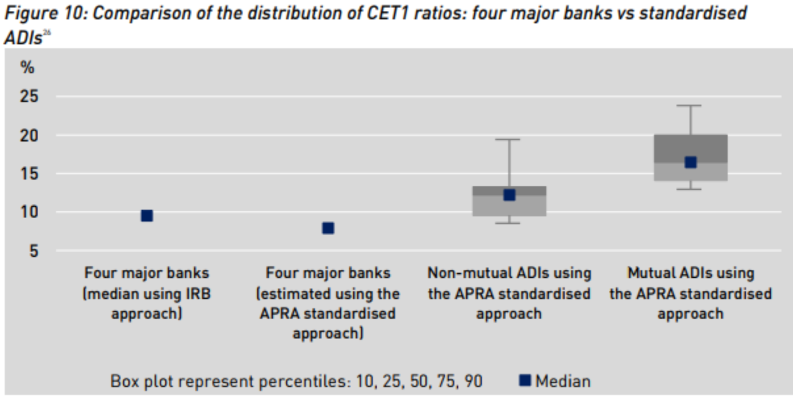
		NSW	QLD	VIC	SA	WA	ACT	NT	TAS	Total
Total Branches	no.	466	177	117	66	41	27	26	12	932
Head Office	no.	40	12	18	5	1	0	1	2	79

Prudentially sound nature of the customer-owned banking sector

The customer-owned model is inherently sustainable and stable. Credit unions, building societies and mutual banks have much higher capital adequacy ratios than the major banks, with this gap further increasing when estimated under a 'like for like' standardised approach (Chart 7). Almost all the regulatory capital held by the sector is in the highest quality form of regulatory capital: Common Equity Tier 1 capital. Capital represents an ability to absorb losses without becoming insolvent. However, while the sector is highly capitalised, individual mutual ADIs (like all other ADIs) need access to timely regulatory capital options to ensure that they can take advantage of opportunities in the market.

[20] Based on KPMG Mutual Industry Review 2016 data. This figure is total employment by the institution, including branches.
[21] http://www.rediatm.com.au/about-us
[22] Based APRA ADI Points of Presence 2016 and internal COBA data

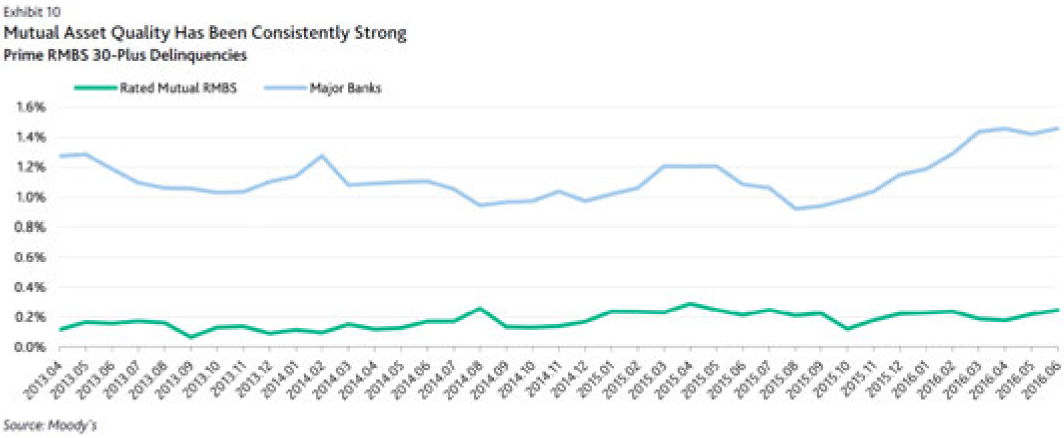
Chart 7: Customer-owned banking sector capital adequacy



Source: APRA 2017 Information Paper: Strengthening banking system resilience, p. 30

Customer-owned institutions have relatively conservative lending standards. This is noted by Moody's which states that the "delinquency performance of mutual home loans has been consistently lower than that of the major banks, which testifies to the more conservative underwriting practices of mutual institutions."[23] Similarly, KPMG notes that a fall in provisions in 2016 reflects the "high quality of the mutuals loan portfolios."[24] This is due to the different incentives faced by the customer-owned banking institution—losses are absorbed by members' funds (i.e. retained earnings held to benefit members) which leads to more conservative lending practices in order to protect member value.

Chart 8: Customer-owned banking sector asset quality



Source: Moody's Mutual Outlook 2017, p. 10

[23] Moody's Mutual Outlook 2017, p. 9
[24] KPMG Mutuals Industry Review 2016, p. 7

Use of aggregation models to reach economies of scale

The customer-owned banking sector uses aggregation models to gain access to economies of scale and to larger networks and systems. The sector generally does this through service providers originally set up by credit unions and building societies. They allow customer-owned institutions to lower costs to provide economical access to services that they would not otherwise be able to access on an individual basis. Regulatory frameworks that enable aggregation are critical to the sector's ability to compete with the major banks. In addition, the customer-owned sector utilises broader partnerships to provide services members. For example, more than 50 of our members have a referral relationship with Bridges Financial Services to provide their customers with access to financial planning advice.

Examples of these aggregation models include Cuscal, Indue, ASL, Data Action and TAS. Cuscal, Indue and ASL are also all ADIs subject to regulation by APRA.

Cuscal
The complete payments partner

Cuscal is Australia's leading provider of end-to-end payments solutions and has over 100 clients from a range of industries. It also provides various transactional banking services. Cuscal's predecessor (Credit Union Services Corporation) was founded by credit unions in 1992 to provide a diverse range of services to the credit union sector. Cuscal remains largely owned by credit unions and mutual banks and its services allows clients to compete with the largest banks in Australia. Cuscal is a founding member in the New Payments Platform (NPP) and can provide Android Pay, Samsung Pay and Apple Pay access to its clients' customers.

indue

Indue was also established by credit unions and to provide a range of wholesale payment solutions and card products to its credit union customers. Its growing customer base now includes: mutual banks, mortgage originators, NGOs, gift card providers and government. Indue's core payment products include direct entry, BPAY, chequing, ATMs and EFTPOS. Indue is also founding member in the NPP.

ASL

ASL (Australian Settlements Limited) was formed in 1993 as a mutual organisation by building societies to provide settlement services and allow them to participate in the various financial sector clearing streams. Through the aggregation of members' transactions ASL is able to significantly reduce transaction costs associated with settling cheque, direct entry, scheme card, BPAY and other financial transactions. ASL is also a founding member in the NPP.

DA
DATA ACTION

Data Action was founded in 1986 as a cooperative by a group of credit unions. Data Action is an Adelaide-based technology services company that is unique in the market as a provider of both software solutions and hosted services. The majority of Data Action's clients are credit unions and mutual banks. Data Action deals with over 1 million banking customers and $25 billion in client assets.

TAS
managed services

TAS (Transaction Solutions) was established in 1989 by a group of credit unions to provide them with the information technology services needed to run their operations. Today, TAS services over 50 per cent of the customer owned banking sector by providing hosted services for critical applications such as core banking systems, collaboration platforms, websites and unified communications.

Customer-owned banks and financial technology

KPMG mLabs

The KPMG mLabs program was designed by KPMG to customer owned banking institutions and their members gain access to 14 leading fintech innovators. Hosted in KPMG's Sydney Office and fintech hub Stone & Chalk, the 12 week program provided the unique opportunity for fintechs to work with a number of like-minded mutuals to co-create products and apply new ways of thinking to their businesses.

Seven Australian mutual banks and credit unions participated in this program— Beyond Bank, CUA, Greater Bank, Heritage Bank, IMB Bank, Police Bank, and Teachers Mutual Bank. KPMG identified 18 qualified collaboration opportunities between the fintech and mutuals with 10 already happening as a result of this program.

Society One

Society One is a digital 'marketplace' lender that predominately provides consumer loans. Society One matches investors who would like to loan money with borrowers who receive different interest rates depending on their credit profile. Since 2012, Society One has connected more than $300 million in loans to customers. It now has ten mutual banks and credit unions among its 200 investor funders.

Amongst these funders, a number of customer-owned banks have also taken equity stakes in Society One: Beyond Bank, G&C Mutual Bank, Regional Australia Bank and Unity Bank. Society One's innovative product has won wider recognition winning the 2017 Innovative Retail Banking Product of the Year as well as Best Digital Offering award in 2016.[25]

Broad access to a multitude of digital wallet solutions

Many COBA members provide access to the full range of digital wallet solutions – Apple Pay[26], Android Pay[27] and Samsung Pay[28] through their partnership with Cuscal. Only one major bank, ANZ, provides a comparable digital wallet offering. Digital wallets allow customers to use their compatible Apple, Android or Samsung devices to pay anywhere where a contactless credit or debit card is accepted.

In addition, some COBA members have developed their own digital wallet solutions through their internet banking applications.

[25] Australian Retail Banking Awards
[26] Apple Pay participating banks and card issuers in Asia-Pacific, https://support.apple.com/en-au/HT206638
[27] Android Pay Participating Banks, https://www.android.com/intl/en_au/pay/participating-banks/
[28] Samsung Pay Banking Partners, http://www.samsung.com/au/apps/samsungpay/banking-partners/

Largest COBA members by assets

List of COBA members

Australian Military Bank	**Macquarie Credit Union**
B&E Personal Banking	**Maleny Credit Union**
Bank Australia	**MOVE**
Beyond Bank Australia	**My Credit Union**
Big Sky Building Society	**MyLife MyFinance**
Broken Hill Community Credit Union	**Nexus Mutual**
Cairns Penny Savings & Loans	**Northern Inland Credit Union**
CAPE Credit Union	**Nova Credit Union**
Central Coast Credit Union	**Orange Credit Union**
Central Murray Credit Union	**P&N Bank**
Central West Credit Union	**People's Choice Credit Union**
Coastline Credit Union	**Police Bank**
Community Alliance Credit Union	**Police Credit Union**
Community First Credit Union	**Pulse Credit Union**
Credit Union SA	**QBANK**
CUA	**QT Mutual Bank**
Dnister Ukrainian Credit Co-Operative	**Queensland Country Credit Union**
Family First Credit Union	**Queenslanders Credit Union**
FCCS	**Regional Australia Bank**
Fire Service Credit Union	**Select Encompass**
Firefighters Credit Union	**South West Slopes Credit Union**
First Choice Credit Union	**Southern Cross Credit Union**
First Option Credit Union	**South-West Credit Union Co-Operative**
G&C Mutual Bank	**Sydney Credit Union**
Gateway Credit Union	**Summerland Credit Union**
Goulburn Murray Credit Union	**Teachers Mutual Bank**
Greater Bank	**The Capricornian**
Heritage Bank	**The Mac**
Heritage Isle Credit Union	**The Mutual**
Holiday Coast Credit Union	**Traditional Credit Union**
Horizon Credit Union	**Transport Mutual Credit Union**
Hume Bank	**Unity Bank**
Hunter United Credit Union	**Victoria Teachers Mutual Bank**
IMB Bank	**Warwick Credit Union**
Laboratories Credit Union	**WAW Credit Union**
Lysaght Credit Union	**Woolworths Employees Credit Union**

Why a competitive banking market is important

A competitive banking market with a diverse range of competitors is important to ensure the best outcomes for consumers in terms of pricing, product and service quality and innovation.

The Financial System Inquiry said "competition and competitive markets are at the heart of the Inquiry's philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system's efficiency."[29]

> "Competition is the cornerstone of a well-functioning financial system and is generally preferred to Government intervention as the mechanism for efficient, resilient and fair outcomes. Policy makers and regulators should minimise barriers to domestic and international competition and seek to encourage competition," the FSI concluded.
>
> "Strong competition, both from new entrants and incumbents, encourages firms to innovate and increase operational efficiency to survive and prosper," the FSI said. "This can be seen in the ongoing industry focus on deploying new technologies in the Australian financial system to improve the quality and reduce the cost of products and services."

ASIC has noted that a lack of competition can contribute to to inappropriate conduct by firms, insufficient choice, limited access and poor quality financial products.[30]

There is a problem with competition in the banking market.

According to the House Economics Committee[31], Australia's banking sector is an oligopoly where the major banks have significant market power that they use to protect shareholders from regulatory and market developments.

> "Oligopolies are problematic when they are able to use pricing power to the detriment of consumers. Australia's banking system is such an oligopoly. Australia's four major banks have significant pricing power, higher than average returns on equity and large market shares," the Committee concluded.

This lack of competition has significant adverse consequences for the Australian economy and consumers, including

- issues around major banks being perceived as too-big-to-fail, such as moral hazard
- reduced incentives for the major banks to innovate and invest in new infrastructure, and
- scope for major banks to use pricing power to extract excess profits from consumers.

The Committee found that the major banks' have significant pricing power and have passed increased costs on to consumers. Three primary causes were identified to explain the lack of competition:

- the major banks' lower cost structures
- the sector's high barriers to entry, and
- consumer inertia.

The Government has endorsed the Committee's findings, with Treasurer Scott Morrison noting that: "This is not a situation the Government is willing to accept." [32]

[29] FSI Final Report: Executive Summary
[30] ASIC Corporate Plan 2017-18 to 2020-21, p. 9
[31] Review of the Four Major Banks, First Report, November 2016
[32] Second reading speech, Major Bank Levy Bill 30 May 2017

The Treasurer told Parliament in May 2017 that Australia's five largest banks are highly profitable and benefit from a regulatory system that has helped to embed their dominant position in the market.

> "For example, the major banks are accredited to use internal ratings-based models that allow them to reduce the amount of capital that they must hold, lowering their funding costs relative to the smaller banks who rely on standardised risk weights. They also contribute to systemic risk through their scale and concentration to the financial system – risks that ultimately fall on the broader Australian community."

Promoting a more competitive banking market does not require any dilution of financial safety or financial system stability.

This view was endorsed by APRA chair Wayne Byres in his opening statement to the PC at its June 2017 hearing:

> "It is sometimes asserted that there must be a trade-off between stability and competition in the financial system. That is not our view. Competition in the financial sector can bring welcome innovation and enhanced outcomes for customers, and good regulatory settings can deliver financially strong competitors, creating both financial stability and a dynamic and innovative marketplace for financial services. APRA's prudential framework has in mind the maintenance of sustainable competition: that is, competitors who are there for the long term – that is, both in good times and bad. The 2008 financial crisis revealed too many business models that only worked in the good times, and ceased to provide services to consumers when adversity arose. The long-term outcome has unfortunately been a more concentrated system."

COBA commissioned a report (attached to this submission) from consultancy firm Pegasus Economics to examine the interaction between competition and prudential regulation of the financial system, *Prudential Regulation & Competition: Never the Twain Shall Meet?* Key messages of the report include:

- Out of concern for stability, competition policy has not always been applied in the banking system.
- The interaction of the Global Financial Crisis combined with the implementation of the Basel II capital framework provided a major fillip to the major banks to the detriment of other ADIs.
- Concern that competition in the provision of financial services could lead to a situation where risk is underpriced and in turn institutions could fail with systemic consequences has given rise to the so-called "competition-fragility" view of banking whereby more competition erodes market power, decreases profit margins, and results in reduced franchise value – the market value of the banks beyond their book values.
    - Under the "competition-fragility" view of banking the accretion of market power is seen as desirable from standpoint of preserving stability in the financial system.
- There is anecdotal evidence to suggest Australian financial regulators are not immune from such attitudes.
- One solution to overcoming the "competition-fragility" view of banking to ensure that competition considerations are given due deliberation is to give APRA a statutory secondary competitive objective as has been adopted in the United Kingdom.

KEY POINTS:

- **A competitive banking market is important to ensure the best outcomes for consumers in terms of pricing, product and service quality and innovation.**

- **Major banks benefit from a regulatory system that has helped to embed their dominant position.**
- **The lack of competition has significant adverse consequences for the Australian economy and consumers.**
- **Promoting a more competitive banking market does not require any dilution of financial safety or financial system stability.**

Role of policymakers & regulators

Recommendation 1

Policymakers and regulators give greater consideration to the impact on competition of the regulatory compliance burden on smaller ADIs and ensure that regulation is targeted, proportionate, risk-based and, where possible, graduated.

The FSI found that there is a risk that regulators and policy makers will not place sufficient emphasis on competition when making decisions and that this is a significant issue given the:

- Extent of market concentration in some parts of the system, and its potential to limit competition in the future.
- Disproportionate effect that regulation can have on smaller firms.
- Potential benefits to the Australian economy of disruptive innovation from new market entrants in the financial system, and improved depth and international connectivity of financial markets from cross-border competition.

The FSI also noted that regulatory frameworks can impose significant barriers to the entry and growth of new players, especially those with business models that do not fit well within existing regulatory frameworks. The FSI further noted that unnecessary compliance costs and poor policy processes are a concern.

Regulation may or may not perfectly deliver the outcome sought, such as protecting consumers, but it invariably increases costs on regulated entities. The cost of regulation puts upward pressure on prices paid by consumers.

As observed by the FSI, the fixed costs of complying with regulation fall more heavily on smaller firms. This effect provides yet another advantage to the major banks because they can spread fixed regulatory compliance costs over a vastly bigger revenue base. Major banks can also afford to take more regulatory risk because they have the resources to manage this risk and contest the positions of regulators.

The steady, long-term trend of consolidation in the customer-owned banking sector is partly explained by the increasingly heavy regulatory compliance burden. While the smallest ADIs are forced to bear the highest relative costs, these institutions pose the smallest risks to financial system stability. Given the lower systemic risk that these institutions present (coupled with their prudent and risk averse culture), the regulatory burden should be lower for customer-owned ADIs than it is for the major banks.

Regulation should be tightly targeted, proportionate, risk-based and, where possible, graduated.

Accommodate different business models

Policy makers and regulators should be more accommodating of different business models to promote diversity and consumer choice. The Senate Economics Committee report[33] into *Cooperative, mutual and member owned firms* in March 2016 recommended that "that the co-operative and mutual sector be considered when the government is preparing a Regulatory Impact Statement that accompanies new regulatory policies." Such a measure

[33] Senate Economics Reference Committee Report into Cooperative, mutual and member-owned firms http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Cooperatives/Report

would provide impetus for policy makers and regulators to have a better understanding of different business models.

Decisions to impose new regulation should be coordinated and the cumulative impact should be assessed. Seen in isolation, a particular regulatory measure may appear relatively benign but the continual introduction of new measures can amount to death by a thousand cuts to smaller players in the market.

Principle 6 of the Government's Guide to Regulation[34] requires policy makers to consult with each other to avoid creating cumulative and overlapping regulatory burdens but it is unclear to what degree this consultation actually happens or whether it is effective.

Our sector, with its strong customer focus and good compliance culture, is being caught up in the backlash against the conduct and culture of the major banks. Regulatory responses to problems created by the major banks should be targeted at the major banks.

For example, the Government has announced as part of its response to the House Economics Committee inquiry into the major banks that it will legislate to implement a new Banking Executive Accountability Regime (BEAR). Treasury's consultation paper[35] on the BEAR notes the Committee's findings about the major banks' poor compliance culture and the major banks' repeated failure to protect the interests of consumers.

However, it is proposed that this regime should apply not just to the major banks but to all ADIs, even though:

- the BEAR will impose excessive red tape on smaller banking institutions
- no case has been made to apply the BEAR to smaller banking institutions
- smaller banking institutions are already effectively and proportionately regulated by APRA's prudential framework, and
- the prudential framework already includes standards covering many of the areas of the BEAR, including culture, remuneration and governance, risk management and requirement for responsible persons to be fit and proper.

In addition to the BEAR, the current regulatory reform schedule facing ADIs comprises dozens of new measures, including:

- new credit card rules
- new consumer credit insurance rules
- new breach reporting rules
- new product design and distribution obligations
- new product intervention power for ASIC
- new co-regulatory model for industry codes
- new external dispute resolution scheme
- new data breach notification requirements
- new reporting obligations about foreign tax residents
- changes to APRA's large exposures framework
- new statistical reporting obligations
- new 'open banking' regime, and
- mandatory participation in comprehensive credit reporting (CCR).

[34] The Australian Government Guide to Regulation, p. 2 https://www.cuttingredtape.gov.au/handbook/australian-government-guide-regulation
[35] Banking Executive Accountability Regime, Consultation Paper, July 2017 https://treasury.gov.au/consultation/c2017-t200667/

Materiality thresholds

In relation to open banking and mandatory CCR, depending on how these particular measures are implemented they could be strongly pro-competitive or they could impose further costly compliance burdens on smaller banking institutions.

Open banking has tremendous potential to empower consumers but forcing all banking institutions into an unrealistic implementation timetable would harm competition by imposing unacceptable costs on smaller banking institutions. In the UK, it is estimated that moving to 'open banking' will cost each institution around $1.7 million (£1 million).[36] Extrapolated across our sector that would amount to $144 million or nearly a third of our sector's total net profit after tax[37]. In the UK, the competition regulator announced a timetable for implementing 'open banking' for the largest banks which have a critical mass of the market. The UK competition regulator considered cost and proportionality and is taking a staged approach, with some measures being mandatory only for the largest banks. This approach avoids imposing unacceptable costs on smaller banking institutions while still delivering a more competitive market. In customer-owned banking institutions, these costs are ultimately borne by the consumer, either through less competitive pricing or through lower future investment.

Similarly, any regime mandating participation in CCR should have a materiality threshold. The big benefits from wider participation in CCR come from participation by the major banks. It would be counterproductive to force small credit providers to make the significant systems investments required to participate in CCR. For smaller credit providers, the cost of participating may out-weigh the benefits, at least initially. Over time there will be strong incentives to participate, so it is unnecessary to mandate participation for smaller banking institutions.

APRA's most recent Stakeholder Survey (2015)[38] of regulated institutions and knowledgeable observers found that the cost of compliance continued to receive by far the lowest score across regulated institutions and the view was reiterated by knowledgeable observers.

> "All items relating to the consultation process were rated positively except one. The item *Changes to APRA's prudential framework considers the costs of regulation imposed on industry* was again the lowest scoring item in the entire survey. The top 2 score for this item was 17.9%, while all other items achieved a top 2 score of 74% or higher—a good result for these other items," the Stakeholder Survey report said.

This underlines the continuing need to reduce costs, complexity and unanticipated negative implications associated with implementing regulatory change.

KEY POINTS:

- **The cost of regulation puts upward pressure on prices paid by consumers.**
- **The fixed costs of complying with regulation fall more heavily on smaller firms.**
- **The regulatory compliance burden provides yet another advantage to major banks because they can spread their costs over a vastly bigger revenue base.**
- **Regulation should be targeted, proportionate, risk-based and, where possible, graduated.**
- **All policymakers and regulators need to better recognize that regulation is an important factor in promoting or suppressing competition.**

[36] This £1 million per institution figure is from Fingleton Associates, Data Sharing and Open Data for Banks, 2014, p. 87.
[37] APRA's Quarterly ADI Performance indicators shows net profit after tax of $487.3m for mutual ADIs in FY2016-17
[38] APRA Stakeholder Survey – 2015 Regulated institutions and knowledgeable observers, Reporting of overall findings, June 2015http://www.apra.gov.au/AboutAPRA/Publications/Documents/ASR-2015-SS-RI-and-KO.pdf

Case for a 'secondary competition objective' for APRA

Recommendation 2

The Government introduce an explicit 'secondary competition objective' into APRA's legislative mandate, including with an accountability mechanism.

The FSI found that prudential regulators have a natural tendency to prioritise stability over competition and long-term efficiency. The FSI noted that the long-term benefits of competition can be potentially difficult to identify or value, while the short-term costs of instability are immediately visible to regulators, governments and the general public.

APRA's mandate is set out in the *Australian Prudential Regulatory Authority Act 1998:*

> "In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia."

This mandate makes it clear there APRA's priorities are financial safety and financial system stability. This is reflected in the APRA Chair's June 2017 opening statement to this PC Inquiry that APRA's prudential framework and activities necessarily focus in the first instance on financial safety and stability.

COBA does not disagree that this is APRA's primary purpose as a prudential regulator. However, the mandate outlines a number of other objectives—efficiency, competition, contestability and competitive neutrality that APRA must balance with financial safety in order to promote financial system stability. The relative importance of these four criteria is unclear aside from being 'less important' than financial stability and financial system stability.

There is question about whether all of APRA's 'other' objectives are created equal. Mr Byres' opening statement addressed this question:

> "APRA's prudential framework and activities necessarily focus in the first instance on financial safety and stability. APRA has no mandate to create or impose standards in relation to its 'balancing considerations' (that is, efficiency, competition, contestability and competitive neutrality). Rather, these balancing considerations are taken into account in designing and implementing our prudential requirements."

The current legislative mandate provides no indication of the relative importance of any of the considerations. In fact, even the order of these considerations is intriguing,[39] because on an alphabetical basis competition should be listed first. Arguably, a regulator could seek to interpret these 'considerations' as equal.

In a 2015 speech, the APRA chair reflected on the challenge for the regulator in considering and balancing the considerations.

[39] It appears that this ordering stems from the Wallis Inquiry Recommendation 34, i.e. that the prudential regulator's charter should emphasise the need to approach prudential regulation in a way that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality. Note innovation was replaced by 'contestability'.

> "Inevitably, this balancing act requires a considerable amount of judgement, and hence it will always be open to debate whether we have struck the right balance."[40]

It is clear to COBA that one of these 'balancing considerations' stands above the others—competition. There is not endless public debate about whether the financial system is 'efficient', 'competitively neutral' or 'contestable'.

Complacency about competition

The FSI found there was complacency about competition among regulators and that the regulatory framework does not systematically identify and address competition trade-offs in regulatory settings.

The FSI Interim report examined a number of proposals to strengthen the regulator focus on competition, including appointing an additional APRA member to focus on competition and giving the ACCC exclusive responsibility for competition matters (i.e. remove it from APRA's mandate). While the Inquiry's Final report rejected both options, the underlying rationales for these decisions raise some interesting points.

In rejecting the first option, the FSI noted that "strengthening consideration of competition issues as part of ordinary regulatory processes was likely to have more effect than appointing a separate competition member." COBA agrees that APRA must consider competition issues as part of ordinary regulatory processes. The question is how to institutionalise this in a way that ensures that it becomes embedded in the regulator culture in an accountable manner?

In rejecting the second option, the FSI noted that this would be counterproductive because it would reduce pressure on regulators to consider these issues. This observation is important recognition of the impact that the 'non-competition' regulators have on the competitive outcomes in the financial sector.

The FSI recommended that, through their annual reports, regulators should demonstrate that they have given explicit consideration to trade-offs between competition and other regulatory objectives when designing regulations.

APRA has recently revamped the format and content of its consultation papers to address competition and the other considerations. These documents now include a table outlining APRA's thoughts about how its proposal fulfils its 'primary' objectives (financial safety and stability) and 'other considerations' (efficiency, competition, contestability and competitive neutrality).

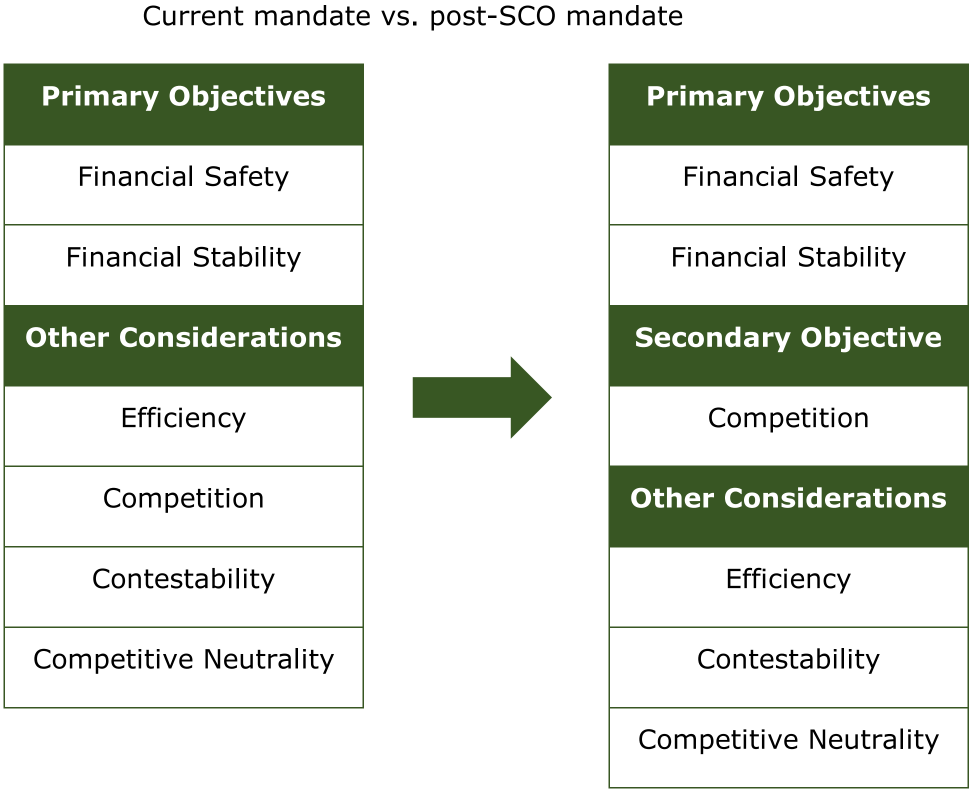
COBA believes that this is a welcome step towards greater regulatory accountability for considering and reporting on the impact on competition of particular regulator proposals.

However, a more effective approach is to change APRA's legislated mandate to introduce an explicit 'secondary competition objective' (SCO).

As noted above, the need for a solution such as a statutory SCO for APRA is discussed in an independent report commissioned by COBA from consultancy firm Pegasus Economics. The report, *Prudential Regulation & Competition: Never the Twain Shall Meet?*, is attached to this submission.

[40] Wayne Byres 2015 speech to AFR Banking & Wealth Summit: 'Achieving a stable and competitive financial system' http://www.apra.gov.au/Speeches/Pages/Achieving-a-stable-and-competitive-financial-system.aspx

Figure 1: Visual representation of a Secondary Competition Objective



An SCO would raise the relative 'priority' of competition compared to APRA's 'other considerations'. The SCO will remain secondary to APRA's primary responsibilities of financial stability and safety. The SCO would include reporting obligations to ensure accountability against the objective.

An SCO would formalise the relative 'prioritisation' of competition and ensure that it becomes ingrained into APRA's day-to-day regulatory processes. It would ensure that the recent focus on competition is not a passing fad but a constant imperative.

The SCO would allow APRA to be more proactive about considering competition, noting that it is no longer balanced alongside efficiency, competitive neutrality and contestability.

We do not doubt that APRA already gives some consideration to competition but we judge this to be inadequate and inconsistent. See below a number of examples of APRA's failure to give due consideration of competition impacts.

UK PRA's secondary competition objective

It is interesting to compare APRA's current obligation to 'balance' the consideration of competition with the requirement (since replaced with an SCO) imposed on its UK peer regulator (PRA) to 'have regard to the need to minimise any adverse effect on competition in the relevant markets that may result from its prudential policy to competition.'

A 2013 UK inquiry, the Parliamentary Commission on Banking Standards (PCBS) [41], concluded that:

> "A 'have regard' to competition simply does not go nearly far enough. As the experience of the FSA shows, a 'have regard' duty in practice means no regard at all. With only a 'have regard' duty given to the PRA, the risk is high that it will neglect competition considerations. This would be of great concern, given the potential for prudential requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants. The current legislation strikes an inadequate balance in this area."

The UK Government agreed with the PCBS recommendation, committing to introduce an amendment to provide the PRA with an SCO. [42] The PRA's SCO subsequently came into force in March 2014. The SCO requires that when making policy in pursuit of its primary objectives of safety and soundness and insurance policyholder protection, the PRA does so in a way that facilitates effective competition, as far as reasonably possible.

A 2016 evaluation of the PRA's approach to its SCO by the Bank of England's Independent Evaluation Office (IEO) [43] found that this new statutory duty has "necessitated a material change of gear."

> "Competition is gaining airtime and traction at all levels of the PRA, and there are numerous instances where competition considerations have influenced policy outcomes. While those developments are encouraging, there remains the need to ensure that the requisite cultural shift has taken root throughout the institution. This is fully recognised by the PRA's management team, who have set in train a number of initiatives accordingly. Delivering lasting cultural change is a challenge in all organisations. The IEO's recommendations therefore seek to build on the efforts of the PRA's management to ensure that the institution is embedding an appropriately proactive and positive approach towards its duties to facilitate competition."

The PRA has now produced two annual competition reports (2016[44] & 2017[45]) outlining implementation of the SCO and reflecting on how the PRA's primary and secondary objectives align.

An SCO does not means that APRA would have to sacrifice its other objectives in pursuit of a more competitive environment. The SCO would mean that the APRA should consider (but is not necessarily required to adopt) those options which deliver greater benefits to competition.

We note that the PC has already considered the question of changing regulator mandates to improve the focus on competition. In its March 2017 report on *Data Availability and Use*,[46] the PC notes that APRA is required to consider competition and contestability in its decisions, although its industry-specific frameworks do not adopt a consistent approach to competition.

> "Building consistent pro-competition provisions into the mandates of Australia's financial sector regulators would help to ensure that regulators keep a firm focus on market access, not least when reviewing and revising regulations (although competition objectives would still need to be balanced with systemic stability)."

[41] Changing banking for good - Parliamentary Commission on Banking Standards, 2013, Conclusions and recommendations, para 212, https://publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2704.htm
[42] UK Financial Services (Banking Reform) Act 2013, section 130, http://www.legislation.gov.uk/ukpga/2012/21/section/6/enacted
[43] Bank of England Independent Evaluation Office, Evaluating the PRA's approach to its Secondary Competition Objective, March 2016, http://www.bankofengland.co.uk/about/Documents/ieo/evaluation0316.pdf
[44] PRA Annual Competition Report 2016, http://www.bankofengland.co.uk/publications/Documents/annualreport/2016/compreport.pdf
[45] PRA Annual Competition Report 2017, http://www.bankofengland.co.uk/publications/Documents/annualreport/2017/compreport.pdf
[46] PC, 2016, Report into Data Availability and Use, p. 552

KEY POINTS:

- **APRA does consider competition and its performance in this regard has improved since the Financial System Inquiry but there are multiple examples of where APRA has failed to give enough consideration to the impact on competition.**
- **APRA's legislative mandate needs to be changed to introduce an explicit 'secondary competition objective' (SCO).**
- **An 'SCO' does not mean APRA would have to sacrifice its other objectives in pursuit of a more competitive environment but would be more accountable about its approach to competition.**
- **APRA's peer regulator in the UK, the PRA, was given an SCO in 2014 and the outcome is a "material change of gear" where "competition is gaining airtime and traction at all levels" and "there are numerous instances where competition considerations have influenced policy outcomes."**

Examples of APRA's failure to give due consideration of competition impacts

Example 1: 'Too big to fail' implicit guarantee for major banks

Major banks benefit from an unfair funding cost advantage due to the perception they are 'too big to fail'. This perception leads to a higher credit ratings and therefore lower debt funding costs.

The FSI recommended action against this problem with the objective of reducing perceptions that some banks are subject to an implicit Government guarantee in order to lessen market distortions created by this perception and improve competition in the banking sector.

The Government agreed that steps should be taken to reduce any implicit government guarantee and the perception that some banks are too big to fail. The Government endorsed APRA as Australia's prudential regulator to implement this recommendation in line with emerging international practice.

APRA's chair told the House Economics Committee in October 2016 that work is underway behind the scenes on a response to the FSI's 2014 recommendation (FSI Recommendation 3).

> "We are thinking about it, and we have been in discussions with the other regulators within the Council of Financial Regulators—Treasury, the RBA, ASIC—on a possible design of this regime in an Australian context. The origins of the concept of loss-absorbing capacity come from the Financial Stability Board recommendation that is being applied to all the global systemically important banks. None of our banks are regarded as globally systemically important, so we are not obliged to implement that regime. But the FSI said that the concept is a good idea and we should think about it in Australia. The FSI also said, 'Don't get ahead of the rest of the world in implementing this'. So we are working behind the scenes but the rest of the world is still thinking about how to implement it, so we are not going to get ahead of the rest of the world."

COBA's view is that if APRA was more concerned about competition if would act with greater urgency.

The distorting impact on competition of the implicit guarantee is getting worse. Credit ratings agency Standard & Poor's (S&P) in May 2017 lowered credit ratings for almost all ADIs including the major banks based on concerns about economic imbalances due to strong growth in private sector debt and residential property prices. S&P simultaneously increased the uplift factor it applies to major banks based on the implicit guarantee by one notch. Such is the distorting impact of the implicit guarantee that the four institutions that dominate the market and drive system-wide risk were able to escape the 'price' of a ratings downgrade prompted by S&P's concerns about system-wide risk.

Commenting on the S&P announcement, Treasurer Scott Morrison estimated the funding cost advantage enjoyed by the major banks to be 20 to 40 basis points.

> "Today that advantage was recognised by Standard & Poor's. It is true that the four major banks and Macquarie Bank were all able to preserve their rating from Standard & Poor's because of the very special place that they hold within our regulatory system. Sadly for those regional banks who do not benefit from that privileged position, they did not get that support from the ratings agencies."

An immediate option available to APRA to reduce the distorting impact of the implicit guarantee is to increase the capital surcharge it applies to the four major banks due to their status as Domestic Systemically Important Banks (D-SIBs). The D-SIB capital surcharge is 1 per cent, at the low end of the international range of such surcharges which can be as high as 6 per cent.

An SCO would allow for greater APRA consideration of measures to address the competitive impacts of 'too big to fail', for example, through its D-SIB mechanism or accelerating development of its total loss absorbing capital framework.

Example 2: The gap in mortgage risk weights

The FSI was critical of the large gap in mortgage risk weights between smaller 'standardised' ADIs and the major banks using the internal ratings based (IRB) methodology. Risk weights determine how much regulatory capital an ADI must hold against an exposure in order to absorb losses.

> "In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another."
>
> "The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks. Because equity is a more expensive funding source than debt, this translates into a funding cost advantage for IRB banks' mortgage businesses to the extent that the riskiness of mortgage portfolios is similar across banks. Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of smaller ADIs will harm competition in the long run."

APRA initially defended its risk weight settings, saying it did not "see any compelling reasons to depart from the Basel II capital framework, now well-established globally, to seek to deal with residual competition issues in housing lending."[47]

Once the FSI recommended that the average IRB risk weight should be increased from 18 per cent to between 25 and 30 per cent, APRA responded by requiring an average risk weight at the bottom end of this range, i.e. 25 per cent. The average risk weight for standardised institutions was 39 per cent.

[47] APRA's Submission the 2014 FSI, http://www.apra.gov.au/Submissions/Pages/14_01.aspx

In this context, we note that the FSI found that some ADIs will not use the IRB approach, because it may not be cost effective for smaller institutions and the gap between IRB and standardised mortgage risk weights should be closed to improve competitive neutrality, regardless of any assistance provided to help with IRB accreditation. Such an approach would reflect the Basel Committee's intention that "standardised approaches constitute a suitable alternative and complement to internal models".[48]

While APRA has made some progress to increase the average mortgage risk weight, there is still a significant gap in certain types of low risk loans. Under the standardised approach, the minimum mortgage risk weight is 35 per cent. However, according to major banks' disclosures, their lowest risk mortgage categories have average risk weights between 5 to 10 per cent. This provides a significant advantage for IRB banks in the 'low risk' market and these exposures account for 17 to 33 per cent of their total mortgage books.[49]

The presence of an SCO would have led to APRA having a greater focus on narrowing the gap between IRB and standardised risk weights (without having to be prompted by the FSI) and greater consideration on the large risk weight differences for individual exposures.

Example 3: Investor lending cap

APRA introduced a 10 per cent growth cap as a macro-prudential measure to limit investor lending credit growth in December 2014.

The design of this blunt instrument benefits banks that expanded their investor lending most aggressively before the cap was applied and banks who already had large investor lending portfolios in actual and proportionate terms. It had the effect of freezing market shares and rewarding banks whose behaviour led to the intervention.

Customer-owned banking institutions have a lower proportion of their book as investor loans compared to major banks. Major banks' portfolios had 40 per cent of their mortgage books as investor lending compared to only 23 per cent for customer owned banking institutions.[50] Our sector held investor lending portfolios of around $15 billion at December 2014 compared to over $400 billion for the major banks,[51] highlighting that growth of investor lending by our sector at even a very high rate is unlikely to have a systemically significant impact. A more flexible 15 per cent limit on customer-owned institutions, for example, would have allowed our sector to prudently gain some market share in this sector with no negative macro-prudential impact.

In the 6 months after the cap was announced, major banks grew their investor lending books by around 13 per cent while our sector's growth rate was around 7 per cent. The fact the major banks were so easily able to reprice their investor lending backbooks demonstrates that this measure has undermined competition. Smaller banking institutions were prevented from competing for existing borrowers wanting to refinance when hit with higher rates by the major banks. This is despite refinancing not actually increasing the level of investor lending in the system.

The cap has restricted customer owned banking institutions' ability to run their business and consequently deliver value to their customers. Customer owned banking institutions seeking to grow investor lending books in line with a board-approved and considered risk appetite cannot do so. Several COBA member institutions have had to turn away valued members from their investor lending products.

[48] BCBS 2015 Revisions to the standardised approach for credit risk, http://www.bis.org/bcbs/publ/d307.pdf
[49] See APS 330 disclosures for the major banks
[50] COBA estimates based on APRA's Quarterly Property Exposures and APRA's Monthly Banking Statistics
[51] As footnote 23

The cap is designed as a macro-prudential measure and the micro-prudential problem of poor lending standards has been alleviated by APRA's action to tighten rules around mortgage lending. Imposing the growth cap on smaller financial institutions with strong lending standards has no impact on macro-prudential outcomes but does harm competition.

This is highlighted by the KPMG Mutuals Industry Review 2016 which notes that:

> "A graduated approach to the lending cap across ADIs will provide an improved regulatory setting that is fairer for smaller players and more in line with best practice, whilst still reinforcing sound residential lending."

An SCO would have led APRA to consider the disproportionate impacts on smaller lenders when setting its macro-prudential measures and potential remedies, for example, through the use of graduated approaches or minimum thresholds. APRA would also be more accountable against any decisions to not take such approaches.

Example 4: CET1 capital instrument for mutual ADIs

COBA is currently engaging positively with APRA about capacity for mutual ADIs to issue capital instruments that qualify as the highest quality form or regulatory capital, Common Equity Tier 1 (CET1). This is a very welcome development and we appreciate APRA's commitment to delivering greater flexibility for mutual ADIs in their capital management.

However, capacity to issue CET1 instruments consistent with our customer owned model is well overdue. Prior to the implementation of the Basel III capital regime in 2012, mutual ADIs could and did issue capital instruments that qualified as the highest quality form of regulatory capital.

Listed banks regularly issue CET1 capital instruments, and it is important that mutual ADIs also have the capacity to do so while preserving their mutual model. Having the option to raise capital in addition to retained earnings allows for more ambitious growth targets, diversifies funding options and provides capacity to seize acquisition opportunities and invest in technology and innovation.

In terms of accommodating mutual banking institutions under Basel III, APRA's prudential framework has fallen behind comparable jurisdictions, i.e. Europe and the UK, where mutual banking institutions have been given capacity to issue CET1 instruments.

In August 2012, APRA's then head of policy Charles Littrell acknowledged that the Basel III rules on capital (designed to apply to internationally active banks) and the link to ordinary shares "does not work particularly well for mutuals." Mr Littrell told the Senate Economics Committee that APRA was working with COBA and that: "We will come up with something that will not necessarily be received joyfully but will achieve the outcome."

In November 2012 the Senate Economics Committee recommended that: "APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed."

APRA subsequently amended the prudential framework to facilitate issuance by mutuals of capital instruments qualifying as 'Additional Tier 1' and 'Tier 2' but did not allow direct issuance of capital instruments for mutuals that qualify as CET1.

In February 2016, Mr Littrell's successor Pat Brennan appeared before Senate Mutuals Inquiry and said that the 'mutual equity interest' conversion option for AT1 and T2 instruments was "our attempt to accommodate the mutuals within the capital framework." Mr Brennan described it as an "interim" measure and conceded: "It is not necessarily easy to use." Mr Brennan also conceded that some overseas jurisdictions "have found a way to accommodate the mutuals in ways that APRA has not."

In March 2016, the Senate Economics Committee recommended that: "APRA set a target date for the outcome of discussions with the co-operative and mutuals sector on issues of capital raising and bring those discussions to a timely conclusion."

As noted above, COBA is optimistic that this issue is close to resolution but it is regrettable that it has taken so long. An SCO would likely have significantly accelerated this process.

Example 5: Use of 'banking'

APRA in August 2015 issued a legislative instrument banning credit unions and building societies from using the term 'banking' in a 'registered corporate, business or trading name or internet domain name.'

For COBA and its member credit unions and building societies, this was a baffling call by the regulator with the potential to undermine competition and competitive neutrality in the banking sector. Given that the business of credit unions and building societies is 'banking', it made little sense to limit and restrict the way they use the term.

All ADIs, whether they trade as banks, building societies or credit unions, are authorised to engage in banking business. Banking Act section 66 restrictions on use of terms such as 'banking' by non-ADIs are meant to ensure potential customers are not misled into believing that such institutions have the same level of capital adequacy, depositor-priority and other prudential requirements that apply to ADIs. No-one is misled by a banking institution calling itself a banking institution.

COBA's 14 August 2015 media statement said: "This proposal by APRA came out of the blue two years ago and was strongly opposed by our sector and supported by no-one. Now it has been introduced with a new legislative instrument and without a Regulation Impact Statement."

An SCO and corresponding reporting obligation would have led to more transparency about APRA's decision making in this particular instance.

COBA expects this issue will be resolved with implementation of the Government's 2017-18 Budget announcement about future use of the term 'bank', i.e. that the prohibition on the term 'bank' by ADIs with less than $50 million in capital will be lifted by legislation to allow them to benefit from the reputational advantages of the term.

Demand-side competition - Empowering Consumers

Recommendation 3

Interventions are needed to empower consumers to switch between banking products but interventions to promote switching should be cost-effective and based on rigorous market studies of banking product markets and consumer behaviour.

While regulatory decisions play an important point in limiting or promoting supply side competition, consumers also play an important role in driving competition. They can do this by comparing different products and switching to the one that is the best value for them. This forces firms to innovate and provide sufficient value to ensure that the consumer is receiving the most appropriate product for their situation. For consumers to be able to do this they must be able to access and act on the right information to make informed choices.

The decision to switch products can be framed as a simple economic decision. If the benefits of switching exceed the costs of switching then the customer will switch. In simple terms, the benefits of switching could be financial savings or improved services. The costs could be search costs and the implicit and explicit costs of switching.

In order to drive competition, consumers must:

- have the awareness to consider it worthwhile to change their financial product provider
- be willing and able to access information about products available in the market
- be able to assess the products available to identify which product provides the best value for them, and
- be willing and able to act by switching to their preferred product.

Customer-owned banking institutions offer the full range of retail banking products and services, including highly competitive home loans, credit cards, personal loans and deposit products. Many of these products are market leading and award winning so the providers of these products strongly support cost effective measures to empower consumers to switch.

As noted by the House Economics Committee inquiry into the major banks, customer inertia limits effective competition.

Factors that affect customers' awareness and capacity to switch include the lack of natural trigger points to look around and the perception that the benefit of switching is minor, particularly compared to the costs. Consumers may simply lack awareness about the range of providers and offerings. In the Australian retail banking market, the major banks and their sub-brands dominate the picture.

Other barriers to switching include difficulty of searching and consumers' inability to:

- compare products on an apples for apples basis
- tell which 'features' would benefit them the most, and
- overcome inherent bias in choosing products (e.g. ignoring credit card interest rates because they assume they will never pay interest).

Across different products, different friction points arise.

Buying a home is, for most people, by far their largest single expenditure item. The sheer size of a home loan means that even a relatively small difference in the interest rate can make a significant difference over the life of the loan. However, many consumers perceive that switching to a new home loan is too difficult. Research[52] for COBA published in February this year found:

- more than one-third of people say they haven't switched because the process is painful, and
- one in five gave the reason of paperwork or it not being worth the effort.

On the other hand, there is a high level of home loan switching. The same poll revealed 36 per cent of people say are they are fairly/very likely to change home loans in the next 12 months. It is estimated that the average home loan borrower changes their loan every four to five years[53]. A KPMG survey found that "sixty one percent of respondents renegotiate their home loan at least once every 5 years"[54].

Mortgage Brokers

Mortgage brokers play an increasingly important role in assisting consumers to find or switch to the right home loan.

ASIC'S March 2017 report[55] *Review of mortgage broker remuneration* put forward a number of proposals to improve consumer outcomes and competition. Representatives from the mortgage industry (including COBA) are jointly developing the industry's response to ASIC's report with the objective of providing an initial response to Treasury, ASIC and industry in November 2017.

ASIC found consumers who use brokers are different to consumers who go directly to lenders. Consumers going through a broker tended to be younger by about two years and have incomes that were around $6,000 lower. ASIC also found that competition in the home loan market is affected by ownership and the limited ability of some lenders to access and remunerate brokers. ASIC proposed that participants in the industry more clearly disclose their ownership structures. ASIC identified conflicts of interest arising from vertical integration in mortgage broking, noting that for the two major banks that own intermediary channels, there is a significant increase in the proportion of loans (including white label loans) being written to those banks through these channels compared to the banks' general market share.[56]

In relation to credit cards, the benefits of switching from a high rate card to a low rate card can be significant, particularly for customers who carry credit card debt. Treasury[57] notes that "of all those cardholders that pay interest on a recurring basis (across all income groups), three-quarters use a standard, gold, platinum or super premium card that have a high interest rate rather than a low interest rate card". While these high rate cards may be appropriate for some users, they probably don't suit those who are incurring interest on their balances. According to the RBA, Australia has $31.5 billion in credit card debt that is attracting interest.[58] While not all this debt will be on high rate cards, there is a significant interest saving if consumers switched to low rate customer-owning banking cards.

[52] COBA media release, Australians say process to switch banks is too painful, 14 February 2017 http://www.customerownedbanking.asn.au/media-a-resources/media-release-alerts/1225-australians-say-process-to-switch-banks-is-too-painful-
[53] https://www.aussie.com.au/blog/dear-john-how-often-should-i-refinance-my-home-loan/
[54] KPMG, 2017, The Australian Home Loan market https://assets.kpmg.com/content/dam/kpmg/au/pdf/2017/australian-home-loan-market-survey-analysis-may-2017.pdf
[55] http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-516-review-of-mortgage-broker-remuneration/
[56] ASIC opening statement to PC inquiry, 29 June 2017, Peter Kell, Deputy Chairman
[57] Credit Cards: Improving consumer outcomes and enhancing competition, May 2016, Australian Government
[58] RBA July 2017 C1 Credit and Charge Card Statistics, Balances accruing interest

Treasury noted that many consumers optimistically (and often mistakenly) believe at the time that they apply for a card that they will always pay off the balance by the end of each statement period and, hence, that the rate of interest charged on a card is not a relevant consideration. Consumer polling[59] for COBA by Essential Research published in January 2015 shows that half the population doesn't know what they're paying in interest on their credit cards and two-thirds of people don't know who offers the lowest credit card interest rates.

NPP to reduce barriers to transaction account switching

In relation to transaction accounts, the House Economics Committee found that existing switching tools for transaction accounts "have failed." The Government has accepted the Committee's recommendation that, following the introduction of the New Payments Platform (NPP), the Government should consider whether additional account switching tools are required to improve competition in the banking sector. The Government will "consider account switching issues further once the NPP is in place and well established."

Based on low use of the switching process, the Committee appears to have assumed that it is the process itself that is the main barrier. It may be other factors that are more important, such as whether consumers believe there are better deals available.

The existing account switching regime was an outcome of the 2011 report *Banking Services Switching Arrangements*[60] which examined the following questions:

- are the obstacles to switching a major barrier to customers pursuing their desired banking relationships?
- would easier switching arrangements contribute to increased competition among financial institutions and deliver worthwhile benefits to customers?
- can easier switching arrangements be implemented at modest cost to industry and with zero or negligible flow-on charges to customers?

Subject to 'limited' data, the report found that avenues for switching banking products (most notably transaction accounts) "can involve hassles which are likely to discourage some potential switchers, but large numbers of switchers are able to get the job done." The report concluded that customers who are sufficiently motivated to switch find it reasonably easy to do so, and that the problems encountered by others may have more to do with motivation and perceptions, rather than real barriers.

The report also found that switching arrangements "hardly rank as a major direct driver of competition in the market for banking services, but they are relevant to facilitating access by customers to the benefits of increased competition arising from innovations, and other sources."

On the basis of these findings, the report suggested that any new arrangements for easier switching "should come with modest price tags."

COBA endorses this approach and the observation in the report about transaction accounts that compared with the often substantial gains to be had from switching home loans or term deposits the potential gains from switching transaction accounts would not loom nearly as large for most customers.

The House Economics Committee expects the NPP will spur competition by simplifying the switching process.

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[59] COBA media release, New poll shows Christmas gift giving could be costing Australians more than we think, 28 January 2015 http://www.customerownedbanking.asn.au/view-2015-media-releases/1106-new-poll-shows-christmas-gift-giving-could-be-costing-australians-more-than-we-think

[60] Australian Government, 2011, Banking services: cost-effective switching arrangementshttps://banking.treasury.gov.au/content/reports/switching/downloads/switchingarrangements_aug2011.pdf

NAB told the Committee that the NPP will significantly enhance the ability of customers to switch between banks.[61] Customers will have a unique account identifier which will enable them to link a unique piece of data (e.g. their email address, mobile number or ABN) to their preferred bank account.

The NPP's website notes that "while the NPP has not been designed to support account switching, it does empower consumers to redirect payments to other accounts through a simple and safe process".

COBA members look forward to offering their customers the benefits of the NPP. The three main commercial services providers to the customer owned banking sector, Cuscal, Indue and Australian Settlements Limited, are all initial participants in the NPP on behalf of our sector.

Commencement of the NPP, along with implementation of an Open Banking regime, could significantly lower barriers to switching. The Treasurer says Open Banking has the potential to transform the way in which Australians interact with the banking system because it will allow consumers to seek out products that better suit their circumstances, saving them money and allowing them to better achieve their financial goals.[62]

Solutions must be cost effective

As noted earlier in this submission, COBA agrees that Open Banking has tremendous potential to empower consumers but forcing all banking institutions into an unrealistic implementation timetable would harm competition by imposing unacceptable costs on smaller banking institutions.

There is no single magic bullet solution to promoting switching.

The owner and operator of the UK Current Account Switching Service (CASS) has examined the potential impact Open Banking may have on the market, particularly around how consumers can compare offerings from different providers. The research indicates that new applications using Open APIs are not enough to see significant movement from customers as their direct effect in enabling consumers to make more rational, informed decisions about their current account is not sufficient to drive significant increases in switching or consideration.

> "It is only when all actors on the supply-side are working together to lower the perceived barriers to switching, whilst driving the creation of innovative and competitive current account products, that the model shows significant increases of consideration and switching. In other words, whilst Open Banking will make it easier to search, customers will not switch unless there is a greater incentive to do so and it is down to the providers to drive that change by developing and marketing new products that are tailored to consumer need at the optimum price."[63]

Further research by the CASS operator looked at the impact of account number portability (ANP) in the UK market and found that the launch of ANP would have a minor and transitory impact on switching volumes.

> "This analysis suggests that the high level of investment required to implement ANP might have an adverse effect through diverting resources from investment in products and services, leading to a less competitive market. The conclusion from this analysis is

[61] NAB response to question on notice
[62] Treasurer media release, Empowering consumers through open banking, 20 July 2017 http://sjm.ministers.treasury.gov.au/media-release/065-2017/
[63] BACS, 2017, What constitutes an effective and competitive current account market? https://www.bacs.co.uk/documentlibrary/cass_switch_report_4_apr17.pdf

> that without perpetual product innovation and promotion no amount of facilitating ease of switching will be enough to sustain an effective market."[64]

These findings underline the need for research in the Australian market about the barriers to switching and a rigorous analysis of the cost effectiveness of proposed solutions.

ASIC's UK peer the Financial Conduct Authority (FCA) carries out holistic, evidence-based market studies of how markets work and whether they could work better. These studies integrate behavioural economics to design and test interventions that will be effective. The FCA does not necessarily regard high switching rates as an ideal outcome and switching rates need to be considered alongside other evidence.

In relation to the home loan market, the FCA has identified behavioural biases[65] that can cause people to misjudge important facts or to be inconsistent. The FCA says choosing a mortgage product is particularly prone to behavioural biases. Mortgage products are complex for most people: like other financial products, mortgages are abstract and intangible and often have many features and complex charging structures. Faced with complexity, consumers can simplify decisions in ways that lead to errors, such as focusing only on headline rates

The FCA's current market study on competition in the UK mortgage sector is exploring how, at each stage of the consumer journey, the available tools (including advice) help mortgage consumers make effective decisions.

COBA supports well considered and cost-effective measures to empower consumers to drive competition. We welcome the Government's decisions to resource the ACCC to establish a dedicated Financial Services Unit to undertake regular in-depth inquiries into competition issues in the financial system.

Implementation of a competition mandate for ASIC could allow for the application of findings from behavioural economics to the regulatory framework in ways that promote competition in markets such as the credit card market. ASIC has noted that behavioural economics is particularly relevant to the selection and use of credit cards because consumer choice can be driven by behavioural biases and is made more difficult by the complexity of the products.

> "Credit cards are at least two products in one—a non-cash payment facility and a credit facility, plus a means of withdrawing cash. They are also often bundled and marketed with other financial products (such as insurance) and loyalty points, which make it more difficult for consumers to separate the price and value to them of each feature. This is particularly the case when some of the costs and benefits are immediate and others are realised in the future."[66]

The Government responded positively to the FSI recommendation that it include consideration of competition in ASIC's mandate: "We support inclusion of competition in ASIC's mandate and we will develop legislation to introduce an explicit reference to consideration of competition in ASIC's mandate in the second half of 2016."[67]

According to ASIC, an explicit competition mandate "will ensure we have a clear basis to consider and promote competition in our regulatory decision making."[68]

COBA recommends rigorous market studies of retail banking product markets, taking into account consumer behaviour and behavioural biases, to identify the barriers to switching and to design interventions to reduce these barriers in the most cost-effective way. We recommend clarity of responsibility between the ACCC and ASIC for carrying out market studies and designing interventions to promote switching.

64 https://www.bacs.co.uk/documentlibrary/cass_switch_report_1_nov.pdf
65 https://www.fca.org.uk/publication/feedback/fs16-03.pdf
66 ASIC submission to Senate Economics Committee inquiry into credit cards, August 2015
67 https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/
68 ASIC opening statement to PC inquiry, 29 June 2017, Peter Kell, Deputy Chairman

KEY POINTS:

- **Consumers play an important role in driving competition by comparing different products and switching to the one that is the best value for them.**
- **Customer inertia limits effective competition.**
- **Across different products, different friction points arise and there is no single magic bullet solution to promoting switching.**
- **Interventions to promote switching should be cost-effective and based on rigorous market studies of banking product markets and consumer behaviour.**

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Appendix 1: Pegasus Economics Report - *Prudential Regulation & Competition: Never the Twain shall Meet?*

Pegasus
Economics

2017

Prudential Regulation & Competition: Never the Twain shall Meet?

Dr Alistair Davey

September 2017
7/31/2017

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Pegasus Economics is a boutique economics and public policy consultancy firm that specialises in strategy and policy advice, economic analysis, trade practices, competition policy, regulatory instruments, accounting, financial management and organisation development.

This report has been commissioned by the Customer Owned Banking Association (COBA) to examine the interaction between competition and prudential regulation of the financial system.

The views and opinions expressed in this report are those of the author.

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Key Messages

Nature of Risk in the Australian Financial System

- The high level of concentration within the Australian banking sector has exacerbated the problem of systemic risk within the Australian financial system.
- High levels of concentration within the Australian banking system also poses a risk to competition in the provision of financial services as warned by the final report of the Financial System Inquiry (Murray Report) (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 255).
- Another risk is the concentration risk in a financial institution's portfolio.
    - This risk arises from an excessive exposure to a single sector or to several highly correlated sectors (i.e. 'sector concentration') as well as from an excessive exposure to certain names (which is often referred to as 'name concentration' or 'granularity') (Düllmann & Masschelein, 2006).
- Investor owned banks have excessive incentives to take risk in the presence of limited liability for their shareholders and also for managers due to contracts that limit their downside and moral hazard due to nonobservable risk positions on the asset side (Vives, 2016).

Fragility in Banking and Regulation

- Banking is not like any other industry; it has important characteristics that make it heavily regulated and subject to public intervention (Vives, 2016).
- The most common form of preventative financial safety regulation is prudential regulation (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 194).
    - Prudential regulation involves the imposition of prescriptive rules or standards governing the prudential behaviour of institutions making certain types of promises.
- Prudential regulation has been designed to provide the banking and financial systems with stability, to avoid the negative effects associated with failing institutions and systemic crises, as well as to protect small deposit holders/investors due to asymmetric information problems (Vives, 2016).
    - The Australian Prudential Regulation Authority (APRA) is responsible for prudential supervision of the Australian financial system.
- "Capital" is one of the most important concepts in banking (Elliott, 2010, p. 3). In its simplest form, capital represents the portion of a bank's assets which have no associated contractual commitment for repayment.
    - A bank's capital essentially represents its ability to withstand losses without becoming insolvent (Gorajek & Turner, 2010, p. 43).

Competition and Banking

- Competition is a process of rivalry between firms, each seeking to win customer's business. The primary objective of competition policy is to promote economic efficiency which in turn boosts and stimulates economic growth.
- For merchants the retail price of a product they charge is brought into some kind of relationship with cost through the competitive process (Adelman, 1957, p. 266). Through this process, competition forces prices down towards the cost of production which enhances allocative efficiency.
- Competition promotes productive efficiency by forcing firms to cut their costs in order not to lose sales to more efficient rivals (Kolasky & Dick, 2003, p. 208). If firms cannot maintain

productive efficiency with their rivals, they risk losing market share and possibly going out of business altogether.

- Out of concern for stability, competition policy has not always been applied in the banking system (Vives, 2016).
  - Competition may influence stability through the liability or asset side of the balance sheet of a financial intermediary.
  - However, competition is not responsible for the inherent fragility within the banking system since vulnerability to runs and panics can emerge independently of competitive tensions.
- Concern that competition in the provision of financial services could lead to a situation where risk is underpriced and in turn institutions could fail with systemic consequences has given rise to the so-called "competition-fragility" view of banking whereby more competition erodes market power, decreases profit margins, and results in reduced franchise value – the market value of the banks beyond their book values (Berger, Klapper, & Turk-Ariss, 2009, p. 100).
  - Under the "competition-fragility" view of banking the accretion of market power is seen as desirable from standpoint of preserving stability in the financial system.
- There is anecdotal evidence to suggest Australian financial regulators are not immune from such attitudes.

Market and Regulatory Failures in the Financial System

- The four systemically important major banks dominate the level of assets held by all categories of authorised deposit-taking institutions (ADIs) in Australia.
- An oligopoly is a market structure characterised by a few participants. It may include a "competitive fringe" of numerous smaller sellers who behave competitively because each is too small individually to affect prices or output (Areeda, Solow, & Hovenkamp, 2002, p. 9).
  - The provision of financial services in Australia – that is dominated by the four major banks – could be characterised as an oligopoly that is supplemented by a competitive fringe that includes regional banks and customer owned banking institutions (mutual banks, credit unions and building societies).
- Implicit within APRA's legislative charter is the notion that competition is a secondary consideration – along with the related concepts of efficiency, contestability and competitive neutrality – as something that can be traded off against financial safety and the overarching objective of promoting financial stability.
  - The notion that APRA sees its role as engaging in a careful balancing act that seeks to preserve financial stability as an overarching objective while potentially trading off secondary objectives such as efficiency, competition, contestability and competitive neutrality raises the possibility it is susceptible to take the so-called "competition-fragility" view of banking in exercising its functions.
- As a consequence of the natural tendency of prudential regulators to prioritise stability over competition and long-term efficiency concerns, the Murray Report raised concerns that broader competition issues would *fall between the cracks* as regulators focus on their specific mandates for stability and consumer protection (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, pp. 255-256).
- APRA downplayed as well as dismissed competition concerns during its implementation of Basel II and did not follow due process by completing the required competition assessment checklist in the Regulation Impact Statement it prepared for Basel II.

- Under Basel II, credit and operating risk weights determined under the standard approach were much higher than under the internal rating basis (IRB) approach used by the major banks.
- Higher risk weights means more capital is allocated to the lending, which leads to a higher cost of funds for ADIs using the standardised approach. The higher cost of funds for ADIs using the standard approach in turn influences their pricing of lending products, thus reducing their competitiveness with IRB banks for lending.
- The adoption of the IRB method also meant the major banks could engage in excessive leveraging and in turn increase their capacity for lending.
    - Based on the average risk weight of residential mortgage exposures for banks using the IRB method in June 2015 implies a leverage multiple of almost 74 times the amount of capital held, more than double the implied leverage for those using the standardised approach.
- It appears that APRA was well aware of competition concerns before the implementation of Basel II but chose to downplay their potential impact.
- The available evidence suggests the interaction of the Global Financial Crisis (GFC) combined with the implementation of Basel II provided a major fillip to the major banks to the detriment of other ADIs.
    - The percentage market share of interest income earned on housing loans by the major banks dramatically spiked as well as permanently increased in the second half of 2008 onwards.
- In its initial submission to the Murray Report inquiry, APRA (2014) was antithetic to the suggestion that differing approaches in risk weights under Basel II could be tilting the playing in favour of banks using the IRB approach and thereby stifling competition.
    - APRA dug its heels in to support the lack of competitive neutrality under Basel II.
- The Murray Report completely rejected APRA's position and recognised the IRB method had usurped competitive neutrality by tilting the playing field against financial institutions using the standardised approach.
- APRA dragged the chain on the competitive impact of the IRB approach until it was forced to act in response to Recommendation 2 of the Murray Report.
    - The Murray Report suggested the minimum risk weight on IRB banks for housing loans in the range of 25 and 30 per cent would be appropriate (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 65).
    - In July 2015 APRA (2015) announced that it would raise the risk weights on IRB banks to at least 25 per cent, at the lowest end of the range suggested by the Murray Report.
- Since the introduction of Basel II there has been a clear bias in favour of housing finance by the banking sector.
    - Housing loans as a percentage of total bank loans has risen from 57 per cent in 2007 to currently around 63 per cent.
    - The main impetus for this increase in housing finance has been the major banks, whose overall share of housing loans as a percentage to total bank loans has risen from 43 per cent in 2007 to currently around 52 per cent, while the market share of all other banks has contracted.
- The bias towards housing lending contained in Basel II has created a risk to the Australian economy through bank lending fuelling a potential asset price bubble.

- Since the Government foreshadowed the Financial System Inquiry in November 2013 with the release of draft terms of reference, APRA's recent conduct in relation to competition issues and competitive neutrality has improved.
    - Recent regulatory action by APRA appears to have slightly levelled the playing field and thus curtailed the market expansion of the major banks in various banking lending categories.
- Given the views expressed by APRA in its first submission to the Murray Report inquiry regarding smaller ADIs, it is doubtful any changes would have transpired had it not been for the additional public scrutiny APRA received by virtue of the Murray Report inquiry and subsequent recommendations.
    - Given that it is just not feasible to have an ongoing inquiry into the financial system, nor for an ongoing Productivity Commission inquiry into competition into the financial system for that matter, it is necessary to consider other policy options to force APRA to place a greater emphasis on competition in its deliberation over the prudential regulation of the financial system.

Competition Reform in Prudential Supervision

- According to Professor Xavier Vives (2016) of the University of Navarra, competition policy and prudential regulation need to be coordinated.
    - This has recently been achieved in the United Kingdom through legislative reforms to its prudential regulatory system.
- In March 2014, the Prudential Regulation Authority (PRA) of the Bank of England was given a statutory secondary competition objective (SCO) which states that:
    - When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.
- The SCO does not require the PRA to act in a manner that is incompatible with its primary objective, i.e. to promote the safety and soundness of the firms it regulates, focusing on avoiding and minimising adverse effects that they can have on the stability of the UK financial system (Bank of England Prudential Regulation Authority, 2016, p. 8).
    - The existence of the SCO means the PRA should consider, but is not necessarily required to adopt, those options which would deliver greater benefits to competition for a given objective of safety and soundness.
    - An added advantage of looking at prudential regulation through a competition lens is that is provides a check on whether prudential interventions are being applied proportionately, and to guard against the risks of unintended consequences.
- One solution to overcoming the "competition-fragility" view of banking that appears endemic to APRA to ensure that competition considerations are given due deliberation in prudential regulatory policy decisions is to give it a statutory secondary competition objective as has been adopted in the United Kingdom.
    - This in turn will help to ensure that competitive neutrality is maintained across all ADIs.

1. Introduction

This report has been commissioned by the Customer Owned Banking Association (COBA) to examine the interaction between competition and prudential regulation within the Australian financial system.

The views and opinions expressed in this report are those of the author.

2. Nature of risk in the Australian financial system

2.1 What is risk?

Risk often appears ubiquitous in modern life (Haines, 2017, p. 181). From the moment we get up in the morning, drive or take public transportation to get to school or to work until we get back into our beds (and perhaps even afterwards), we are exposed to risks of different degrees (Damodaran, 2008, p. 3). At the more extreme end, we are inundated with news of terrorist attacks, environmental catastrophe and the emergence of diseases such as swine flu and Ebola, brought to us through a never-ending media stream (Haines, 2017, p. 181).

Given the ubiquity of risk in almost every human activity, it is surprising there is little consensus about the definition of risk (Damodaran, 2008, p. 5). Multiple definitions have evolved in multiple professions (Hubbard, 2009, p. 79). The definition of risk we will adopt here is:

> *A state of uncertainty where some of the possibilities involve a loss, injury, catastrophe, or other undesirable outcome (i.e., something bad could happen). (Hubbard, 2009, p. 80)*

This definition is in accord with the common usage of the term that refers to any sort of uncertainty viewed from the standpoint of the unfavourable contingency (Knight, 1964, p. 233).

2.2 The Nature of Risk in the Financial System

The financial system is a system of promises (Blundell-Wignall, Atkinson, & Roulet, 2014, p. 59). The basic elements of financial contracts are promises – promises to make payments at specified times, in specified amounts and in specified circumstances (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 179). Financial arrangements which take the form of trust relationships also involve promises – promises to manage assets in the best interests of beneficiaries. Financial promises are among those products and services which incorporate risk, including the risk that the promise will not be kept.

The financial system provides the framework within which these promises are created and exchanged (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 179). Unlike the markets for most other goods and services, the exchange of many financial contracts takes into account both the explicit contractual promise and the varying risk that the promise will not be kept. Identifying, allocating and pricing risk is a key role of the financial system.

Within the financial system the most basic risk is credit risk (Benetton, Eckley, Garbarino, Kirwin, & Latsi, 2017, p. 8). Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms (Basel Committee on Banking Supervision, 1999, p. 1). Credit risk is one of the main risks that financial intermediaries – such as banks – face (Rodgers, 2015, p. 1).

Credit risk is related to 'creditworthiness' and whether or not a person or institution making a financial promise can be trusted to keep it (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997,

p. 181). Creditworthiness depends on the honesty, financial standing and operational systems of the promisor. For most banks, loans are the largest and most obvious source of credit risk (Basel Committee on Banking Supervision, 1999, p. 1).

Assessing the creditworthiness of borrowers is a specialised task which can consume considerable resources, time and expertise (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 182). It can be undertaken within a financial institution or outsourced to specialist firms, such as a rating agencies. The difficulty of assessing credit risk is exacerbated by information asymmetry whereby the borrower may have a better understanding of the risk associated with their intended investment than does the lender.

The failure to meet a financial promise is quite common in any market economy and there is an inevitable presumption that some loans will fail from time to time (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1996, pp. 95-96). As credit risk materialises and borrowers fail to make repayments, banks are forced to recognise the reduction in current and future cash inflows this represents (Rodgers, 2015, p. 1). These ‘credit losses’ reduce a bank’s profitability and can affect capital.

The mass failure to meet financial promises can give rise to systemic problems within the financial system. Indeed, credit risk has been the underlying driver of most systemic banking crises in advanced economies over recent decades (Rodgers, 2015, p. 1).

Systemic risk is the risk that the failure and distress of a significant part of the financial sector reduces the availability of credit which in turn may adversely affect the real economy (Acharya, Pedersen, Philippon, & Richardson, 2009). A systemic banking crisis is characterised by three elements: macroeconomic fragility; contagion; and a triggering event that acts as a coordinating device (Dewatripont & Freixas, 2011, p. 425).

Triggering events can come from:

- the public sector such as when a central bank unexpectedly and suddenly contracts liquidity;
- an external shock, such as a natural disaster or terrorist attack; or
- the financial markets themselves, such as when a large private financial firm fails (Taylor, 2009, p. 36).

If systemic risk materialises then it typically has a significant negative impact on the economy because of the central position of the financial system in a monetary economy (Vives, 2016). Hence, macroeconomic fragility refers to the likelihood that a systemic banking crisis could severely affect the whole economy (Taylor, 2009, p. 36).

Contagion risk refers to the risk that financial difficulties at one or more banks spill over to large number of banks or the financial system as a whole (Schoenmaker, 1996). Within a contagion, there is a mechanism for transmission from one infected entity to another (Kolb, 2011). According to Amil Dasgupta (2004) from the London School of Economics, there are two broad classes of transmission mechanisms in a rational economy:

- adverse information that precipitates a crisis at one institution also implies adverse information about another; and
- financial institutions are often linked to each other through direct portfolio or balance sheet connections.

In the context of systemic risk, large banks are of particular importance because their failure could pose significant risks to other financial institutions and the financial system as a whole (Moch, 2013, p. 2908). The Financial Stability Board (2013, p. 3) has defined systemically important financial institutions (SIFIs) as those of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences.

The Basel Committee on Banking Supervision (2013, pp. 7-8) has adopted four criteria to identify SIFIs:

- Size – the link between the size of an institution and the systemic impact that its distress or failure will bring about is generally accepted as a key factor in the assessment of its systemic importance. The size of the balance sheet and off-balance sheet exposures of the institution, the volume of transactions it engages in and processes, the volume of assets it warehouses or manages are all indicative of the extent to which its clients will be starved of funds, its business with other institutions will be disrupted and the magnitude of losses its counterparties may face.
- Substitutability – some institutions lack immediate substitutes for the key role they play in the economy. They are systemically important not so much because other institutions are financially exposed to them but because other financial market participants rely on them for the continued provision of key specialised services. This would describe, for instance, institutions charged with providing systemically important infrastructure services, such as clearing, payment and settlement of trades, or custodial services. Limited substitutability is likely to be much more of a concern when the services provided are large in volume, or where they provide a key link in connections among financial institutions.
- Interconnectedness captures situations when financial distress in one institution materially raises the likelihood of financial distress in other institutions because of the network of contractual relations in which the institution operates. This chain effect operates on both sides of the balance sheet, i.e., there are inter-connections on the funding side as well as on the provision of funds. The larger the number of links (the larger the number of creditors and clients), the higher potential to cause spillovers onto either clients and/or creditors. In addition, the larger the size of the individual exposures (the "thickness" of the links), the greater the potential that these effects will be magnified. Moreover, the complexity of the connections within a network, as well as confidence factors when a core element of the system comes under stress, can add to the uncertainty of participants in situations of stress, further increasing the risk that distress may take systemic proportions. (Staff of the International Monetary Fund and the Bank for International Settlements, and the Secretariat of the Financial Stability Board, 2009, pp. 9-10)
- The systemic impact of a bank's distress or failure is expected to be positively related to its overall complexity – that is, its business, structural and operational complexity. The more complex a bank is, the greater are the costs and time needed to resolve the bank.

The obvious question arises as to whether there are any SIFIs operating in Australia. The Australian Prudential Regulation Authority (APRA) (2013) has identified four SIFIs operating in Australia:

APRA's assessment methodology has regard to the Basel Committee's four key indicators of systemic importance: size, interconnectedness, substitutability and complexity. Based on its assessment of these indicators, APRA has determined that the following authorised deposit-taking institutions are [Domestic Systemically Important Banks]:

Australia and New Zealand Banking Corporation

Commonwealth Bank of Australia

National Australia Bank

Westpac Banking Corporation.

The four Australian SIFIs – the Australia and New Zealand Banking Corporation (ANZ), the Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac Banking Corporation (Westpac) – will be collectively referred to as the major banks.

A policy problem arises in the event of the failure of a SIFI and the subsequent contagion it envelops in that it creates large negative externalities or spillovers. Externalities occur when participants to an economic transaction do not necessarily bear all of the costs or reap all of the benefits from a transaction. If the impacts of externalities are not reflected in the costs incurred by the participants involved in the transaction, markets will tend to over-produce negative externalities. These include disruption to the ability of the financial system to provide credit and other essential financial services to households and businesses and in turn harm the real economy (Dudley, 2013).

The high level of concentration within the Australian banking sector has exacerbated the problem of systemic risk within the Australian financial system, as outlined in the final report of the 2014 Financial System Inquiry (Murray Report):

… the banking sector is concentrated, with the four major banks being the largest players in virtually all respects. This concentration, combined with the predominance of similar business models focused on housing lending, exacerbates the risk that a problem at one institution could cause issues for the sector and financial system as a whole. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 34)

In turn, the high level of concentration within the Australian banking system poses a risk to competition in the provision of financial services as warned by the Murray Report (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 255).

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events (Basel Committee on Banking Supervision, 2006, p. 144). Operational risk is essentially an amalgamation of many disparate risks (Holmes, 2003). While there have been many attempts to define it positively, its primary definition remains a negative one – losses that aren't related to either credit or market events. Such events include fraud, settlement errors, accounting and modelling mistakes, lawsuits, natural disasters, information technology breakdowns, and many other types of loss.

In the provision of financial services, market risk is defined as the risk of losses in on and off-balance-sheet positions arising from movements in market prices (Basel Committee on Banking Supervision, 2006, p. 157). For a bank the risks subject to this requirement are:

- the risks pertaining to interest rate related instruments and equities in the trading book; and
- foreign exchange risk and commodities risk throughout the bank.

Another risk is the concentration risk in a financial institution's portfolio. This risk arises from an excessive exposure to a single sector or to several highly correlated sectors (i.e. 'sector concentration') as well as from an excessive exposure to certain names (which is often referred to as 'name concentration' or 'granularity') (Düllmann & Masschelein, 2006). Name concentration happens when the idiosyncratic risk cannot be perfectly diversified due to large (relative to the size of the portfolio) exposures to individual borrowers (Grippa & Gornicka, 2016, p. 4). Idiosyncratic risk represents the effects of risks that are particular to individual borrowers (Basel Committee on Banking Supervision, 2006a, p. 4). Sector concentration emerges when the portfolio is not perfectly diversified across sectoral factors, corresponding to systematic components of risk (Grippa & Gornicka, 2016, p. 4). According to the Basel Committee on Banking Supervision (2006a, p. 3):

> *Historical experience shows that concentration of credit risk in asset portfolios has been one of the major causes of bank distress. This is true both for individual institutions as well as banking systems at large.*

Banks have excessive incentives to take risk in the presence of limited liability for their shareholders and also for managers due to contracts that limit their downside and moral hazard due to nonobservable risk positions on the asset side (Vives, 2016).

According to the Governor of the Reserve Bank of Australia (RBA), Dr Philip Lowe (2008, p. 88):

> *It is all too clear that most episodes of financial disturbances have their roots in the build-up of risk in good times.*

In turn, when things turn bad in a downturn, the risk built up in the good times quickly crystallises (Lowe, 2008, p. 88).

3. Fragility in Banking and Regulation

3.1 Fragility in Banking

Banking is not like any other industry; it has important characteristics that make it heavily regulated and subject to public intervention (Vives, 2016).

Banks create liquidity that leaves them vulnerable to runs (Vives, 2010, p. 12).[1] Banks protect entrepreneurs from the liquidity needs of investors/depositors. On the asset side, banks specialise in assessing the relative viability and profitability of projects put forward by entrepreneurs and, based on their information production on these projects, they grant loans to the entrepreneurs (Carletti & Hartmann, 2002, p. 8). On the liability side, banks are special in that they rely to a significant extent on (many small) short-term demandable deposits, which they pool and then invest in long-term loans provided to entrepreneurs.

There is an underlying fragility in banking in that there is a coordination problem with investors, who may decide to call-back their short-term deposits and make a bank that is solvent fail (Vives, 2010, p. 13). A solvent bank may be victim of purely speculative panic, with depositors withdrawing their funds, and the bank being forced to quickly liquidate assets and incurring a fire sale penalty (Vives,

[1] Liquidity refers to how easily it is to turn assets into cash.

2016). The root of the problem is the dependence of banks on short-term debt and the maturity mismatch this entails.

Traditional bank runs involve massive withdrawals by individual depositors queuing at the door of banks (Vives, 2016). In the early 1990s in Australia, there were a number of runs on some financial institutions, including a couple of banks (Bank of Melbourne and Metway Bank) (Gizycki & Lowe, 2000, p. 183). In general, these runs were stopped by public sector intervention.

In turn a run on a bank could lead to contagion and a systemic problem with the financial system. The Organisation for Economic Co-operation and Development (OECD) (2011, p. 20) has summed up the problem in the following terms:

> *.. the financial system can become unstable, largely because banks, funded in large part by withdrawal-on-demand liabilities and holding longer term risky assets, are themselves inherently unstable, and that instability can generate sizeable negative spill-over effects.*

The social cost of a bank failure is perceived to be large (Vives, 2016). The social cost includes the costs of financial distress and economic distress. Financial distress is borne by the bank's creditors and shareholders. The failure of a bank has adverse consequences for non-financial firms because individual bank-firm relationships are valuable as a source of capital to the private sector. A crisis that leads to a contraction of bank capital may result in a credit crunch, with severe disruption to the entire economy.

3.2 Prudential Regulation of Banking

3.2.1 Market failures in banking

The basic building block of microeconomics is the theory of perfect competition which is essentially used as a benchmark by which to assess 'real world' outcomes. The underlying assumptions of perfect competition are:

- Lots of buyers and sellers.
- The product is homogenous. That is, consumers cannot distinguish between the products produced by different firms.
- Perfect information. All firms are fully informed about their production possibilities and consumers are fully aware of their alternatives.
- There are no entry or exit barriers.

Under perfect competition, every participant is a ***price taker*** as they can sell or buy as much or as little as they want without affecting the price.

The polar opposite of perfect competition is monopoly where there is only one firm supplying the entire market. A monopolist is ***price maker*** and the basic result under monopoly is production is cutback and the price is raised by the monopolist in order to maximise their profit. A monopoly is objectionable on economic grounds because it reduces output and increases price, in turn creating a deadweight or efficiency loss. The outcome under monopoly is that an inefficient level of output is produced because some of the consumers who would have purchased the product in a competitive market do not choose to do so at the higher price, which is referred to as a loss of allocative efficiency. Monopoly pricing also results in a wealth transfer from consumers to the seller of a product (Depoorter, 1999, p. 501). The power to behave as a price maker is referred to as monopoly power as well as market power.

The economic and legal literature has provided several different definitions of market power. One commonly used definition is that provided by American economist Abe Lerner which is the ability of a firm to push its price above marginal cost (Lerner, 1934). However, the problem with the Lerner definition of market power is that it is often difficult to measure marginal cost in the real world.

Another definition of market power comes from prominent American competition law experts Carl Kaysen and Donald Turner (1959, p. 75):

> *A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions.*

This definition has been used by the Australian Competition and Consumer Commission (2002, p. 64) and in a prominent Australian legal judgement.[2] Another definition of market power provided by prominent American competition law experts William Landes and Richard Posner (1981, p. 937) is "the ability of a firm to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded".

Banking and financial markets intensively display an entire array of classical market failures that violate the conditions of perfect competition (Vives, 2016). There is asymmetric information both between bank and customer and between firm and bank, raising issues in relation to moral hazard and adverse selection generating incentives for excessive risk taking.[3]

Some degree of market power is created in banking markets through the presence of switching costs (Vives, 2016). Switching costs are the additional costs over the market price that consumers incur if they elect to abandon their investment and switch to another product (Goldfine & Vorrasi, 2004, p. 213). The costs of switching increase when consumers are unable to recover the useful life of their investment in a product if they choose to shift to another brand. Switching costs arise when consumers value forms of compatibility that require otherwise separate purchases to be made from the same firm (Farrell & Klemperer, 2007, p. 1971). Large switching costs lock in a consumer once they have made an initial product purchase, so they are effectively buying a series of goods and services (Farrell & Klemperer, 2007, p. 1972). In banking, consumers face switching costs if they decide to switch from one bank to another and the costs incurred may be associated with the physical change of accounts and regular bill payments.

Banking markets also suffer from externalities relating to fragility with coordination problems and contagion (Vives, 2016).

The general case for market intervention and regulation is predicated on market failure. Traditionally, the function of government has been seen as a benign corrector of the market economy when it falters (Tollison, 1985, p. 906). The multiple market failures prevalent in banking markets has led to government intervention through regulation to try to ameliorate some of the adverse effects. This has been done through financial safety regulation that seeks to alter the risks that would otherwise be attached to financial promises through providing a degree of assurance to promisees (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 192).

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[2] Cited with approval by Dawson J in *Queensland Wire Industries Proprietary Limited v The Broken Hill Proprietary Company Ltd and Anor* (1989) 167 CLR 177 at 200

[3] Further information on asymmetric information, moral hazard and adverse selection is provided in the Appendix to this report.

The most common form of preventative financial safety regulation is prudential regulation (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 194). Prudential regulation involves the imposition of prescriptive rules or standards governing the prudential behaviour of institutions making certain types of promises. Prudential regulation in part substitutes the judgment of regulators for that of regulated financial institutions and their customers.

3.2.2 Addressing market failure – Prudential Regulation

The basic underlying objective of prudential regulation is to increase the probability of a promise being honoured, and since this relates to the creditworthiness of the promiser, it follows that the focus of regulation must be on the promising entity (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 303). Institutions offering payment services or conducting the general business of deposit taking are clear candidates for prudential regulation (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 304). The nature of deposit taking, particularly the transformation of illiquid assets into liquid liabilities, the information asymmetry for depositors and the fact that institutional failure has the potential to cause systemic instability, warrants intense prudential regulation.

Prudential regulation has been designed to provide the banking and financial systems with stability, to avoid the negative effects associated with failing institutions and systemic crises, as well as to protect small deposit holders/investors due to asymmetric information problems (Vives, 2016).

The Australian Prudential Regulation Authority (APRA) is responsible for prudential supervision of the Australian financial system. APRA is an integrated prudential regulator responsible for deposit-taking institutions (banks, building societies and credit unions) as well as friendly societies, life and general insurance companies and superannuation funds.

Section 8 of the *Australian Prudential Regulation Authority Act 1998* (Cwlth) sets out the legislative purpose for establishing APRA. Section 8 makes clear that APRA's primary purpose in exercising its prudential powers is to protect depositors and other members of the community holding financial promises issued by regulated financial institutions (Australian Prudential Regulation Authority, 2014, p. 15).

Deposit-taking institutions are regulated by APRA under a single licencing regime and are all covered by the same 'depositor protection' provisions of the *Banking Act 1959* (Cwlth). This legislation gives APRA the power to act in the interests of depositors, including revoking licences, making prudential standards or issuing enforceable directions, to appoint an investigator or statutory manager to an authorised deposit-taking institution (ADI) in difficulty or take direct control of the institution itself. If the difficulties prove intractable, APRA can apply to the courts to wind-up an ADI.

Under the 'depositor protection' provisions of the *Banking Act 1959*, depositors have first claim to the assets of an ADI in a wind-up. To support depositors' interests, all ADIs are required to hold assets in Australia at least equal to their deposit liabilities in Australia. Depositors are also protected through the Financial Claims Scheme (FCS) where eligible deposits are guaranteed up to a limit of $250,000 per customer.

3.2.3 Existing regulatory framework

"Capital" is one of the most important concepts in banking (Elliott, 2010, p. 3). In its simplest form, capital represents the portion of a bank's assets which have no associated contractual commitment for repayment. It is, therefore, available as a cushion in case the value of the bank's assets declines or its liabilities rise. Banks attempt to hold the minimum level of capital that supplies adequate protection, since capital is expensive, but all parties recognise the need for such a cushion even when they debate the right amount or form. A bank's capital essentially represents its ability to withstand losses without becoming insolvent (Gorajek & Turner, 2010, p. 43).

The Basel Committee on Banking Supervision (2016) (Basel Committee) which is headquartered at the Bank for International Settlements in Basel, was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.

In 1988 the Basel Capital Accord (now referred to as Basel I) was approved by the Basel Committee and set capital requirements for banks in proportion to risk metrics referred to as 'risk weights'. Initially these risk weights were set by regulators (Benetton, Eckley, Garbarino, Kirwin, & Latsi, 2017, p. 2). According to Basel I:

> *Two fundamental objectives lie at the heart of the Committee's work on regulatory convergence. These are, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the* ***framework should be in fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks****. (Basel Committee on Banking Supervision, 1988)*[4]

Basel I stipulated that banks should hold minimum capital in the amount of eight per cent of their risk-weighted assets (Düllmann & Masschelein, 2006). Under Basel I, loans secured by residential mortgages were assigned a risk weight of 50 per cent, whereas all other loans were given a risk weight of 100 per cent (Terry, 2009, p. 26).

Basel I gave banks the ability to control the amount of capital they required by shifting between assets with different weights on balance sheet, and by securitising assets and shifting them off balance sheet (Blundell-Wignall, Atkinson, & Roulet, 2014, p. 53). Banks quickly accumulated capital well in excess of the regulatory minimum, and capital requirements, in effect, had no constraining impact on banks' risk taking.

To link capital more closely to banks' own risk estimates, the Basel II agreement in 2004 made provision for some banks to use their internal models to calculate risk weights (Benetton, Eckley, Garbarino, Kirwin, & Latsi, 2017, p. 2). Basel III was agreed in 2010 amid growing concerns about the operation of risk weights.

The core of the Basel rules on capital reflects a belief that the necessary level of capital depends primarily on the riskiness of a bank's assets (Elliott, 2010, p. 4). Since capital exists to protect against risk, more capital is required to be held when greater risks are being taken. The focus is on the asset side because liabilities are generally known with great precision, since a deposit must be repaid based on specific contractual terms. Unlike bank liabilities, bank assets can go down, or occasionally up, in value. In particular, bank loans may not be repaid and securities may default or may need to be sold at a time when their market value has declined.

The Basel Capital Accord has been applied to Australian banks since 1988 (Australian Prudential Regulation Authority, 2014, p. 39). APRA implemented the Basel II agreement in 2008 and has been progressively implementing the Basel III agreement since 2013.

[4] Emphasis added by the author of this report.

There are three ‘Pillars’ of the Basel II framework: Pillar 1 sets out minimum capital requirements to address credit, operational and market risk; Pillar 2 outlines the supervisory review process (including supervisory discretion to set higher capital requirements where necessary); and Pillar 3 seeks to impose market discipline through disclosure requirements.

An Australian bank’s regulatory capital is the sum of its ‘Tier 1’ and ‘Tier 2’ capital, net of all specified ‘deductions’ (Gorajek & Turner, 2010, p. 43). Tier 1 capital consists of the funding sources to which a bank can most freely allocate losses without triggering bankruptcy. This includes, for example, ordinary shares and retained earnings, which make up most of the Tier 1 capital held by Australian banks. Tier 2 capital is made up of funding sources that rank below a bank’s depositors and other senior creditors, but in many cases are only effective at absorbing losses when a bank is being wound up (Gorajek & Turner, 2010, p. 44). In this way, Tier 2 capital provides depositors with an additional layer of loss protection after a bank’s Tier 1 capital is exhausted. Both Tier 1 and Tier 2 capital are measured net of deductions, which are adjustments for factors that lessen the loss absorption capabilities of capital.

For capital adequacy purposes, Australian banks are required to quantify their credit, market and operational risks (Gorajek & Turner, 2010, p. 44). The most significant risk of these is typically credit risk. Credit risk is measured as the risk-weighted sum of a bank’s individual credit exposures, which gives rise to a metric called ‘risk-weighted assets’. APRA requires all locally incorporated banks to hold total capital of at least 8 per cent of their risk-weighted assets (Gorajek & Turner, 2010, p. 46).

Under Basel II agreement, there were three methods for calculating minimum capital requirements:

1. the standardised (externally set) risk weights;
2. foundation internal ratings basis (FIRB); and
3. advanced internal ratings basis (AIRB) (Terry, 2009, p. 27).

Under the standardised approach, the risk weights are prescribed by APRA and are generally based on directly observable characteristics of each exposure (Gorajek & Turner, 2010, p. 44). For example, if a residential mortgage has a loan-to-valuation ratio of 70 per cent, full documentation and no mortgage insurance, APRA specifies a risk weight of 35 per cent. The value of the loans in each category is multiplied by the prescribed risk weight and the product is multiplied by 8 per cent to determine the minimum capital requirement (Terry, 2009, p. 27). Corporate exposure risk weights are based on external credit ratings and are generally higher than for residential mortgages because the exposures are usually riskier (Gorajek & Turner, 2010, p. 45).

APRA (2007, p. 3) has categorised the FIRB and AIRB as advanced approaches which rely on an ADI’s own internal risk-assessment and measurement methodologies. The FIRB uses internal estimates of the probability of loan defaults (PD) and feeds this into a more complex probability-based formula (that relies on the supervisor’s estimates of the other risk components) to determine the risk weight to be used to calculate the amount of capital to be held against the loan (Terry, 2009, p. 28). The AIRB uses internal estimates of loss given default (LGD) and the other risk components (effective maturity and the exposure at default) in a prescribed formula to determine the risk weight and hence the capital charge against a loan.

Three banks, CBA, Westpac and ANZ, were given approval to use the AIRB from January 2008 while NAB was given permission to use the FIRB (Terry, 2009, p. 29). NAB (2008) subsequently received approval to use AIRB as from 1 July 2008. Macquarie Bank has also received accreditation for FIRB.

4. Competition and Banking

4.1 Benefits of Competition

According to Professor Xavier Vives (2016) of the University of Navarra:

> *The imperfections of banking markets do not imply that the benefits of competition for static and dynamic efficiency, well established since Adam Smith, do not apply to banking.*

Competition is a process of rivalry between firms, each seeking to win customer's business. The primary objective of competition policy is to promote economic efficiency which in turn boosts and stimulates economic growth. According to the 1993 independent committee of inquiry into National Competition Policy (Hilmer Report):

> *Competition policy is not about the pursuit of competition per se. Rather, it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives. (Hilmer, Rayner, & Taperell, 1993, p. xvi)*

According to the recent Competition Policy Review (Harper Report):

> *Competition policy is aimed at improving the economic welfare of Australians. It is about meeting their needs and preferences by making markets work properly. (Harper, Anderson, McCluskey, & O'Bryan, 2015, p. 7)*

For merchants the retail price of a product they charge is brought into some kind of relationship with cost through the competitive process (Adelman, 1957, p. 266). Through this process, competition forces prices down towards the cost of production which enhances allocative efficiency.

Competition also promotes productive efficiency by forcing firms to cut their costs in order not to lose sales to more efficient rivals (Kolasky & Dick, 2003, p. 208).[5]. If firms cannot maintain productive efficiency with their rivals, they risk losing market share and possibly going out of business altogether. It has long been recognised in the economic literature that competition plays an important role in reducing managerial slack. Adam Smith (1961) recognised as far back as 1776 that "monopoly ... is a great enemy to good management". Prominent British economist Sir John Hicks (1935, p. 8) opined "[t]he best of all monopoly profits is a quiet life."

Harvey Leibenstein (1966; 1973) believed that a lack of competitive pressures may lead firms with monopoly power to neglect the pursuit of productive efficiency and tolerate what he described as x-inefficiency. X-inefficiency represents the gap between actual and minimum possible production costs. While x-inefficiency can affect both monopolists and firms operating in competitive markets alike, it will impose a far greater cost burden on a monopolist as they will have no discipline imposed upon them externally through competition with rival firms. According to Professor Vives (2016):

> *The importance of X-inefficiency in explaining deadweight losses in banking does not seem to be less than in other industries…*

[5] Productive efficiency, also referred to as technical efficiency, means that production takes place using the least costly amount of resources for a given level of technology.

Indeed, there is a vast literature suggesting the deregulation of the banking sector across the world has had an impact on reducing X-inefficiency (Vives, 2016).

Allocative along with productive efficiency are static concepts of efficiency. Static efficiency refers to holding society's technological know-how constant (Kolasky & Dick, 2003, p. 247). On the other hand, dynamic efficiency refers to the efficiency benefits achieved through research, development, and innovation, including the diffusion of technology to produce new products and processes (Fox, 2008, p. 78). Dynamic efficiency brings benefits to consumers either through the introduction of improved new products that buyers value more highly ("product innovations"), or through the use of new, lower cost ways of producing existing products ("process innovations") (Commerce Commission, 2003, p. X).

Competition also provides a spur for dynamic efficiency. Firms undertake innovation through research and development (R&D) to improve their competitiveness. R&D can help a firm lower its costs of production and/or produce better products giving it a competitive advantage over its rivals in the market place. The benefits which firms seek to capture through R&D, namely lower costs, higher productivity and better products, if realised, will ultimately generate higher rates of economic growth.

According to Professor Vives (2016):

> *Competition policy should be enforced in the banking sector. This is how it should be to guarantee competitive financial input for the economy and to foster growth. Competition nurtures efficiency and innovation, and delivers consumer welfare when regulation is appropriate.*

4.2 Tension between competition and prudential regulation

Out of concern for stability, competition policy has not always been applied in the banking system (Vives, 2016). Competition may influence stability through the liability or asset side of the balance sheet of a financial intermediary. On the liability side, competition may increase instability by exacerbating the coordination problem of depositors/investors, and consequently fostering runs and/or panics, which may become systemic. However, competition is not responsible for the inherent fragility within the banking system since vulnerability to runs and panics can emerge independently of competitive tensions.

On either the liability or asset sides, competition may increase the incentives to take risk and correspondingly the probability of failure of banks (Vives, 2016). Competition can lead to a riskier bank portfolio and higher probability of failure due to the adverse selection problem. Furthermore, increased rivalry may reduce incentives to screen and monitor borrowers.

Concern that competition in the provision of financial services could lead to a situation where risk is underpriced and in turn institutions could fail with systemic consequences has given rise to the so-called "competition-fragility" view of banking whereby more competition erodes market power, decreases profit margins, and results in reduced franchise value – the market value of the banks beyond their book values (Berger, Klapper, & Turk-Ariss, 2009, p. 100). Competition in turn encourages banks to take on more risk in order to increase returns.

Under the "competition-fragility" view of banking the accretion of market power is seen as desirable from standpoint of preserving stability in the financial system. As banks gain market power, their franchise value increases (Berger, Klapper, & Turk-Ariss, 2009, p. 103). Because franchise value represents intangible capital that will only be captured if the bank remains in business, such banks face high opportunity costs of going bankrupt and hence they become more reluctant to engage in risky activities. They tend to behave prudently by holding more equity capital, by holding less risky portfolios, and/or by originating a smaller loan portfolio.

RBA Assistant Governor Michele Bullock (2017) has recently summarised the "competition-fragility" view of banking in the following terms:

> *One view is that a concentrated banking system promotes financial stability in a number of ways. It is sometimes argued, for example, that if a concentrated banking system implies less competition, the large banks will be more profitable and able to generate capital organically, increasing their resilience. This argument therefore suggests that a concentrated banking system will promote financial stability. Having a few large banks might also promote financial stability in other ways. Larger banks might be more diversified in the risks they take on and have more sophisticated risk management systems. It could also be argued that it is easier for our prudential regulator, the Australian Prudential Regulation Authority (APRA), to supervise and regulate a small number of large banks.*

Empirical support for the "competition-fragility" view of banking originally came from Michael Keeley (1990) who found that increased competition and deregulation in the United States during the 1980s reduced monopoly rents and resulted in a surge of bank failures.[6] A large academic literature provides support to the "competition-fragility" nexus (Berger, Klapper, & Turk-Ariss, 2009, p. 102). For example, Thorsten Beck and Asli Demirguc-Kunt from the World Bank and Ross Levine from Brown University (2006) find that crises are less likely in economies with more concentrated banking systems.

According to Professor John Boyd of University of Minnesota and Gianni De Nicolo of the IMF (2005, pp. 1332-1333), the "competition-fragility" view of banking has had enormous influence over the thinking of financial regulators and central bankers:

> *We believe that the body of research … has had a material impact on bank regulators and central bankers. Specifically, we believe there is a widely held view among policy makers that reduced competition in banking is not necessarily bad because, other effects not withstanding, reduced competition results in a more stable banking industry…*
>
> *For obvious reasons, policy spokespersons are loath to publicly state that they encourage monopoly rent earning by banks so as to stabilise that sector. However, there is a historical track record of events that is strongly suggestive... There is also much suggestive evidence based on the treatment of banks in the many banking crises around the world. Local and international agencies have pursued aggressive merger policies in almost all crisis situations, even in bank markets that were already highly concentrated by any standard.*

There is anecdotal evidence to suggest Australian financial regulators are not immune from such attitudes, with the then Chairman of the Australian Competition and Consumer Commission (ACCC) Graeme Samuel (2009) commenting on the ACCC's decision not to oppose CBA's acquisition of BankWest:

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[6] A monopoly rent is the excess distribution earned by any factor of production in a production process above the amount required to draw the factor into the process or to sustain the current use of the factor.

> *With the advice that we had at the time, remember this was almost at the peak of the near global panic in terms of the banking system and the financial system worldwide towards the end of last year. This advice that we had at the time from both APRA and the Reserve Bank, I think, gave us absolutely no choice, we had to approve that merger. Now if we had that over again, I'm not sure that we would have any different of – or any different result based on the advice that we received from APRA and the Reserve Bank.*

In these comments, Mr Samuel appears to be insinuating the ACCC subverted its usual competition assessment process in the merger of BankWest with the CBA at the behest of APRA and the RBA.

However, the "competition-fragility" view of banking that purports that the exercise of market power leads to more stability in the financial system has not gone unchallenged. According to Tommaso Padoa-Schioppa (2001, p. 16), a former executive board member of the European Central Bank:

> *… if banks were strengthened by the gymnastics of competition, the banking system would be stronger and more resilient to shocks.*

Professor Franklin Allen of the University of Pennsylvania and Professor Douglas Gale of New York University (2004, p. 455) have suggested that subordination of competition policy to financial stability may be unwise for a number of reasons. First, the extent to which there is a negative trade-off between competition and financial stability may be questioned in that while the costs of financial crises are high, it does not follow that it is necessary to reduce competition to avoid those costs. Second, the wide range of estimates of the efficiency costs from concentration is at least consistent with a high efficiency gain from greater competition. Third, the costs of financial crises occur infrequently, perhaps every decade or few decades, whereas the inefficiency cost from a lack of competition are borne continuously.

Professor Franklin Allen, Professor Elena Carletti of the European University Institute and Professor Robert Marquez of the University of California at Davis (2011) have argued that when credit markets are competitive, market discipline coming from the asset side induces banks to hold positive levels of capital as a way to commit to monitor and attract borrowers.

More recent studies have provided empirical support for the benefits of competition in improving stability in the financial system. Professor Klaus Schaeck of Bangor University and Martin Cihak of the International Monetary Fund (2012) have found that competition goes hand in hand with higher capital ratios based on a study of 2,600 banks across 10 European countries. This led Schaeck and Cihak (2012, p. 861) to draw the following conclusions:

> *We conclude that the most important contribution of this study is the evidence supporting the notion that competition incentivises banks to increase capital holdings…*
>
> *In light of the recent crisis, these results have important implications for policymaking, as they suggest that a critical re-examination of the idea that restricting competition (e.g., via activity and entry restrictions) is a way to achieve sounder banking systems.*

In a follow-up study, Schaeck and Cihak (2013) investigated the relationship between competition, productive efficiency and stability and tested whether improvements in productive efficiency is the mechanism through which competition enhances stability in the financial system. Schaeck and Cihak found that competition robustly improves stability via the channel of productive efficiency.

Assistant Professor Deniz Anginer of Virginia Tech and Asli Demirguc-Kunt and Min Zhu from the World Bank (2014) investigated the relationship between bank competition and systemic stability and found a robust positive relationship between the two. They found that greater competition encourages banks to take on more diversified risks, making the banking system less fragile to shocks. Anginer, Demirguc-Kunt, and Zhu (2014, p. 21) conclude:

> *Our paper has important policy implications. Unlike most of the earlier literature, our findings suggest that market power is associated with greater systemic fragility, which suggests the importance of ensuring a competitive environment in banking.*

A recent study by Dr Aurélien Leroy of the University of Nantes and Associate Professor Yannick Lucotte of the Paris Business School (2017) on the existence of a trade-off between competition and stability among European listed banks has found that while competition encourages bank risk-taking and thus increases individual bank fragility, that competition also enhances financial stability by decreasing systemic risk. Leroy and Lucotte (2017, p. 210) thus conclude:

> *… our results suggest that pro-competitive policy should be undertaken in the European banking system to maintain macro-financial stability.*

5. Market and Regulatory Failures in the Financial System

5.1 Australian Banking system as an Oligopoly

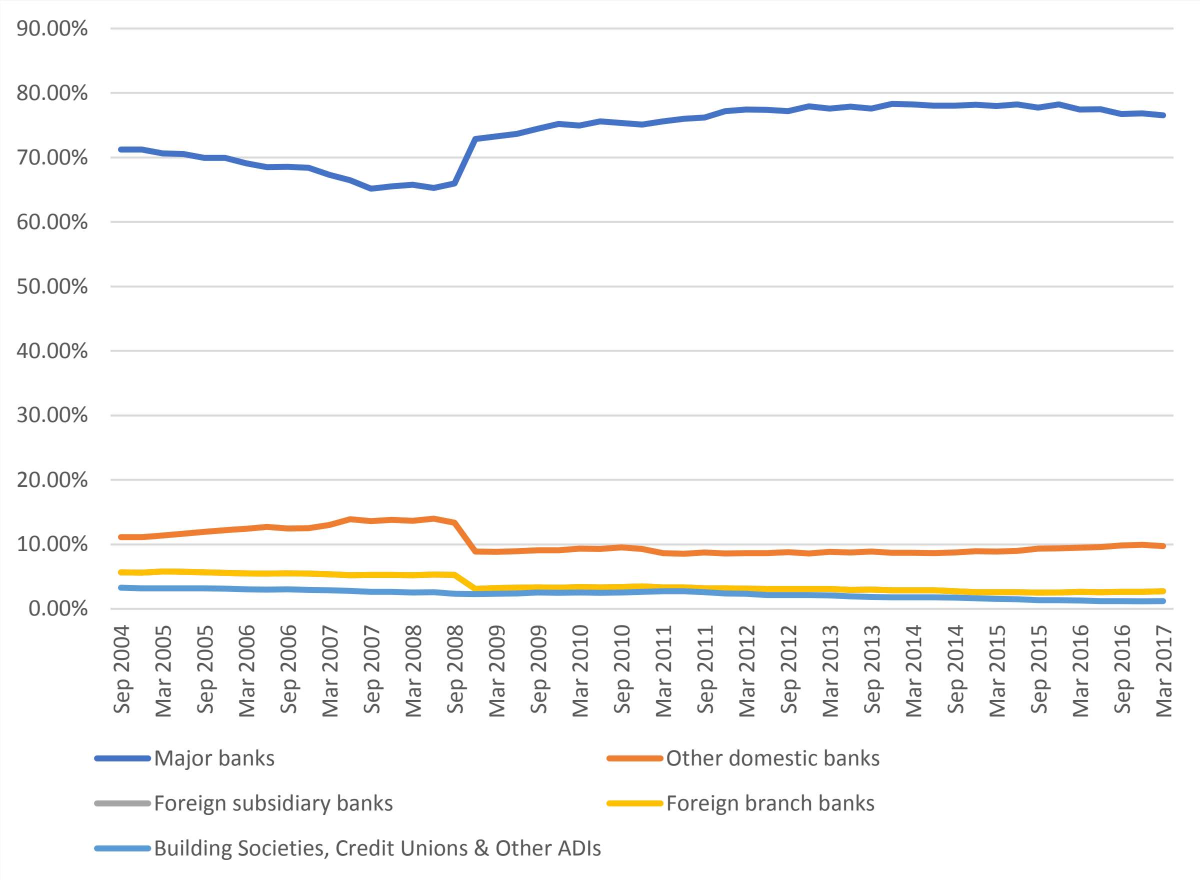
According to the Murray Report:

> *Some sectors of the Australian financial system are **concentrated**. In particular, the banking sector is concentrated, with the four major banks being the largest players in many aspects of the financial system and having significant market influence (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 3).*[7]

The four systemically important major banks dominate the level of assets held by all categories of ADIs in Australia, as outlined in Figure 1 below.

[7] Emphasis is in the original document.

Figure 1: Percentage of Assets held by Category of Authorised Deposit-Taking Institution – September Quarter 2004 to March Quarter 2017



Source: APRA (2017a)

An oligopoly is a market structure characterised by a few participants. It may include a "competitive fringe" of numerous smaller sellers who behave competitively because each is too small individually to affect prices or output (Areeda, Solow, & Hovenkamp, 2002, p. 9). The provision of financial services in Australia – that is dominated by the four major banks – could be characterised as an oligopoly that is supplemented by a competitive fringe that includes regional banks and customer owned banking institutions (mutual banks, credit unions and building societies).

Within economic theory, there is no single determinate solution to the problem of oligopoly with many possible outcomes being postulated. The range of solutions runs the full gamut of possible outcomes from that reminiscent of perfect competition to that of a monopoly. The reason there is no single unique solution to the problem posed by oligopoly is because of the interdependency of market participants.

A number of theories of oligopoly predict that once firms recognise their interdependency, their most rational course of action would be to behave in a manner reminiscent of a monopoly. The outcome from these models has been described as tacit collusion, also known as conscious parallelism. While firms are not part of a cartel arrangement that are seeking to formally collude by cutting back on production and raising prices, the firms are able to coordinate their conduct so that an outcome similar to cartel or monopoly is achieved.[8]

[8] A cartel is where there is a formal agreement amongst competing firms to collude to fix prices or cutback on production. The objective of a cartel is organise firms so they behave in manner similar to the outcome

However, just because a market is characterised as having an oligopolistic structure does not necessarily mean that it will be prone to tacitly collusive behaviour. While market concentration can certainly provide guidance as to which markets are likely to raise competition concerns, it is certainly not the be-all and end-all of the matter. Market concentration is only one of a number of factors that should be relied upon in determining whether a market is likely to result in any abuse of market power.

Economic theory would caution that the level of market concentration alone may not necessarily be the prime determinant for the actual state of competition in a market. In this regard, Professor David Round, the former Director of the Centre for Regulation and Market Analysis at the University of South Australia, has warned:

> *… concentration statistics or even market shares attributable to individual firms by themselves tell us nothing about the dynamics of competition within a relevant market. They present a snapshot only, and tell us neither how firms obtained those market shares, nor whether those shares are currently increasing or decreasing, and they certainly offer no guide as to what might happen as future market conditions change. (Round, 2006, p. 54)*

Similarly, RBA Assistant Governor Michele Bullock (2017) has recently observed:

> *… concentration of itself does not necessarily imply a lack of competition. Indeed, indicators of market structure such as measures of concentration are not regarded as a very accurate measure of competition. In principle, four large banks could still compete very actively among themselves.*

Thus, a competition analysis focusing solely on market concentration could be fundamentally flawed because it ignores other critical factors. These other factors include the height of barriers to entry and the extent of sunk costs incurred by new entrants.

An entry barrier is a structural characteristic of a market that protects the market power of incumbent operators by making new entry unprofitable (Church & Ware, 2000, p. 11). Prominent American economist Joseph Bain (1956) considered the force of potential competition as a regulator of price and output of comparable importance to that of actual competition and focused on the height of barriers to entry as the critical determinant of the price level. According to Professor Vives (2016), entry barriers are pervasive in banking. According to the Murray Report:

> *Licencing provisions and regulatory frameworks can impose significant barriers to the entry and growth of new players, especially those with business models that do not fit well within existing regulatory frameworks. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 255)*

The theory of contestable markets is a reformulation of Bain's work on barriers to entry whereby oligopolistic behaviour can be explained by means of the constraint imposed by potential competition. Under this theory, an entry barrier has been defined as "anything that requires an expenditure by a new entrant into an industry, but that imposes no equivalent cost upon an incumbent" (Baumol & Willig, 1981, p. 408).

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achieved by a monopoly. Within market economies, there are generally competition laws (also known as antitrust laws) prohibiting cartel arrangements.

From this definition, a distinction is drawn between fixed costs and sunk costs. Fixed costs do not necessarily constitute a barrier to entry because they affect incumbents and entrants alike. However, any entry cost that is unrecoverable is a sunk cost. The need to sink costs into a new firm imposes a difference between the incremental cost and the incremental risk that are faced by an entrant and an incumbent (Baumol & Willig, 1981, p. 418). In the case of an incumbent, such funds have already been expended and they are already exposed to whatever risks the market entails. In contrast, the new firm must incur any entry costs on entering the market that incumbents don't bear. Entry will occur in the event the profits expected by a successful entrant outweigh the unrecoverable entry costs that will be lost in the case of failure. Hence, the need to sink costs can therefore constitute a barrier to entry.

In banking, sunk costs could include investment in a branch network, automatic teller machine (ATM) network, advertising, investing in communications networks/technology, and specialised human capital.

Structural conditions exist within the Australian financial system whereby competition problems could manifest themselves. Despite this, the Murray Report found that competition within the financial system was adequate for the time being, although it also acknowledged the potential dangers:

> *… the high concentration and steadily increasing vertical integration in some sectors has the potential to limit the benefits of competition in the future. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 255)*

Arguably, one of the biggest factors leading to the diminution in level of competition within the Australia financial system in the past decade has been the interaction of the Global Financial Crisis (GFC) coinciding with the introduction of Basel II.

5.2 Basel II, APRA and Competition

5.2.1 APRA's Competition Mandate

Section 8 of the *Australian Prudential Regulation Authority Act 1998* (Cwlth) sets out the legislative purpose for establishing APRA. According to APRA (2014, p. 15), section 8 makes clear that APRA's primary purpose in exercising its prudential powers is to protect depositors and other members of the community holding financial promises issued by regulated financial institutions.

Section 8(2) requires APRA to balance financial safety with efficiency, competition, contestability and competitive neutrality, subject to an overarching requirement to promote financial stability.[9] Implicit within APRA's legislative charter is the notion that competition is a secondary consideration – along with the related concepts of efficiency, contestability and competitive neutrality – as something that can be traded off against financial safety and the overarching objective of promoting financial stability. In this regard, the interim Murray Report observed that regulators are required to make judgements in balancing sometimes competing objectives (Murray, Davis, Dunn, Hewson, & McNamee, 2014, p. 3.121). Similarly, APRA (2014, p. 15) has observed that its legislative purpose provides it with "a clear mandate but one that requires a careful balancing act."

[9] Competitive neutrality occurs where no entity operating in an economic market is subject to undue competitive advantage or disadvantage (Organisation for Economic Co-operation and Developmen, 2012, p. 17).

The notion that APRA sees its role as engaging in a careful balancing act that seeks to preserve financial stability as an overarching objective while potentially trading off secondary objectives such as efficiency, competition, contestability and competitive neutrality raises the possibility it is susceptible to take the so-called "competition-fragility" view of banking in exercising its functions. In this regard, the Murray Report observed:

> *Conduct and prudential regulators have a natural tendency to prioritise fairness or stability over competition and long-term efficiency. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 19)*

As a consequence of this natural tendency of prudential regulators, the final Murray Report raised concerns that broader competition issues would *fall between the cracks* as regulators focus on their specific mandates for stability and consumer protection (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, pp. 255-256).

To address this problem, the interim Murray Report suggested that APRA could do more to emphasis competition matters (Murray, Davis, Dunn, Hewson, & McNamee, 2014, p. 3.121). To address this problem in the final Murray Report, it recommended the state of competition in the financial system be reviewed every three years and that there should be improved reporting of how APRA balanced competition against its core objective (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 254).

5.2.2 Implementation of Basel II

According Andrew Haldane (2013, p. 25), the Chief Economist of the Bank of England:

> *These design features of Basel II were intended to provide incentives to banks to move to internal models and thereby improve their risk management. The link from the use of models to improved risk management is at best tenuous. But more fundamentally, this design feature may also have potentially perverse consequences for systemic risk and competition.*

According to Adrian Blundell-Wignall and Caroline Roulet from the OECD (2013, p. 8), OECD research has consistently argued the Basel system is excessively complex, rendering it ineffective, and that a simple leverage ratio should be the primary regulatory tool for bank capital.[10]

The internal rating basis (IRB) method for calculating risk weights provided for under Basel II has been described by some as essentially self-regulation. The IRB approach relied on the self-interest of the banks to lead them to use the best possible estimates of risk in their own management of assets (Elliott, 2010, p. 5).

According to then Prime Minister Kevin Rudd (2009, p. 23):

> *… the Basel II guidelines, published in June 2004, have now been demonstrated to be inadequate because they left the determination of risk to flawed credit-ratings processes and the banks' own "self-regulated" internal assessment models.*

Andrew Haldane (2013, p. 18) has observed the IRB approach – like other attempts at self-regulation – has arguably been gamed or arbitraged:

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[10] Leverage – or gearing as it is sometimes called, is the extent to which a business funds its assets with borrowing rather than equity (Ingves, 2014). Leverage ratios measure the extent to which a bank has financed its assets with equity.

Under a self-assessed standard, banks may have both the incentive and the ability to shade downward risk weights, or to switch to lower risk-weighted asset categories, thereby boosting reported capital ratios. The aggregate evidence is consistent with this having occurred secularly and on a significant scale.

In the Australian context, the Murray Report observed:

Concerns have also been raised that banks may have the capacity —and incentive — to manipulate IRB models to achieve a lower capital requirement. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 85)

Competition Issues with the Implementation of Basel II

APRA downplayed as well as dismissed competition concerns during its implementation of Basel II and did not follow due process by completing the required competition assessment checklist in the Regulation Impact Statement it prepared for Basel II. The actions of APRA in turn implies the "competition-fragility" view is endemic to the organisation. The outcomes arising from the interaction of the GFC coupled with the implementation of Basel II vindicates the criticisms of Basel II from a competition perspective.

When Basel II was published in 2004 banks were informed the capital weight given to mortgages would fall from 50 per cent under Basel I to 35 per cent under Basel II, and to as little as 15-20 per cent depending on whether and how a bank would use the IRB method (Blundell-Wignall, Atkinson, & Lee, 2009, pp. 15-16). Thus under Basel II, credit and operating risk weights determined under the standard approach were much higher than those under the IRB method used by the major banks. In this regard, the RBA (2015, pp. 54-55) found that at the end of June 2015 the average risk weight of residential mortgage exposures using the IRB method was 17 per cent as compared to 40 per cent using the standardised approach.

Higher risk weights mean more capital is allocated to the lending, which leads to a higher cost of funds for ADIs using the standardised approach. The higher cost of funds for ADIs using the standard approach in turn influence their pricing of lending products, thus reducing their competitiveness with IRB banks for lending. On the other hand, the use of lower capital weights under the IRB method raises the return on capital for a given mortgage asset, and the corollary of this is that greater concentration in low-capital-weighted mortgages improves the overall bank return (Blundell-Wignall, Atkinson, & Lee, 2009, p. 16). As former Group Executive of Business Banking at NAB Joseph Healy (2010) observed:

Basel II has been a big boost to banks with a strong Retail Banking franchise, enhancing returns on what was an already very profitable segment by lowering the cost of capital required to be funded out of margins. Fact.

The adoption of the IRB method also meant the major banks could engage in excessive leveraging and in turn increase their capacity for lending. Based on the average risk weight of residential mortgage exposures for banks using the IRB method in June 2015 implies a leverage multiple of almost 74 times the amount of capital held, more than double the implied leverage for those using the standardised approach.

Through its implementation of Basel II, APRA put smaller ADIs at a major competitive disadvantage and undermined competitive neutrality. Professor Christine Brown of Monash University and

Professor Kevin Davis of the University of Melbourne warned of this possibility as far back in 2002 that Basel II could threaten competitive neutrality in the banking system:

> *Basel 2 has significant potential to affect structure, conduct and performance in three distinct areas or the economy. First, it may alter the industrial structure of the banking industry if capital incentives do provide a competitive advantage to banks using advanced risk management techniques. (Browne & Davis, 2002)*

Rather presciently, Professor Davis (2005) also warned:

> *If the internal risk weights for IRB banks for housing mortgages and retail lending are as low as the Quantitative Impact Studies have indicated, there is the potential for such banks to make significant inroads into those markets at the expense of other banks operating under the standardised approach. It would be quite anomalous if a capital accord developed primarily to suit the sophisticated activities of very large banks in international markets, had the effect of giving them a competitive advantage in the 'bread and butter' markets where smaller local banks can, arguably, assess and manage risk equally well.*

It appears that APRA was well aware of competition concerns before the implementation of Basel II but chose to downplay their potential impact. According to then APRA Executive General Manager Charles Littrell (2003):

> *There are material competition issues associated with Basel II…*
>
> *The main domestic competition issue is the split between [internal ratings based] banks and standardised ADIs, including smaller banks. We recognise the potential for competitive disequilibrium between [internal ratings based] and standardised approach users, particularly in home loans. Doubtless this will be a matter for considerable industry discussion and possibly some angst, but our calculations indicate that the larger bank's current capital advantages will not widen materially as a result of Basel II's introduction.*

The then Chairman of APRA, Mr John Laker (2006), dismissed concerns of smaller financial institutions at an overseas conference in the following terms:

> *Many smaller ADIs have expressed concerns that this outcome will, nonetheless, change their competitive position vis-à-vis the larger banks. We in APRA, however, do not view Basel II as a vehicle for changing the competitive landscape but rather as an opportunity to better align regulatory capital with the risks that ADIs assume and how well those risks are managed. It is also worth noting that there have long been differences in the average capital ratios of different sectors of the ADI industry in Australia.*

While Mr Laker's observations that there had long been differences in the average capital ratios of different sectors of the ADI industry is probably correct, he did not address whether implementation of Basel II would open up further differences between the major banks and other ADIs and thus dramatically alter the competitive landscape, thereby undermining competitive neutrality.

The final Regulation Impact Statement (RIS) for the implementation of Basel II was prepared by APRA (2007) in November 2007. The final RIS was silent on the potential competitive disadvantage of smaller ADIs under Basel II despite the requirement to complete a competition assessment checklist that included the following question:

> *Would the regulatory proposal restrict or reduce the ability of businesses to compete?*
>
> *For example:*
>
> *– control or substantially influence the price at which a good or service is sold;*
>
> *– alter the ability of suppliers to advertise or market their products;*
>
> *– set standards for product/service quality that are significantly different from current practice; or*
>
> *– significantly alter costs of some suppliers relative to others. (Office of Best Practice Regulation, 2007, p. 30)*

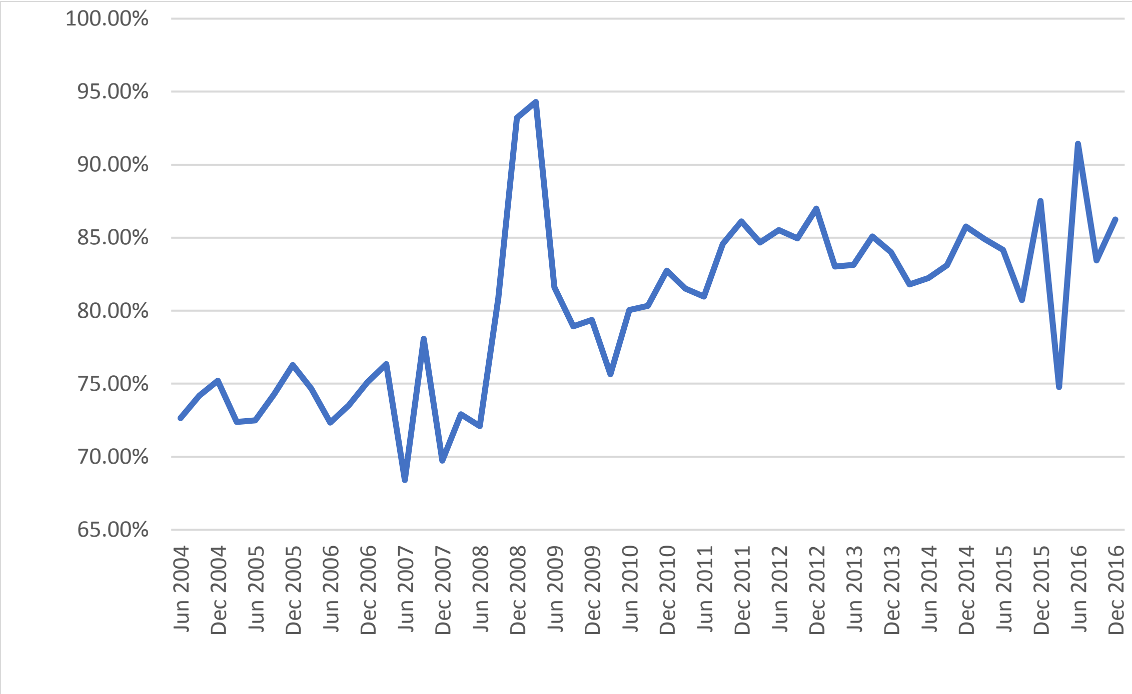
While APRA was required to complete a competition assessment checklist, it failed to fulfil this requirement. Despite the potential for smaller ADIs being placed at a competitive disadvantage under Basel II not being addressed, the RIS was assessed as adequate by the Office Best Practice Regulation (2008). This suggests the RIS was more of a 'tick all of the boxes' exercise than a serious examination of potential regulatory flaws within the Basel II framework.

Furthermore, APRA (2007, p. 7) declared advanced methods were the exclusive domain of the major banks:

> *The larger Australian banks are among the global banks that commenced developing sophisticated risk management systems and internal economic capital models prior to the release of Basel II. This gives those banks a foundation on which to base the advanced Basel II methodologies. The small ADIs do not have the resources, or indeed the need, to implement the advanced approaches and will implement the standardised approaches.*

The available evidence suggests the interaction of the GFC combined with the implementation of Basel II provided a major fillip to the major banks to the detriment of other ADIs. This can be seen in Figure 2 below that shows the percentage market share of interest income earned on housing loans by the major banks dramatically spiked as well as permanently increased in the second half of 2008 onwards.

Figure 2: Percentage Market Share of Interest Income Earned by the Major Banks – September Quarter 2004 to March Quarter 2017



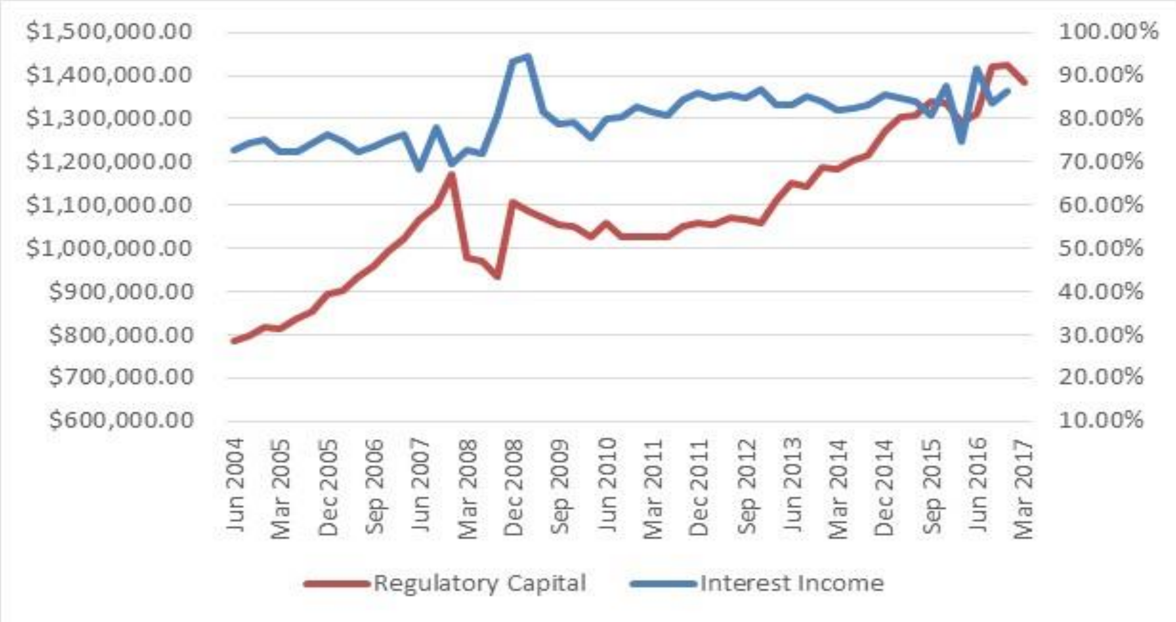
Source: APRA (2017a)

APRA (2014, p. 73) has attributed this dramatic change entirely upon the drying-up of funding from the residential mortgage-backed securities market on which some of the other ADIs had previously relied during the GFC. However, this change also coincided at a time when the major banks were able to hold much less regulatory capital for credit risk thus lowering their cost of funds, providing them with the scope to reduce their relative prices on home loan products by virtue of the IRB method. As a matter of economic theory, even a monopolist will generally be expected to pass along at least some portion of a reduction in marginal costs (Frankel, 2007, p. 47). As business commentator Alan Kohler has observed, the IRB method:

> *… represents a built-in regulatory bias towards the banking oligopoly in Australia, and makes it much harder for the smaller players to take market share off them because their interest rates have to be higher to pay for the capital.*

From the beginning of 2008 until 2013 there appears to be something of an inverse relationship with varying lags between the amount of regulatory capital held for credit risk by the major banks and changes in their market share on interest income earned on housing loans. This is illustrated in Figure 3 below. The amount of regulatory capital for credit risk held by the major banks prior to the implementation of Basel II in the December quarter 2007 wasn't finally exceeded until December 2013.

Figure 3: Regulatory Capital Held for Credit Risk ($ millions) and Percentage Share of Interest Income Earned by the Major Banks – September Quarter 2004 to March Quarter 2017



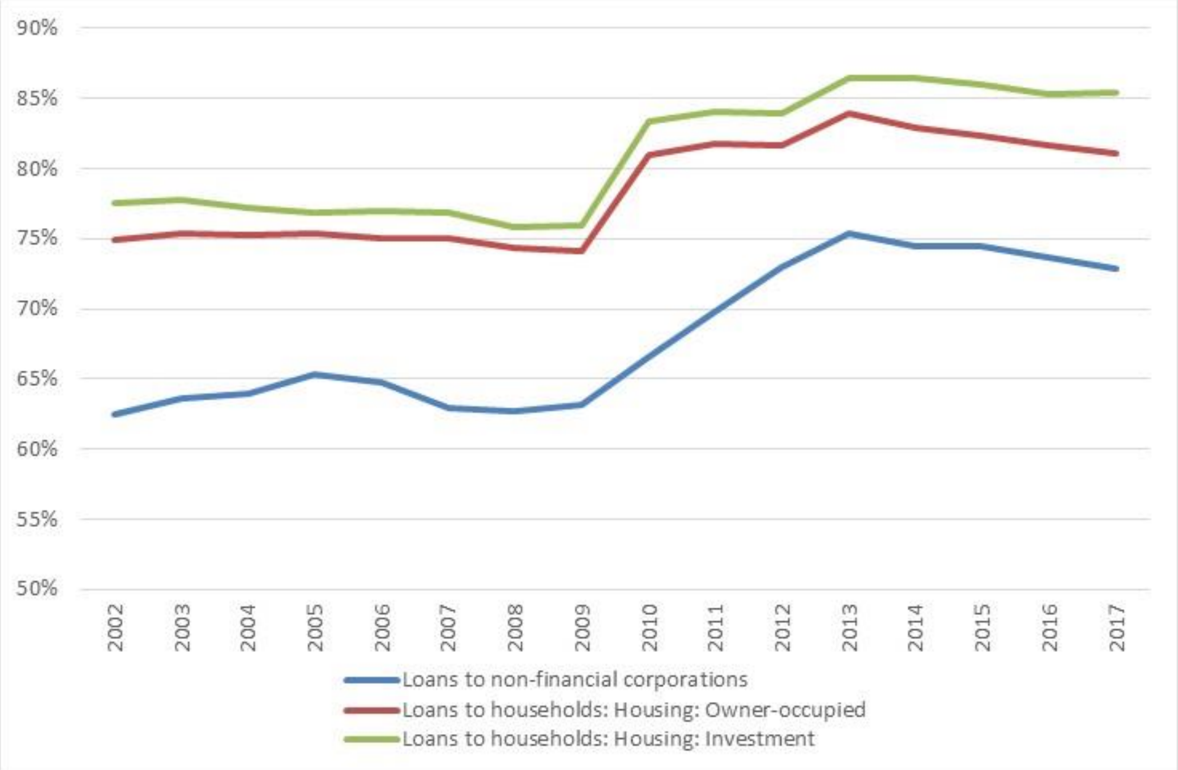
Source: APRA (2017a)

During period of implementation for Basel II, the major banks increased their market share across the three main bank lending categories of:

- owner occupied housing;
- investment housing; and
- lending to non-financial corporations.

This is outlined in Figure 4 below.

Figure 4: Percentage Market Share of the Major Banks for Bank Lending for Owner Occupied Housing, Investment Housing and Non-Financial Corporations – 2002 to 2017



Source: APRA (2017)

In its initial submission to the Murray Report inquiry, APRA (2014) was antithetic to the suggestion that differing approaches in risk weights under Basel II could be tilting the playing in favour of banks using the IRB approach and thereby stifling competition:

> *APRA's prudential requirements may affect the relative position of competitors in particular regulated industries by imposing differential capital costs, but other factors – such as scale, business models and operating and funding costs – are likely to have larger impacts on the competitiveness of smaller institutions. (Australian Prudential Regulation Authority, 2014, p. 15)*
>
> *APRA does not see any compelling reasons to depart from the Basel II capital framework, now well-established globally, to seek to deal with residual competition issues in housing lending. Comparing the specific risk-weight for a particular loan under the two approaches will give a misleading impression of the competitive impact of Basel II. (Australian Prudential Regulation Authority, 2014, p. 76)*

APRA dug its heels in to support the lack of competitive neutrality under Basel II even though the Chief Economist of the Bank of England, Andrew Haldane (2013, p. 25), had commented the previous year that:

> *A second unintended consequence of the move to a model-based regulatory framework is that it has tended to work in quasi-discriminatory ways. In particular, it has tended to discriminate both between small and large banks and between new entrants and existing incumbents in the amounts of capital they are required to hold even against identical exposures.*

> *The reason for this is that small or new entrant banks will generally adhere to … simple standardised approaches for measuring risk. In general, they will have neither the data nor the technology to support internal model approaches. But simpler, standardised approaches tend to require much higher amounts of capital than internal model approaches. Indeed, this was a design feature of Basel II.*
>
> *These design features of Basel II were intended to provide incentives to banks to move to internal models and thereby improve their risk management. The link from the use of models to improved risk management is at best tenuous. But more fundamentally, this design feature may also have potentially perverse consequences for systemic risk and competition.*

It is also evident from research across the world that Basel II and the introduction of the IRB method provided an unfair competitive advantage to those financial institutions that could take advantage of it. In relation to the United Kingdom, a Bank of England Staff Working Paper recently concluded:

> *The switch to Basel II gave lenders using internal (IRB) models a comparative advantage in capital requirements (compared to lenders using the standardised approach, or SA), particularly at low loan-to-value (LTV) ratios, and this was reflected in prices and quantities. Lenders in general reduced their prices by more for low (versus high) LTV lending. (Benetton, Eckley, Garbarino, Kirwin, & Latsi, 2017, p. 26)*

The Murray Report completely rejected APRA's position and recognised the IRB approach had usurped competitive neutrality by tilting the playing field against financial institutions using the standardised approach:

> *In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another. This conclusion is supported by the findings of APRA's recent stress test, which found regulatory capital for housing was more sufficient for standardised banks than IRB banks.*
>
> *The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks. Because equity is a more expensive funding source than debt, this translates into a funding cost advantage for IRB banks' mortgage businesses to the extent that the riskiness of mortgage portfolios is similar across banks.*
>
> *Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of smaller ADIs will harm competition in the long run. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 61)*

APRA dragged the chain on this matter until it was forced to act in response to Recommendation 2 of the Murray Report which recommended that APRA should:

> *Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB*

risk-weight models and those using standardised risk weights. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 60).

The Murray Report suggested the minimum risk weight on IRB banks for housing loans in the range of 25 and 30 per cent would be appropriate (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 65). In July 2015 APRA (2015) announced that it would raise the risk weights on IRB banks to at least 25 per cent, at the lowest end of the range suggested by the Murray Report.

Implementation of Basel II and Over-Exposure to Housing Finance

Despite previously acknowledging that concentration of credit risk in asset portfolios has been one of the major causes of bank distress, the Basel Committee made no allowance for credit risk concentration in the IRB methodology. The risk-weighting formulas in Basel II are based on a specific mathematical model, developed by the Basel Committee, which is subject to the restriction that it is *portfolio invariant*; that is, the capital required to back loans should depend only on the risk of that loan, not on the portfolio to which it is added (Blundell-Wignall & Atkinson, 2010, p. 12). The major disadvantage of this approach is that it does not reflect the importance of diversification as an influence on spreading and minimising portfolio risk. Thus, the minimum capital requirements associated with any type of loan due to credit risk simply rise linearly with the holding of that asset type, regardless of the size of the exposure (that is, appropriate diversification is simply assumed). This means that Basel II did not penalise portfolio concentration.

Sector concentration risk is an important issue; for instance, if a loan portfolio is excessively concentrated in credit to firms in a particular sector, a shock to the sector could have a significant impact on the entire portfolio (Düllmann & Masschelein, 2006).

Concentration of credit risk if it is dealt with at all under Basel II, was left to prudential supervisors under Pillar 2 (Blundell-Wignall & Atkinson, 2010, p. 12). In relation to APRA (2007a, p. 5), concentration of credit risk was covered under Pillar 2 under the category of Pillar 1 inherent risks that were not fully captured by the Pillar 1 processes. According to APRA (2007a, p. 13):

Credit concentration risk – where the ADI's internal credit risk economic capital model already reflects actual exposure sizes and default correlations to the relevant industry, geographic and other systematic risk factors, there is no need for any specific adjustment for such risk.

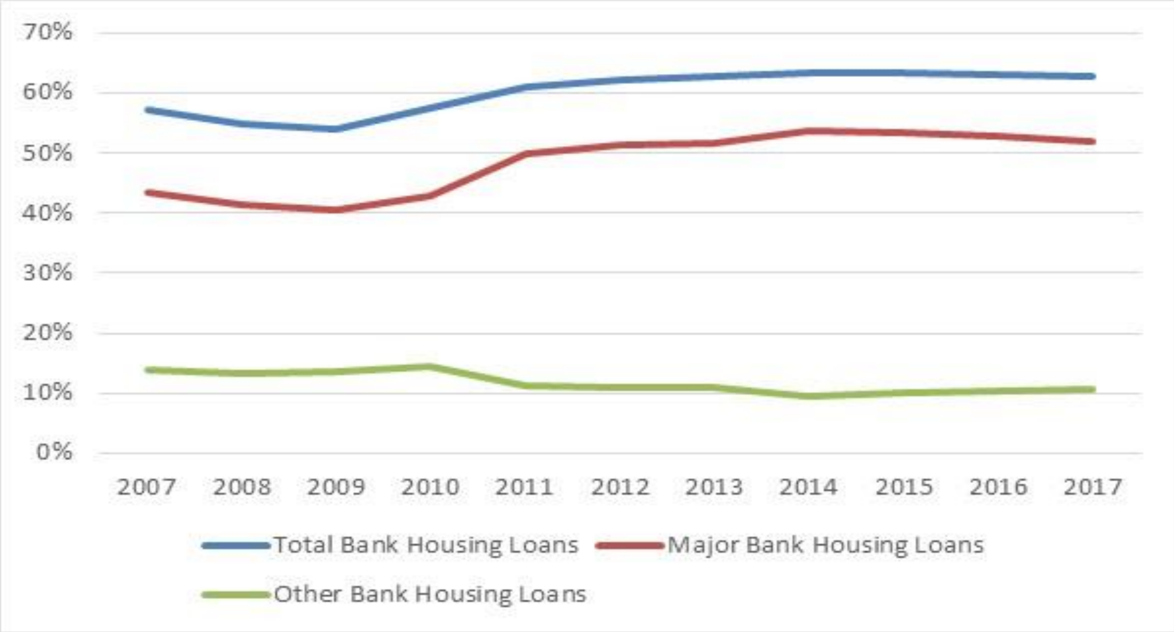
However, if the exposure size and correlation assumptions employed in the model do not closely approximate those of the ADI's own unique credit portfolio, a concentration risk adjustment may be required. Large exposure size and high correlations increase the amount of losses that could be sustained as a result of particular adverse circumstances.

Since the introduction of Basel II there has been a clear bias in favour of housing finance by the banking sector. Housing loans as a percentage of total bank loans has risen from 57 per cent in 2007 to currently around 63 per cent.[11]

The main impetus for this increase in housing finance has been the major banks, whose overall share of housing loans as a percentage to total bank loans has risen from 43 per cent in 2007 to currently around 52 per cent, while the market share of all other banks has contracted. This is outlined in Figure 5 below.

[11] Data sourced from APRA (2017).

Figure 5: Total Bank Housing Loans, Major Bank Housing Loans and Other Bank Housing Loans as a Percentage of Total Bank Loans – 2007 to 2017



Source: APRA (2017)

While there are government policy settings that encourage housing lending such as the first home owners grant scheme, the capital gains tax exemption on the family home and certain tax advantages associated with negative gearing, Basel II appears to have also been another contributing factor in the redirection of bank lending towards housing finance. This is because Basel II cut the risk weights for housing lending in general, but also provided a greater fillip for systemically important banks through cutting risk weights even more for those banks able to utilise the IRB method. This problem was highlighted by former Group Executive of Business Banking at NAB Joseph Healy (2010) who warned:

> *… the bias towards home lending has clearly been influenced by the international Basel II capital adequacy rules which took effect in Australia in 2007-08.*
>
> *These rules implicitly encourage banks to favour residential mortgage lending over business lending as residential mortgages attract a lower capital charge under both standardised and advanced accreditation frameworks.*
>
> *This means that banks can do on average three to four times more mortgage lending relative to business lending in terms of capital management. All other things being equal, we have a system that makes it more attractive for banks to lend the marginal dollar on a weekend holiday home than to a small business! One could reasonably regard this outcome as perverse.*

In its submission to the Murray Report inquiry, APRA (2014, p. 72) acknowledged that some had argued that its capital requirements for housing lending had been a major influence in encouraging an 'excessive' concentration of ADI balance sheets on housing lending.

However, no one knows if APRA has addressed the excessive concentration on housing lending on the balance sheets by the major banks, or even if it has as to whether any adjustments made could be considered adequate. This is because Pillar 2 adjustments are entity specific and are not publicly disclosed (Byres, 2011).

In turn, the bias towards housing lending contained in Basel II has created a risk to the Australian economy through bank lending fuelling a potential asset price bubble. The Murray Report warned about the risk posed by housing lending to the Australian economy in the following terms:

> *Australia's banks are heavily exposed to developments in the housing market. … A sharp fall in dwelling prices would damage household balance sheets and weigh on consumption and broader economic growth. It would also reduce the quality of the banking sector's balance sheets and the capacity of banks to extend new credit, which would compromise the speed of a subsequent economic recovery. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 22)*

This is consistent with recent comments by the RBA (2017, p. 19) that the main risks from a housing asset price bubble are primarily macroeconomic rather than systemic:

> *The risks associated with strong investor credit growth and increased household indebtedness are primarily macroeconomic in nature rather than direct risks to the stability of financial institutions… the concern is that investors are likely to contribute to the amplification of the cycles in borrowing and housing prices, generating additional risks to the future health of the economy. Periods of rapidly rising prices can create the expectation of further price rises, drawing more households into the market, increasing the willingness to pay more for a given property, and leading to an overall increase in household indebtedness. While it is not possible to know what level of overall household indebtedness is sustainable, a highly indebted household sector is likely to be more sensitive to declines in income and wealth and may respond by reducing consumption sharply.*

However, before dismissing concerns altogether that a housing asset price bubble could trigger a systemic crisis rather than just a severe economic downturn, an International Monetary Fund research paper has previously warned:

> *When banks are involved in financing asset price booms, … as in real estate mortgage and corporate sector financing, risks of adverse consequences of a following asset bust are typically much higher. The main reason is that these booms involve leverage and banks, implying that the flow of credit to the economy gets interrupted when a bust occurs. (Claessens & Kose, 2013, p. 11)*

A recent paper published by the UK Centre for Economic Policy Research on the impact of the Basel process on the resilience of banks in the European Union has concluded:

> *This analysis reveals that the adoption of internal models for credit risk (Basel II) was an especially major driver of the build-up of systemic risk exposure in Europe.*
>
> *…*
>
> *Rather than providing incentives for better risk management for the larger and internationally active banks, precisely those sophisticated banks used internal models to carve out even more equity in order to increase return on equity and at the same time reduce resiliency. In light of these results, placing caps on the use of internal models seem reasonable policy options. (Gehrig & Iannino, 2017)*

The current predisposition of the major banks toward housing lending has prompted several commentators to observe that they have become giant building societies. According to former NAB Chief Executive Officer Don Argus back in 2010:

> *I think the Australian banking sector has gone too far. You can look at some of them now as giant building societies. (Maiden, 2010)*

According to business commentator Alan Kohler (2015):

> *A funny thing happened to business lending on the way from the GFC.*
>
> *Australia's banks turned into giant building societies, lending almost exclusively against residential property and rarely, if ever, making unsecured loans to businesses or people any more.*

The bias towards housing risks creating a significant misallocation of resources across the Australian economy, potentially lowering economic growth. Given an economy's stock of physical capital, labour, human capital, and knowledge, the way in which those aggregate quantities of inputs are allocated across households, firms and industries determines the economy's overall level of production (Jones, 2011, p. 2). The optimal allocation will maximise welfare through maximising output and growth in the long run. However, other allocations result in lower levels of output and growth and will manifest themselves in lower levels of multi-factor productivity (MFP).[12]

Productivity growth, which means producing more output with fewer inputs, is a crucial determinant of national living standards. According to the 2008 Nobel Laureate for economics Paul Krugman (1992, p. 9):

> *Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.*

Aggregate productivity growth can essentially reflect two broad factors: first, technical progress and more and better human and physical capital in the various industries; second, reallocations of capital and labour from poorly performing sectors to those that perform well (Bank for International Settlements, 2015, p. 53). However, evidence shows that credit booms tend to undermine this second factor.

Credit booms tend to undermine productivity growth as they occur (Borio, Kharroubi, Upper, & Zampolli, 2015, p. 2). A large part of this impact reflects the shift of labour to lower productivity growth sectors. This is typically sectors that are particularly credit-intensive even though they may not be very productive in the long run (Bank for International Settlements, 2015, p. 53). This depresses productivity growth – and thus potential output – even long after credit has stopped growing. For example, the shift of labour into a temporarily bloated construction sector (Borio, Kharroubi, Upper, & Zampolli, 2015, p. 2). Finally, the subsequent impact of labour reallocations that occur during a boom is much larger if a crisis follows.

[12] MFP is the ratio of output to the combined inputs of labour and capital. MFP is a more comprehensive productivity measure because it identifies the contributions of both - capital and labour - to output.

While the most recent estimates reveal that MFP across the market sector of the Australian economy have ticked up, the construction sector has been something of a recent productivity laggard.[13] This slowdown in MFP in the construction sector has occurred at a time when the relative contribution of residential building to the construction sector has dramatically increased due to an upsurge in residential building construction coupled with the end of the mining boom.[14]

Although APRA has made a number of recent regulatory decisions that has forced the major banks to raise their capital holdings (see section 5.2.3 below), this may not necessarily address the over-emphasis on housing lending by the major banks. As Alan Kohler (2015) has observed, the major banks will be loath to waste any new capital raised on loans that count dollar for dollar against that new capital, and will be even more inclined to focus on real estate. This in turn suggests a fundamental design flaw in the credit risk weightings under Pillar 1 of Basel II. Unfortunately, the revised Basel III framework doesn't address this problem as the weighting system under Pillar 1 continues to suffer from the assumption of portfolio invariance (Blundell-Wignall & Atkinson, 2010, p. 20).

Adrian Blundell-Wignall and Paul Atkinson from the OECD (2010, p. 20) have suggested that it may be possible to deal with concentration issues under Pillar 1 through the adoption of a quadratic penalty applied to deviations from a diversified benchmark portfolio – the minimum leverage ratio would apply if a firm was on benchmark, but it would have to add increasingly more capital the more it deviated from benchmarks.

Following recommendation 7 from the Murray Report as well as the Basel III framework, APRA has introduced a leverage ratio deal to address excessive leveraging under Pillar III of Basel III. According to APRA (2014b, p. 10), the leverage ratio was designed to:

- restrict the build-up of excessive leverage in the banking system, helping to avoid a destabilising deleveraging process that could damage the broader financial system and the economy; and
- reinforce the risk-based requirements with a simple 'backstop' measure that provides additional safeguards against model risk and measurement error.

However, Adrian Blundell-Wignall, Paul Atkinson and Caroline Roulet from the OECD (2014, p. 7) have criticised the proposed Basel leverage ratio as inadequate to deal with excessive leveraging:

> *… the 3% Tier 1 leverage ratio "back-up" goal being considered by the [Basel Committee on Banking Supervision] for 2019 is too lax. It allows leverage of 33-times capital and, in addition, banks are permitted to net derivatives transactions when calculating the leverage ratio. This latter arrangement has always puzzled the present authors: netting is a settlement concept, particularly in the event of default, and it does not in any way protect a bank from market risk. Hence netted derivatives are not an appropriate basis on which to base ex-ante capital rules. Leverage ratios that give rise to capital for ex-ante market risk would be larger than those allowed under Basel III.*

In order to rein in excessive leveraging by the major bank in housing lending, APRA has resorted to more direct regulatory interventions following discussions with other members of the Council of

[13] See Productivity Commission (2013; 2014; 2015; 2016).

[14] See Australian Bureau of Statistics (2017).

Financial Regulators.[15] In December 2014 APRA (2014a) announced that it would take steps to reinforce sound residential mortgage lending practices by increasing the level of supervisory oversight on mortgage lending. In particular APRA (2014a) flagged to ADIs that it would be paying particular attention to specific areas of prudential concern, including:

- higher risk mortgage lending — for example, high loan-to-income loans, high loan-to-valuation (LVR) loans, interest-only loans to owner occupiers, and loans with very long terms;
- strong growth in lending to property investors — portfolio growth materially above a threshold of 10 per cent will be an important risk indicator in considering the need for further action;
- loan affordability tests for new borrowers — these should incorporate an interest rate buffer of at least 2 per cent above the loan product rate, and a floor lending rate of at least 7 per cent, when assessing borrowers' ability to service their loans.

At the end of March 2017, APRA (2017b) initiated additional supervisory measures to rein in certain residential mortgage lending practices in order to reduce risks, writing to all ADIs advising that APRA expected them to:

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

APRA's resort to these measures to rein in excessive leveraging suggests that its ongoing adherence to Basel arrangements that place the use of risk-weighted capital ratios as the most appropriate mechanism for determining an ADI's capital adequacy is failing.

5.2.3 Other Recent Action by APRA

Since the Government foreshadowed the Financial System Inquiry in November 2013 with the release of draft terms of reference, APRA's recent conduct in relation to competition issues and competitive neutrality has improved.

In December 2013 APRA (2013) announced its decision to impose an additional capital charge of 1 per cent (referred to as the higher loss absorbency (HLA) capital requirement) on Australia's four domestic systemically important banks (D-SIBs), ANZ, CBA, NAB and Westpac. According to the APRA (2013) media release:

[15] The Council of Financial Regulators is the coordinating body for Australia's main financial regulatory agencies and comprises the RBA, which chairs the Council APRA, the Australian Securities and Investments Commission (ASIC) and the Australian Treasury.

> *Based on a range of considerations, APRA has determined that a one per cent HLA requirement will apply to the four D-SIBs. This must be met by Common Equity Tier 1 capital and will be implemented as an extension of the capital conservation buffer as defined in Prudential Standard APS 110 Capital Adequacy.*
>
> *The D-SIB framework will come into effect from 1 January 2016.*

In response to recommendation 2 from the Murray Report, in July 2015 APRA (2015) announced that it would raise the risk weights on IRB banks to at least 25 per cent, at the lowest end of the range suggested by the Murray Report.

Recommendation 1 from the Murray Report was for:

> *Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 41)*

In response to the Murray Report recommendation 1, in July 2017 APRA (2017c) announced

> *For ADIs that use the internal ratings-based approach to credit risk, APRA has concluded that it is necessary to raise minimum capital requirements by around 150 basis points from current levels to achieve capital ratios that would be consistent with the goal of 'unquestionably strong'.*
>
> *…*
>
> *In the case of the four major Australian banks, APRA expects that the increased capital requirements will translate into the need for an increase in CET1 capital ratios, on average, of around 100 basis points above their December 2016 levels. In broad terms, that equates to a benchmark CET1 capital ratio, under the current capital adequacy framework, of at least 10.5 per cent.*

For ADIs that use the standardised approach to credit risk, APRA (2017c) concluded that it was only necessary to only raise minimum capital requirements by approximately 50 basis points from current levels to achieve capital ratios that would be consistent with the goal of 'unquestionably strong'.

Recent regulatory action by APRA appears to have slightly levelled the playing field and thus curtailed the market expansion of the major banks in various banking lending categories as can be seen in Figure 4 above.

Given the views expressed by APRA in its first submission to the Murray Report inquiry regarding smaller ADIs, it is doubtful any changes would have transpired had it not been for the additional public scrutiny APRA received by virtue of the Murray Report inquiry and subsequent recommendations. Given that it is just not feasible to have an ongoing inquiry into the financial system, nor for an ongoing Productivity Commission inquiry into competition into the financial system for that matter, it is necessary to consider other policy options to force APRA to place a greater emphasis on competition in its deliberation over the prudential regulation of the financial system.

6. Competition Reform in Prudential Supervision

According to Professor Vives (2016), competition policy and prudential regulation need to be coordinated. This has recently been achieved in the United Kingdom through legislative reforms to its prudential regulatory system.

The UK Prudential Regulation Authority (PRA) of the Bank of England has two primary objectives: to promote the safety and soundness of the firms it regulates, focusing on avoiding and minimising adverse effects that they can have on the stability of the UK financial system; and an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.

In March 2014, the PRA of the Bank of England was given a statutory secondary competition objective which states that:

> *When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.*

This Secondary Competition Objective (SCO) requires the PRA to take a more proactive stance towards competition than had previously been the case for the Financial Services Authority, the PRA's regulatory predecessor (Independent Evaluation Office - Bank of England, 2016, p. 5).

The PRA was originally established as part of the Bank of England by the UK Financial Services Act 2012. Not dissimilar to APRA's current legislative purpose, the PRA originally commenced with a 'have regard' duty with respect to competition, namely to "the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions" (Parliamentary Commission on Banking Standards, 2013, p. 473). In essence, this regulatory principle sought to ensure that competition considerations were at least a factor the PRA should consider when taking actions to meet its primary objectives (Dickinson, Humphry, Siciliani, Straughan, & Grout, 2015, p. 337).

During the passage of the UK Financial Services Act 2012, the House of Commons Treasury Committee (2012, p. 33) recommended the PRA be given a secondary competition objective:

> *It remains our view that competitive markets need both freedom to exit and freedom to enter. The Bill contains no proposal for specific objectives related to competition for the Prudential Regulation Authority. We recommend that the House of Lords consider amending the Bill to make competition an objective of the Prudential Regulation Authority.*

While this suggestion was not taken up at the time during the passage of the original legislation, the UK Parliamentary Commission on Banking Standards (2013, p. 474) made a similar recommendation the following year:

> *The Commission has concluded that the PRA should be given a secondary competition objective. A 'have regard' to competition simply does not go nearly far enough. As the experience of the FSA shows, a 'have regard' duty in practice means no regard at all. With only a 'have regard' duty given to the PRA, the risk is high that it will neglect competition considerations. This would be of great concern, given the potential for prudential*

requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants. The current legislation strikes an inadequate balance in this area.

In 2013, the UK Government agreed with the UK Parliamentary Commission on Banking Standards' recommendation and introduced the SCO (Dickinson, Humphry, Siciliani, Straughan, & Grout, 2015, p. 337).

The SCO does not require the PRA to act in a manner that is incompatible with its primary objectives (Bank of England Prudential Regulation Authority, 2016, p. 8). The existence of the SCO means the PRA should consider, but is not necessarily required to adopt, those options which would deliver greater benefits to competition for a given objective of safety and soundness or policyholder protection. An added advantage of looking at prudential regulation through a competition lens is that it provides a check on whether prudential interventions are being applied proportionately, and to guard against the risks of unintended consequences. The SCO does not mean that the PRA is a 'competition regulator'.

The PRA (2016, pp. 10-13) has adopted a four-pronged approach to the implementation of the SCO:

1. Structural changes and increasing capability – the PRA has undertaken a series of measures to embed the SCO in its ways of working, to ensure that competition issues are considered wherever relevant.
2. Research agenda – the PRA is undertaking a number of research projects on the relationship between prudential regulation, financial stability and effective competition.
3. Internal and external communication of the PRA's approach to the SCO – the PRA has made progress in communicating the SCO and its practical implications both internally and externally.
4. Working with external stakeholders – the PRA has built strong and effective working relationships with competition regulators.

As part of its research agenda, the PRA (2017, p. 14) has already completed two research projects focusing on:

- the impact of IRB models on the pricing of mortgages; and
- developing indicators of effective competition in the UK deposit-taking sector.

To address the competitive disadvantage faced by firms using the standardised approach in the residential mortgage lending market, the PRA (2017, p. 5) undertook a review in 2016 of its approach to IRB credit risk model applications from smaller banks and building societies. The findings showed that many of the specific issues raised by IRB aspirants were linked to an overarching perception the PRA did not welcome IRB applications from smaller firms. As part of this review, the PRA (2017, pp. 6-7) has proposed measures that should enable firms that wish to obtain IRB permissions to understand better the PRA's expectations for IRB applications, and therefore enable firms to take investment decisions with greater confidence.

In designing policies, the PRA (2016, p. 7) must have regard to a number of 'regulatory principles' set out in primary legislation, including the principle of 'proportionality'. That is, burdens imposed on a firm's activity are proportionate to the benefits expected, and where appropriate, the PRA will exercise its functions in a way that recognises the difference in the nature, size and complexity of businesses carried out by different firms. Therefore, in designing policies and making rules, the SCO complements this principle by recognising that a 'one size fits all' approach could cause market distortions.

In its pursuit of proportionality, the PRA (2017, p. 11) has proposed refinements to its Pillar 2A capital framework to address concerns over the differences between standardised approach and IRB model risk weights. Proposals would allow supervisors to exercise judgement and reduce variable Pillar 2A add-ons for firms using the standardised approach for credit risk where appropriate.

The UK Government also requires the PRA to publish an annual report on how it is delivering against its competition objective across financial services, to set out clearly the steps being taken to drive more competition and innovation and to help ensure the right incentives exist for new banks to enter the market (HM Treasury, 2015, p. 57).

The SCO has at its centre the notion of effective competition (Dickinson, Humphry, Siciliani, Straughan, & Grout, 2015, p. 334). Such a concept is not unfamiliar in Australian competition law.[16]

One solution to overcoming the "competition-fragility" view of banking that appears endemic to APRA to ensure that competition considerations are given due deliberation in prudential regulatory policy decisions is to give it a statutory secondary competition objective as has been adopted in the United Kingdom. This in turn will help to ensure that competitive neutrality is maintained across all ADIs.

[16] *Re Queensland Co-operative Milling Association Ltd* (1976) 8 ALR 481, 515.

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Appendix: Asymmetric Information, Adverse Selection and Moral Hazard

Information about whether a product has a serious defect may be 'privately observed' by those who access to it and 'unobservable' by those who don't (Mohlo, 1997, p. 1). Such information is referred to as private information. On the other hand, if information is available to everyone then it is referred to as 'public information' or 'publicly observable'. The presence of private information creates an 'information asymmetry' whereby some people are better informed than others.

In the event that informational asymmetries exist between buyers and sellers in a market, the 2001 Nobel Laureate for economics George Akerlof (1970) demonstrated that this would give rise to the problem of adverse selection. Akerlof used the example of the market for used cars where buyers could buy either good cars or defective cars that were described as 'lemons'. In the presence of asymmetric information, Akerlof showed that the used car market would either contract into a market for 'lemons' or collapse altogether. In order to address the problem of asymmetric information and adverse selection, Akerlof (1970, p. 488) suggested that government intervention may be warranted in some instances:

> *There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual sellers. As a result there tends to be a reduction in the average quality of goods and also in the size of the market. It should also be perceived that in these markets social and private returns differ, and therefore, in some cases, government intervention may increase the welfare of all parties.*

Adverse selection can occur in banking markets when consumers looking to deposit their savings are unable to assess the credit worthiness of a financial institution or on the part of financial institutions in assessing the credit worthiness of a loan applicant.

Moral hazard occurs in any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly' (Krugman, 2009, p. 63). Moral hazard infers a disposition on the part of individuals or organisations to engage in riskier behaviour, than they otherwise would, because of a tacit assumption that someone else will bear the costs and consequences if the incurred risk turns out badly (Wolf, 1999, p. 60). The inadequate control of moral hazards often leads to socially excessive risk taking (Dowd, 2009, p. 143).

Moral hazard originates from analysing the effects of insurance. When a person purchases full insurance to cover all of their potential losses, they no longer have an incentive to invest in private precautions to prevent potential losses from occurring (Bell & Parchomovsky, 2012, p. 1930).

Two partial solutions have been suggested to address the problem of moral hazard:

- incomplete coverage against loss; and
- observation by the insurer of the care taken to prevent loss (Shavell, 1979, p. 541).

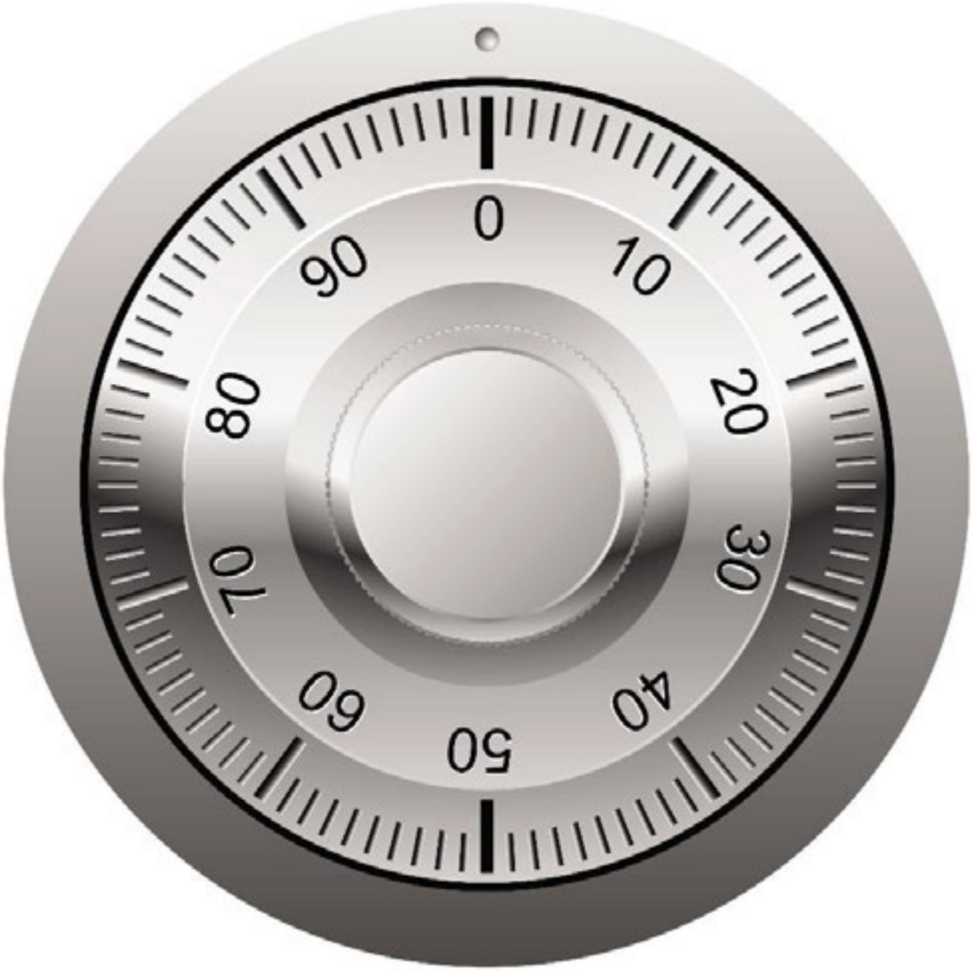
Incomplete coverage gives an individual or organisation a motive to prevent loss by exposing them to some financial risk. Observation of the case gives an individual or organisation a motive to prevent loss, as it allows the insurer to link the perceived level of care to either the insurance premium or the amount of coverage paid in the event of a claim.

Moral hazard is often seen in the context of the principal-agent problem, which concerns the difficulties associated with trying to motivate the agent to act in the best interests of the principal. The principal-agent problem occurs because the desires or goals of the principal and the agent are in conflict and it is difficult or expensive for the principal to verify what the agent is actually doing.

Whereas adverse selection is a problem of pre-contractual opportunism which gives people the opportunity to lie in the presence of private information prior to the initiation of a contract, moral hazard is a problem of post-contractual opportunism where the presence of some unobservable action provides people with the opportunity to cheat after the contract is signed (Mohlo, 1998, p. 8).

Appendix 2: Deloitte Access Economics Report - *Progress on key recommendations of the Murray Inquiry*

Deloitte.
Access Economics



Progress on key recommendations of the Murray Inquiry

Commissioned by the Customer Owned Banking Association
December 2016

Contents

Glossary

Acronym	Full name
ADI	Authorised Deposit-taking Institution
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
ARFP	Asian Region Funds Passport
ASIC	Australian Securities and Investments Commission
BCBS	Basel Committee for Banking Supervision
COBA	Customer Owned Banking Association
FSB	Financial Stability Board
FSI	Financial System Inquiry
GDP	Gross Domestic Product
IRB	Internal-ratings-based
PC	Productivity Commission
ROE	Return on Equity
RBA	Reserve Bank of Australia
SOE	Statement of Expectations
TLAC	Total loss absorbing capacity

Executive summary

The Customer Owned Banking Association (COBA) engaged Deloitte Access Economics to report on progress in implementing the following recommendations of the 2014 Financial System (Murray) Inquiry (FSI):

- **Recommendation 1:** Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.
- **Recommendation 2:** Raise the average internal-ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.
- **Recommendation 3:** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practices, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions (ADIs) and minimise taxpayer support.
- **Recommendation 30:** Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's (ASIC) mandate.

The Government released its response to the FSI recommendations on 20 October 2015, and agreed to 43 of the 44 recommendations.

While there has been some progress on all four recommendations, significant work remains. Some of the steps to strengthen the focus on competition in the financial system, such as amending ASIC's mandate and updating the regulators' statements of expectations, could likely have been progressed on a faster timeframe.

Progress on recommendation 1

The Government agreed that the Australian Prudential Regulation Authority (APRA) should ensure that the capital ratios of all Australian banks are 'unquestionably strong'. The FSI defined this as requiring capital ratios to be in the top quartile of internationally active banks.

APRA completed its second international comparison of ADI capital ratios in 2016, and found that the major Australian ADIs had increased their capital ratios to be broadly in line with the FSI's definition of unquestionably strong.

While the FSI's 'benchmark' may be broadly met by the major banks, it may not be maintained at this level continuously. APRA has, quite reasonably, taken a broader view of the definition of unquestionably strong, and has stated that it will consider other measures of strength. APRA will recalibrate its final capital requirements with these other considerations in mind.

The Basel Committee for Banking Supervision (BCBS) is expected to finalise guidance on reforms to the capital framework by end-2016. APRA is planning industry consultations in 2017 and will look to implement revisions to the capital framework during 2018.

Progress on recommendation 2

The Government agreed to narrow the gap between average mortgage risk weights employed by IRB banks and those employed by standardised banks.

In July 2015, APRA announced higher mortgage risk weights for banks using an IRB approach to capital, raising the average risk weight for mortgages to at least 25%. This requirement came into effect in July 2016.

However, this adjustment is an interim measure pending the BCBS finalising reforms to the capital framework, and APRA's subsequent implementation in Australia. As with Recommendation 1, full implementation of this recommendation is not expected until at least 2018.

Progress on recommendation 3

The Government agreed to address the perception of 'too big to fail', and noted that a greater loss absorbing and recapitalisation capacity will help to allay this perception. However, given the need to align with international practice, the Government noted that implementation will occur beyond 2016.

The final international standards for total loss absorbing capacity (TLAC) have now been published, providing clarity on the international approach to the issue. APRA is now expected to consider the application of TLAC requirements in Australia. However, given the likely time needed to monitor international implementation (which will be phased in between 2019 and 2028) and undertake industry consultation, it is unlikely that completion of this recommendation will occur in the short-term. Progress is inherently slow given the complexity and need to consider international developments.

While the international TLAC requirements only apply to Global Systemically Important Banks, APRA believes it will not be alone in extending the regime beyond this group.

Progress on recommendation 30

The Government agreed to the FSI's recommendations to: ask the Productivity Commission (PC) to review the state of competition in the financial system; introduce competition into ASIC's legislative mandate; issue Statements of Expectations requiring the regulators to explain how they balance competition with their other mandates.

As part of this recommendation, the Government also committed to establish the Asian Region Funds Passport to support cross-border activity in managed investment schemes. The Asian Region Funds Passport was launched in April 2016.

There has been little progress on the substantial aspects of this recommendation related to updating the regulators' responsibilities.

Conclusion

Delays to or not completing implementation of the recommendations would adversely affect the ability of the financial system to realise the benefits of these reforms. These benefits were identified by the FSI as helping to:

- ensure the robustness of the financial system;

- aid competition in the banking sector; and
- address the "too big to fail" issue in the banking sector.

Some progress has been made on all four recommendations, but significant work is still required to complete implementation. Much activity is scheduled over the next 12-24 months on Recommendations 1, 2 and 30, as industry consultation on regulatory and legislative change is required on many of the outstanding commitments. On the other hand, the phased implementation of TLAC at the international level and absence of a set timeframe for Recommendation 3 means that the process will probably unfold on a much longer timeline.

Furthermore, while progress against the four recommendations will help rebalance the competitive dynamics in the banking sector, it may not be enough to increase financial system competition substantially. With the PC's proposed financial system competition review expected to be completed in 2017, but terms of reference yet to be established, we propose potential terms of reference for the inquiry, focusing on the banking sector.

Suggested terms of reference for the Productivity Commission
The PC should conduct an inquiry into the state of competition in the financial system.

In undertaking this inquiry, the PC should consider:

1. **What are the competitive dynamics of the financial system?**
   Including examining trends in:
   a) industry consolidation;
   b) horizontal and vertical integration;
   c) exit of existing participants and new entrants, such as fintechs;
   d) innovation, such as digital disruption; and
   e) customer switching.

2. **Why is there not more competition in the financial system?**
   Including considering:
   a) whether regulators' rules and procedures are creating inappropriate barriers to competition;
   b) whether other Government policies are creating inappropriate barriers to competition, such as taxation policy, and have appropriate regard to other business models, including the customer owned model;
   c) whether other factors have affected competition, such as other non-regulatory or policy-related barriers to entry and broader economic conditions;
   d) the appropriate balance/trade-offs between competition and:
      - financial system performance;
      - access to financing, including for different segments of users
      - systemic stability; and
      - growth.

3. **What needs to be done to support more competition?**
   Including considering:
   a) removing barriers to competition by modifying or removing inappropriate regulatory rules and Government policies; and
   b) taking actions to support greater competition, such as:

- additional support for standardised ADIs to achieve IRB accreditation including technical assistance (see Chapter 3.1.1); and
- requiring a competition impact statement to be undertaken as part of all regulatory impact assessments (see Chapter 2.4.1).

In considering question 3, the PC should have in mind the impact of changes on the long-term interests of consumers, i.e. consumer welfare.

The PC should draw on the experiences in overseas jurisdictions, the expertise of academics, industry and Government subject matter experts, and consult widely and broadly, including with participants and consumers.

Deloitte Access Economics

1 Introduction

The Customer Owned Banking Association (COBA) represents the customer owned banking sector in Australia. Its members are mutual banks, credit unions and building societies.

This report provides an update on the implementation progress of key recommendations of the 2014 Financial System (Murray) Inquiry (FSI). The focus of the update is on the recommendations which have implications for competition in the banking sector, including the markets in which smaller Authorised Deposit-taking Institutions (ADIs) operate, such as COBA's members.

The total assets of Australia's major banks was $3.5 trillion as of September 2016 (APRA 2016e). While the total assets of mutual ADIs—including mutual banks, credit unions and building societies—is small in comparison, it is growing as a share of all ADIs. The total assets of mutual ADIs increased to $104 billion in September 2016, representing year-on-year growth of nearly 8%, compared to a 1.3% contraction in the total assets of all ADIs over the same period (APRA 2016e).

The FSI examined how the Australian financial system was positioned to meet Australia's evolving needs. The FSI made 44 recommendations seeking to promote efficiency, resilience and fairness of the financial system. As part of its review, the FSI recognised the role played by smaller ADIs such as mutual banks, credit unions and building societies particularly with regard to encouraging a competitive financial system.

On 20 October 2015, the Government responded to the FSI recommendations by setting out a reform agenda aimed at improving Australia's financial system. The Government agreed to 43 of the 44 FSI recommendations, and added three additional actions. These included initiatives to be implemented over a number of years. A number have implications for mutual banks, credit unions and building societies as well as the broader banking sector in which they operate.

One year has now elapsed since the Government published its response. Furthermore, the Government is shortly expected to task the Productivity Commission to review the state of competition in the financial system, which is expected to be completed by the end of 2017, three years after the completion of the FSI.

Against this background, COBA engaged Deloitte Access Economics to report on progress in implementing the following FSI recommendations that were endorsed by the Government:

- **Recommendation 1:** Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.
- **Recommendation 2:** Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.
- **Recommendation 3:** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practices, sufficient to facilitate the orderly resolution of

Australian authorised deposit-taking institutions and minimise taxpayer support.

- **Recommendation 30:** Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

Given the interdependency of these recommendations and other reforms, and the need to coordinate with international efforts to address some of these issues, the progress of implementation to date has been varied. The Customer Owned Banking Association seeks to promote greater impetus for continued progress on the implementation of these recommendations.

1.1 Report structure

The subsequent sections of the report are structured as follows:

- Chapter 2 explains key concepts behind the four recommendations, summarising the background from the FSI final report;
- Chapter 3 reports on progress in implementing the four recommendations, drawing from publicly available information;
- Chapter 4 discusses the costs and benefits of each of the four recommendations, drawing from existing analysis; and
- Conclusion, which summarises the state of play of the four recommendations, and considers potential terms of reference for the proposed Productivity Commission inquiry into competition in the financial system, with a focus on the banking sector.

2 Summary of selected recommendations

2.1 Recommendation 1 – Capital levels

Recommendation 1

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

The FSI recommended that Australian authorised deposit-taking institutions (ADIs) increase their capital ratios such that they are 'unquestionably strong'. The main objective of the recommendation is to improve the resilience of the banking sector and consequently reduce the risk of financial failure in the case of an external shock to the financial system.

ADIs fund their assets, for example mortgages, using a mix of liabilities, including deposits, other debt, and equity capital. The Australian Prudential Regulation Authority's (APRA) prudential regulations require that ADIs hold a certain portion of their funding as specific types of capital (see Appendix A). The type and amount of capital required to be held is determined through an assessment of the weighted risk of the assets which comprise the ADI's balance sheet. The share of capital held against the ADI's risk-weighted assets is known as the capital adequacy ratio.

The FSI (2014) noted the importance of capital in the banking sector:

> *"Capital, particularly equity capital, is an essential element in both actual and perceived financial soundness, acting as a shock absorber for unexpected losses. Once equity has been exhausted, a bank is generally non-viable — and could well have been before that point. Equity capital is therefore an important determinant of how likely a bank is to fail. Capital is also a safety buffer for creditors, as it is typically exhausted before the bank defaults on its obligations. By making creditor funds relatively safer, high levels of capital assist to maintain confidence in a bank, even in times of market stress."*

The FSI suggested that a capital ratios within the top quartile of internationally active banks is the appropriate benchmark for Australian ADIs to qualify as unquestionably strong. The FSI also judged that this standard should apply to all ADIs, not just the major banks. However, the focus so far has been on the major banks (see Chapter 3.1). The FSI indicated at the time that it considered the capital ratios of the major Australian banks not to be in the top quartile of their internationally active peers.

The FSI recommended that the increase in capital ratios should primarily take the form of Common Equity Tier 1 (CET1) capital, which represents the highest quality form of capital (see Appendix A). This type of capital comprises tangible equity such as shareholder common equity. The FSI noted that evidence available at the time suggested that the CET1 capital ratios of the major Australian banks were likely to be between 10.0% and 11.6%.[1] On the other hand, the Basel Committee on Banking Supervision (BCBS) estimated the global 75th percentile of CET1 capital ratios was 12.2% in December 2013. At the time, the FSI judged that capital ratios of the major Australian banks were *"likely to be above the global median but below the top quartile."*

However, capital levels are difficult to compare across jurisdictions as national prudential regulators adopted different approaches to measuring capital (APRA 2015a). In other words, it is not straight-forward to compare capital ratios based on APRA regulations with those in other jurisdictions. In recognition of this, the FSI recommended that APRA *"develop a reporting template for Australian ADI capital ratios that is transparent against the minimum Basel capital framework."* This was proposed under Recommendation 4 of the FSI Final Report.

2.2 Recommendation 2 – Narrow mortgage risk weight differences

Recommendation 2

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

The level of capital required to be held by an ADI is determined by the capital adequacy ratio set by APRA as well as the risk weight target which is applied to specific asset classes. All other things equal, a lower risk weight applied to the asset class will mean that the ADI will not have to hold as much capital in reserve.

The standardised risk weights are a common set of risk weights that reflect the general risks of different broad asset classes. These risk weights are not tailored to specific ADIs and are set by APRA at a conservative level to ensure ADIs are adequately capitalised. These standardised risk weights are used by financial institutions that have not achieved accreditation for IRB models.

[1] The CET1 capital ratio for mutual banks, credit unions and building societies was 15.9% as at December 2013 (RBA 2014). This relatively higher capital ratio compared to the larger banks is partly due to their less diversified business models and different corporate structures.

IRB risk weights are used by banks accredited by APRA to use IRB models for calculating capital ratios. In Australia, so called 'accredited ADIs' include the four major banks and Macquarie Bank. Accredited ADIs use their own IRB models to determine risk weights for certain credit exposures. These are based on assessed risks of the asset and institution, thereby achieving a tailored risk weight.

ADIs determine the relevant risk weights to apply in one of two ways: (i) using an internal-ratings-based (IRB) model; and (ii) based on a set of standardised risk weights. The FSI recommended APRA adjust the requirements for calculating risk weights for housing loans to narrow the difference between the average mortgage risk weights for ADIs using the IRB approach and those using standardised risk weights. The FSI thought that this would improve competitive neutrality of capital regulation between different classes of ADIs.

Accredited ADIs can refine their models to achieve lower risk weights. Should an IRB bank determine a risk weight for a given asset type that is lower than determined under the standardised approach, the accredited ADI can use a much smaller proportion of equity funding compared to banks using standardised risk weights. As equity is a more expensive funding source than debt, all other things equal, this translates into a funding cost advantage for IRB banks. At the time the FSI was published, the average mortgage risk weight determined under the standardised approach was 39%, which was significantly higher than the average mortgage risk weight of 18% for banks using IRB models.

The FSI considered both reducing the average mortgage risk weight for those ADIs using standardised risk weights and raising the average mortgage risk weights for ADIs using IRB models. However, as reducing the average mortgage risk weight for ADIs using standardised risk weights was considered to potentially increase vulnerability of the system, the FSI recommended the latter option.

At the same time, the FSI acknowledged that there should remain a difference between the mortgage risk weights under both models to retain the incentive for standardised banks to develop IRB models. As such, it did not seek to eliminate the gap between the two approaches.

2.3 Recommendation 3 – Loss absorbing and recapitalisation capacity

Recommendation 3

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

The FSI recommended that APRA implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice. While higher capital ratios seek to reduce the risk of failure of an ADI, a loss-absorbing and recapitalisation framework seeks to support the orderly resolution of an ADI in the event of its failure. That is, to mitigate the effects of a failure by ensuring that any critical economic functions can continue to operate and to ensure losses are borne by shareholders and creditors rather than taxpayers. The framework would set out the equity and debt instruments on an ADI's balance sheet upon which losses would be imposed in the event that the ADI fails and enters resolution. This is also known as 'bail-in'.

More broadly, by implementing such a framework, the objective would be to reduce public perceptions of an implicit government guarantee being provided to banks deemed 'too big to fail'.

International practice on loss absorption and recapitalisation focuses on global systemically important banks (G-SIBs). G-SIBs are identified by the Financial Stability Board (FSB) to be financial institutions whose distress or failure, because of their size, interconnectedness, lack of substitutability, extent of global activity and complexity, would cause significant dislocation in the global financial system and have adverse consequences for the wider economy (BCBS 2013).

While the Australian banking sector does not include institutions considered to be G-SIBs, many countries indicated they may also apply to Domestic Systemically Important Banks (D-SIBs).[2] Furthermore, the FSI noted that *"As a small, open, capital-importing economy, Australia cannot stand outside international practice."*

As this was a still unfolding area of international practice, the FSI suggested that Australia proceed with caution. Nonetheless, the FSI recommended that an Australian framework should follow a number of guiding principles:

- Clearly set out the instruments eligible for inclusion in a loss-absorbing and recapitalisation capacity requirement.
- Ensure clarity of the creditor hierarchy with clear layers of subordination between classes.
- Ensure clarity of the mechanisms and triggers under which creditors will absorb losses.
- Seek to ensure eligible instruments can be exposed to loss without adverse consequences for financial stability, including being held by investors who can credibly be exposed to loss.

The FSI also specified that an ADI's deposit liabilities should not be subject to bail-in, so as to maintain the practice of depositor preference in Australia.[3]

[2] Similarly, D-SIBs assessed by APRA as domestic banks which are systemically important in Australia due to their size, interconnectedness, lack of substitutability, and complexity, and include Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, National Australia Bank Limited and Westpac Banking Corporation (APRA 2013).

[3] Depositor preference gives depositors a priority claim on the assets of a failed ADI ahead of other unsecured creditors (Turner 2011).

2.4 Recommendation 30 – Strengthening the focus on competition in the financial system

Recommendation 30

Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

The financial system *"being subject and responsive to market forces, including competition"* was central to the FSI's philosophy. While the FSI assessed competition in the Australian financial system to be *"generally adequate"*, it recognised that the highly concentrated banking sector had the potential to limit the benefits of competition in the future.

Some of the FSI recommendations were aimed at promoting competition in specific circumstances. However Recommendation 30 sought to deliver a stronger overall focus on competition in the financial system. In particular, the FSI suggested that regulators and policy makers do not place sufficient emphasis on competition in their decision making.

Some of the regulators' mandates formally recognise their roles with respect to competition:

- the *Reserve Bank Act 1959* specifies that the duty of the Reserve Bank of Australia (RBA) Payments System Board includes ensuring that it exercises its powers in a way which best contributes to *"promoting competition in the market for payments services, consistent with the overall stability of the financial system"*.
- the *Australian Prudential Regulation Authority Act 1998* requires that *"In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia"*.

However, competition is not explicitly reflected in the mandate of the Australian Securities and Investments Commission (ASIC). The *Australian Securities and Investments Commission Act 2001* requires that ASIC to promote commercial certainty and economic development and efficiency while reducing business costs.

In the context of this inconsistency, the FSI recommended that ASIC's mandate should include a requirement to *"take competition issues into account as part of its core regulatory role."*

In addition, the FSI recommended that the regulators improve their reporting of how competition is factored into their decisions. For those that have a competition mandate, there is no requirement to explain how they balance competition considerations with their other regulatory objectives. Thus, the application of the competition mandate is ad hoc.

- For example, APRA is currently required to consider competition and contestability in its mandate but the FSI concluded that the industry framework used by APRA does not adopt a consistent approach to the issue.

The FSI noted that conduct and prudential regulators have a tendency to prioritise fairness or stability over competition – the benefits of competition are typically long-term and hard to value, while the costs of instability or unfair outcomes are often immediately visible. The FSI recommended that the effect of regulatory proposals on competition should be explained in consultation documents and annual reports.

While the Financial Stability Review produced by the RBA regularly assesses the state of financial stability, the FSI noted that there is no regular assessment of the state of competition in the financial system. The FSI also suggested that introducing an external review of the state of competition in the financial sector every three years could put additional pressure on the issue.

The FSI acknowledged that no single solution will guarantee the 'right' level of competition in the future, particularly given the concept can change over time. However, periodic reviews could help regulators keep up with the latest developments. In particular, the FSI suggested that the review should include a focus on changes in barriers to international competition, such as identifying impediments to cross-border competition and other barriers to the free flow of capital across borders, such as tax impediments.

The FSI also recommended that, as an immediate first step, regulators should examine their rules and procedures with the aim of modifying or removing those which create barriers to competition, and identify *"alternatives and more pro-competitive approaches."* It asked each regulator to report to Government ahead of the external review.

2.4.1 Other examples

The FSI is not alone in suggesting that regulators may not give adequate consideration to the competitive implications in their rule-making. For example, the Senate Economics Reference Committee (2016a) inquiry into co-operative, mutual and member-owned firms, noted that these firms operate differently from regular companies and should be appropriately regulated relative to their size and operations.

The Senate Committee identified that APRA's application of the regulatory capital framework does not recognise certain capital instruments issued by mutual ADIs (mutual equity interests; MEI) as CET1 instruments, which it suggests may have implications for competitive neutrality. That is, APRA's regulations currently do not recognise MEI issued by mutual ADIs in the ordinary course of business as equivalent to ordinary shares of non-mutual ADIs.

With respect to this issue, APRA's General Manager of Policy Development, Pat Brennan, noted (Senate 2016b):

> *"The structure of the banking industries and the regulatory frameworks are different in each country, but it is fair to say that some jurisdictions have found a way to accommodate the mutuals in ways that Australia has not. Sometimes that is due to the different legislative frameworks that they work in; at other times I feel it is sometimes regulators taking a different approach."*

More broadly, the Senate Committee inquiry recommended that co-operative and mutual sector be considered when the Government is preparing a Regulatory Impact Statement that accompanies new regulatory policies.

'One-size-fits-all' regulations can have implications for competition. For example, APRA's policy to address the risks it sees in the housing sector may have unintended consequences (APRA 2014):

> *"…strong growth in lending to property investors — portfolio growth materially above a threshold of 10 per cent will be an important risk indicator for APRA supervisors in considering the need for further action"*

A cap on the growth of investor housing credit may have the effect of preventing competition playing out in this market. On balance, systemic stability concerns may outweigh this, but there may be value in APRA providing greater transparency that it has considered the broader impacts of such policies, including on competition.

3 Progress on recommendations

The Government released its response to the FSI recommendations on 20 October 2015, by setting out a reform agenda aimed to improve Australia's financial system. The Government agreed to 43 of the 44 FSI recommendations, and added three additional actions.

This report focuses on the Government's commitments related to FSI Recommendations 1, 2, 3 and 30. To the extent that the Government outlined specific timeframes for implementation, these have been taken into account in assessing the state of play.

3.1 Progress on Recommendation 1

Key points

- The Government agreed that APRA should ensure the capital ratios of all Australian banks are 'unquestionably strong'. However, the focus so far has been on the Australian major banks.
- APRA published an international comparison of ADI capital ratios in 2015, which was updated in 2016. The most recent comparison found that the major Australian ADIs had capital ratios in the top quartile of internationally active bank capital ratios. This was driven by increases in capital holdings by the major banks.
- While the FSI's 'benchmark' may be broadly met by the major banks, it may not be maintained at this level continuously. APRA has, quite reasonably, taken a broader view of the definition of 'unquestionably strong' compared to that proposed by the FSI, and has stated that it would be considering other measures of strength. APRA would recalibrate its final capital requirements with these considerations in mind.
- The BCBS is expected to finalise guidance on reforms to the capital framework by end 2016. APRA is planning industry consultation in 2017, and will look to implement revisions to the capital framework during 2018.

The Government response (Australian Government 2015a):

> *"The Government agrees that the capital ratios of Australian banks should be unquestionably strong. This will ensure the financial system remains resilient during difficult times and will maintain investor confidence.*
>
> *We support and endorse APRA as Australia's prudential regulator to implement this recommendation and will continue to closely monitor the resilience of our banks.*
>
> *APRA released an international capital comparison study on 13 July 2015, which found that Australia's major banks' capital levels are currently below the top quartile of internationally active banks (the baseline target proposed by the Financial System Inquiry), even after adjusting for APRA's conservative approach to measuring capital."*

While the FSI's proposed a definition of 'unquestionably strong', that is, Australian banks' capital ratios within the top quartile of internationally active banks, APRA has, quite reasonably, taken a broader view of this definition.

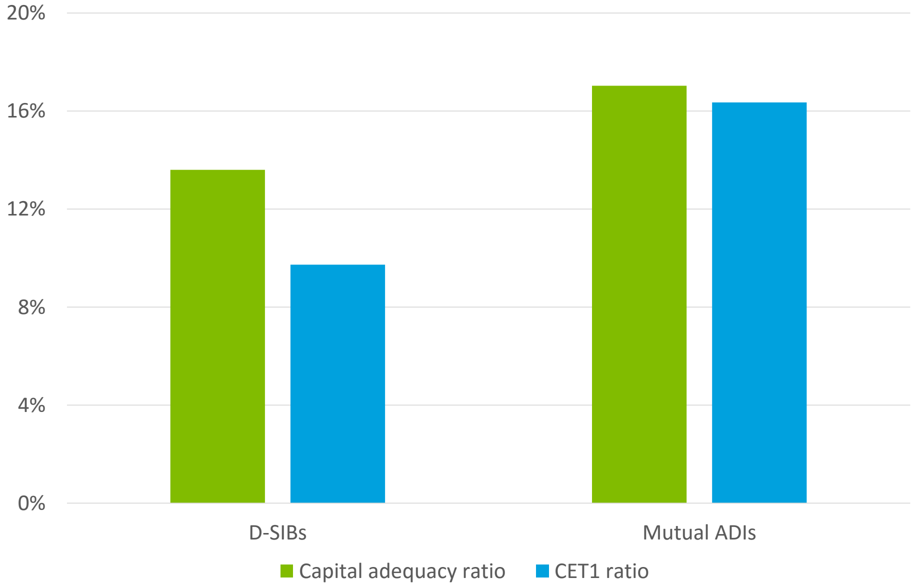
The Government tasked APRA to take additional steps to ensure Australian banks have unquestionably strong capital ratios by the end of 2016. Although it recognised that *"the content and timing of regulatory changes will take into account developments in the Australian economy and in international financial regulatory frameworks"* (Australian Government 2015a).

In July 2015, APRA released its initial study comparing the capital ratios of Australia's major banks with a group of their international banking peers (APRA 2015a). The study found that, as at June 2014, the capital ratios of Australia's major banks were well positioned compared to international peers yet below the top quartile. APRA suggested that to reach the bottom of the top quartile would require an increase of around 70 basis points in CET1 capital ratios (Byres 2015a). However, the 2015 study did note the difficulty in comparing capital positions across jurisdictions – there is no internationally harmonised capital ratio that provides a measure of capital adequacy for the purposes of cross-jurisdictional comparisons.

APRA updated the study in 2016, and found that as of December 2015, the ADIs' combined CET1 ratios had moved into the top quartile of internationally active banks. This was a result of the major Australian banks raising around $20 billion of new equity and an additional $7 billion from retained earnings since the start of 2015 (RBA 2016a).

As of end September 2016, the average CET1 ratio of the Australian D-SIBs was 9.7%, while the mutual ADIs had an average CET1 ratio of 16.4% (Chart 3.1:). Similarly, the average capital adequacy ratio of the D-SIBs was 13.6%, while the mutual ADIs had an average capital adequacy ratio of 17.0%.

Chart 3.1: Capital ratios by institution type (end September 2016)[a,b,c]



[a] Capital ratios have not been adjusted for international comparability.

[b] Capital ratios for some mutual ADIs are as at end June 2016.

[c] Capital ratios are a simple average of all institutions.

Source: Deloitte Access Economics, APRA (2016e), financial institutions' reports

While APRA (2015a & Byres 2015a) viewed the top quartile positioning of Australian ADIs in the internationally active banks as a useful indicator of strength, given the variability of such a benchmark, it took a broader view of what 'unquestionably strong' should mean:

> *"APRA sees fourth quartile position as a useful 'sense check' of the strength of the Australian capital framework against those used elsewhere, but does not intend to directly link Australian requirements to a continually moving benchmark such that frequent recalibration would be necessary."*

This means that while the top quartile positioning of Australian ADIs relative to their international peers was achieved, APRA does not consider the maintenance of this positioning to be the sole objective of being unquestionably strong.

APRA has noted that there are other measures which it will consider, including for example, calibrating the final capital requirements with regard to (Byers 2016b):

- rating agency measures of capital strength; and
- the results of banks' stress tests.

APRA has yet to clarify how it will account for the quality of prudential supervision in Australia, or other institutional factors that may have contributed to the resilience of the sector during the global financial crisis.

Nonetheless, the international capital framework has yet to be finalised. APRA expects that a complete package of reforms will be endorsed by the

Governors and Heads of Supervision of BCBS member countries in January 2017 (Byers 2016b).

In terms of the timeframe, APRA Chairman Byers noted that:

> *"Given the number and potential impact of the changes that will be proposed, 2017 will be a year of consultation. We don't expect to have final standards before this time next year. And even if that is the case, they would not take effect until at least a year after that."*

While the FSI recommended that, and the Government committed to, all Australian ADIs having capital ratios that are unquestionably strong, APRA's focus so far has been on the Australian major banks. Understandably, this may be reasonable from a systemic stability perspective. It remains unclear how the commitment to unquestionable strength will be implemented more broadly.

3.1 Progress on Recommendation 2

Key points

- The Government agreed to narrow the gap between average mortgage risks weights.
- In July 2015, APRA announced higher mortgage risk weights for banks using an IRB approach to capital, raising the average risk weight for mortgages to at least 25%. This requirement came into effect in July 2016.
- This remains an interim measure while the BCBS finalises the reforms to the capital framework, and APRA's subsequent implementation in Australia. As with Recommendation 1, full implementation of this recommendation is not expected until at least 2018.

The Government response (Australian Government 2015a):

> *"The Government agrees that the gap between average mortgage risk weights should be narrowed. This will aid competition in the banking sector.*
>
> *We support and endorse APRA as Australia's prudential regulator and its initial actions announced on 20 July 2015 to raise the average IRB mortgage risk weights to at least 25 per cent from 1 July 2016 to implement this recommendation. The major banks have subsequently undertaken capital raisings to increase their capital levels.*

> *We will take an active and ongoing role in monitoring developments as a result of these changes."*

Prior to the release of the Government's response to the FSI in October 2015, APRA had announced in July 2015 an increase to the mortgage risk weights for the IRB banks to an average of at least 25% to come into effect from 1 July 2016. The major banks subsequently undertook capital raising to increase their capital levels.

This adjustment was always designed to be an interim measure, with the final calibration pending the outcome of the deliberations of the BCBS to finalise reform of the capital adequacy framework and APRA's subsequent consideration of how these reforms should be applied in Australia. In the House of Representatives Standing Committee on Economics (2016b) hearings, APRA Chairman Byres stated:

> *"… given that the Basel international framework is currently up for grabs, it is being revised, and potentially the rules around mortgage risk weights will be changed – I think it is almost inevitable they will be changed in some way – we put in place an interim measure that has closed the gap."*

The BCBS released a consultative document in March 2016 looking to introduce constraints on the IRB risk weights (BCBS 2016a). The consultative document recognised the dispersion in the levels of estimated risk weights that banks were attributing to the same exposures. Consequently, the BCBS proposed to place a floor to ensure a minimum level for IRB risk weights.

As part of the ongoing maintenance of IRB models by ADIs, and supervision by APRA, a range of changes have been made to banks' IRB models since the July 2015 announcement. The impact of these modelling changes, as well as the July 2015 adjustment would have made the average mortgage risk weight for IRB banks well in excess of the 25% target. To address this, in August 2016, APRA reaffirmed its original mortgage risk weight target of 25% (APRA 2016b). That is, allowing some ADIs to readjust their settings to ensure the outcomes are closer to the target.

While full implementation of this recommendation is not expected to be complete until at least 2018 (Byres 2016b), APRA did take steps to put in place an interim measure even prior to the release of the Government response.

3.1.1 Supporting ADIs to achieve IRB accreditation

In their submissions to the FSI, some major banks suggested that standardised banks should be supported to achieve IRB accreditation as a means to aid competition between the major banks and other banks (ANZ 2014, Commonwealth Bank, 2014, Westpac 2014). The FSI suggested that APRA could consider how to make the IRB accreditation process less resource intensive. In December 2015, APRA (2015c) announced two changes to make the IRB accreditation process easier for ADIs:

- **Staged IRB accreditation**, which no longer requires ADIs to meet accreditation requirements for all their credit portfolios before any model can be used; and

- **Decoupling operation risk modelling from IRB accreditation**, to allow an ADI to use the standardised approach for operational risk modelling.

3.2 Progress on Recommendation 3

Key points

- The Government agreed to address the perception of 'too big to fail', and noted that a greater loss absorbing and recapitalisation capacity will support this. However, given the need to align with international practice, the Government noted that implementation would occur beyond 2016.
- The final international standards for TLAC have now been published, providing clarity on the international approach to the issue.
- APRA will now be expected to consider the application of TLAC requirements in Australia. However, given the likely time needed to monitor international implementation (which will be phased in between 2019 and 2028) and undertake industry consultation, it is unlikely that completion of this recommendation will occur in the short-term.
- While the international TLAC requirements only apply to Global Systemically Important Banks, APRA believes it will not be alone in extending the regime beyond this group.

The Government response (Australian Government 2015a):

> *"The Government agrees that steps should be taken to reduce any implicit government guarantee and the perception that some banks are too big to fail. Should an ADI fail, greater loss absorbing capital will facilitate orderly resolution.*
>
> *We endorse APRA as Australia's prudential regulator to implement this recommendation in line with emerging international practice."*

Recognising the need to proceed with caution and align with emerging international practice, the Government stated that implementation would probably occur beyond 2016.

In November 2015, the G20 leaders endorsed the Financial Stability Board's Principles on Total Loss-absorbing Capacity (TLAC) for G-SIBs (FSB 2015). The FSB standard was developed in consultation with the BCBS, and comprises a set of guiding principles and the terms of the minimum TLAC requirement for G-SIBs, including its size and the characteristics of financial instruments that can be counted towards the requirement.

In October 2016, the BCBS (2016b) released its final standards on TLAC holdings, which outlined how banks' investments in TLAC instruments would be treated in regards to regulatory capital. For example, banks should deduct from their regulatory capital investments in the TLAC of other banks.

The international TLAC standards only apply to G-SIBs, so no Australian bank is required to conform in accordance to international timeframes – with phased implementation between 2019 and 2028. However, in light of the Government's commitment, APRA has noted (Byres 2015c):

> *"The Government's response endorsed APRA to implement this recommendation, and I am sure we will not be alone in extending the TLAC regime beyond G-SIBs."*

The FSI recommended that this requirement be implemented slowly in Australia based on international practice. In addition to considering international developments, APRA has noted that it will be important to consider what best suits the particular characteristics of the Australian financial system (Byres 2015c). Nonetheless, the scope of this regime remains uncertain.

While the international framework is now clearer, slow implementation of TLAC requirements have previously been supported by APRA (2016a), which has stated that it will *"take advantage of [the] lack of fixed deadline and hasten slowly"* (Byers 2015a).

3.3 Progress on Recommendation 30

Key points

- The Government agreed to the FSI's recommendations to: ask the Productivity Commission to review the state of competition in the financial system; introduce competition into ASIC's legislative mandate; issue Statements of Expectations requiring the regulators to explain how they balance competition with their other mandates.
- The Government has also committed to establish the Asian Region Funds Passport to support cross-border activity in managed investment schemes.
- There has been little progress on the substantial aspects of this recommendation related to updating the regulators' responsibilities, however, the Asian Region Funds Passport was launched in April 2016.

The Government response (Australian Government 2015a):

> *"The Government agrees to implement periodic reviews of competition in the financial sector.*
>
> *We will task the Productivity Commission to review the state of competition in the financial system by the end of 2017, three years after the completion of the Inquiry. Subsequent periodic reviews will be undertaken as appropriate.*
>
> *We support inclusion of competition in ASIC's mandate and we will develop legislation to introduce an explicit reference to consideration of competition in ASIC's mandate in the second half of 2016.*
>
> *We will also be clear in the Statements of Expectations that regulators should explain in each annual report how they have balanced competition with other elements of their mandates.*
>
> *We are addressing barriers to cross border trade in managed investment schemes through establishment of an Asian Region Funds Passport and we will legislate to give effect to the Asian Region Funds Passport in the second half of 2016."*

To date, the Government has yet to issue its terms or reference to the Productivity Commission (PC) for the review of competition in the financial sector. The Government is expected to task the Productivity Commission with this review by the end of 2017 (Senate 2016c).

The scope of the competition review will be determined by the Government. However, as the PC's inquiry into the efficiency and competitiveness of the superannuation system is expected to begin in mid-2017, it is likely that the competition review will not focus on the superannuation system. The FSI Final Report included a number of potential avenues of inquiry:

- assessing changes in the barriers to international competition; and
- examining the rules and procedures of regulators to assess whether those that create inappropriate barriers to competition can be modified or removed, or whether alternative and more pro-competitive approaches can be identified.

The Government committed to include competition in ASIC's legislative mandate and stated it would develop legislation in the second half of 2016. ASIC (2014), in response to the FSI, supported the inclusion of competition into their mandate:

> *"The pursuit of this objective would not take precedence over ASIC's other objectives. Rather, it would enhance them, by recognising the importance of competition in encouraging commercial certainty, efficiency, consumer confidence and the development of the economy. We think that this is a vital step in the development of Australia as a centre of financial excellence and a regional financial hub."*

While the Government has yet to publish the draft legislation to amend ASIC's mandate, in part the FSI's emphasis on competition was a consideration for ASIC to make the *ASIC Corporations (Repeal and Transitional) Instrument 2016/396* in September 2016. This legislative instrument extends the temporary relief from additional regulatory burden provided to foreign financial services providers. This relief was otherwise due to expire on 1 October 2016.

The next opportunity to introduce this amendment to Parliament will be in February 2017 – however, this will depend on other legislative priorities.

In the meantime, other aspects of the recommendations could contribute to enhancing regulator's consideration of competition. The Government committed to clarify in regulators' Statements of Expectations (SOE) that they should explain in each annual report how they have balanced competition with other elements of their mandates. However, the Government has not yet updated the SOEs of ASIC or APRA.

ASIC Chairman, Greg Medcraft, in the October 2016 hearings of the House of Representatives' Standing Committee on Economics (2016a), said *"At the moment [ASIC] have basically no involvement in competition power"*. He also stated that:

> *"… giving ASIC a competition power—extending competition to ASIC, which was recommended by the financial systems inquiry. I believe that is also very important. As with the Financial Conduct Authority in the UK, having that competition power will be very important in the future, particularly in the nature of our system."*

This suggests that the formal mandate will be an important part of changing the regulator's mindset. In contrast, APRA Chairman Byres stated (House of Representatives' Standing Committee on Economics 2016b):

> *"We have a statutory mandate that basically says 'Think about financial safety, and promote financial stability, but in doing that don't go to the ultimate extreme. Balance that with considerations of competition, efficiency, competitive neutrality and contestability.' The way we operationalise that is to say that it is not our job to set standards for competition, efficiency et cetera, but if we are faced with a policy choice that delivers prudential outcomes, which one is more likely to have a better competitive outcome? Or, how can we achieve prudential outcomes, first and foremost, without damaging any of those other considerations?"*

While there has been no formal changes to the SOE of APRA, APRA's approach suggests some implicit consideration of competition in its decision-making. In fact, APRA considers that its prudential role can help ensure the benefits of competition (Byres 2015b):

> *"Regulators like APRA will naturally have a strong focus on safety: that is what Parliament has tasked us to do. We can and do also play a role in encouraging sound competition, but first and foremost that will be driven by how financial institutions establish*

> *their own governance practices, culture and incentive structures. Strong governance, a culture of disciplined capital and risk management, and with rewards only for those who generate genuine risk-adjusted returns over the long term, will be critical for ensuring the benefits of competition can be harnessed in the interests of the community at large."*

In regards to the FSI's reporting recommendation, APRA (2016d) noted that:

> *"APRA will be looking to provide more information on how it balances financial safety with these other objectives, and more actively seek industry input on these issues so that policy choices are best able to balance these considerations without undermining prudential outcomes."*

More recently, in November 2016, the House of Representatives Standing Committee on Economics (2016d) found that:

> *"Australia's banking sector is an oligopoly. The major banks have significant market power that they use to protect shareholders from regulatory and market developments."*

The Committee recommended that the ACCC provide to the Treasurer six monthly reports with specific proposals to improve competition in the banking sector. It also suggested that if the ACCC does not identify specific proposals, it should justify its position. While such a role for the ACCC was not part of the FSI's recommendations, it represents further efforts to increase the accountability of regulators for competition in the banking sector.

As part of its response to the FSI, the Government also undertook to promote competition in managed investment schemes by establishing the Asian Region Funds Passport (ARFP) in second half of 2016. This initiative was originally recommended by the Australian Financial Centre Forum in its 2010 report (also known as the Johnson report). It has been explored through the Asia-Pacific Economic Cooperation Finance Ministers' Process, with a commitment to implementing the passport by 2016 (APEC 2016). In April 2016, representatives from Australia, Japan, Korea and New Zealand signed the ARFP Memorandum of Cooperation.

Overall, substantive implementation of Recommendation 30 has been limited.

3.4 Progress overview

The table below provides an overview of the key developments to date.

Table 3.1: State of play overview

	2015	2016	2017	2018	State of play
Recommendation 1 Capital levels	APRA published international comparison study of ADIs capital ratios – found that the major banks do not meet the FSI's definition of "unquestionable strong".	**1H2016** • APRA published results of updated international comparison study – found that the capital ratios of the major banks are now in the in the top quartile of international peers. **2H2016** • ***Govt. commitment:*** *APRA to take additional steps to ensure our banks have unquestionably strong capital ratios.*	• In January, BCBS expects to finalise deliberations of a complete package of reform to the international capital framework. • APRA expects to undertake Industry consultation on the application of the BCBS reforms to the capital requirements.	APRA expects to finalise the calibration of capital requirements to occur during 2018.	**Some progress, yet to be completed.** • Steps already taken which have seen an increase in the capital ratios of the Australian major banks. • Current schedule suggests that implementation may be completed in 2018.
Recommendation 2 Narrow mortgage risk weight differences	Prior to release of the Government's response to the FSI, APRA announced an increase in average mortgage risk weights to at least 25% for IRB banks.	**1H2016** • BCBS released consultative document for reducing variation in credit risk-weighted assets **2H2016** • Increase in average mortgage risk weights under IRB models came into effect. • APRA assessed major Australian banks to have average mortgage risk weights in excess of 25% target.	• In January, BCBS expects to finalise deliberations of a complete package of reform to the international capital framework. • APRA expects to undertake Industry consultation on the application of the BCBS reforms to the capital requirements.	APRA expects to finalise the calibration of capital requirements to occur during 2018.	**Some progress, yet to be completed.** • Still in progress, although interim steps have been taken. • Current schedule suggests that implementation may be completed in 2018.

	2015	2016	2017	2018	State of play
Recommendation 3 Loss absorbing and recapitalisation capacity	• In November, the FSB published the final TLAC standards for G-SIBs. • In November, G20 Leaders endorsed the FSB standard and implementation for G-SIBs set to occur gradually between 2019 and 2028.	• In October, the BCBS released standards on the treatment of TLAC holdings in regulatory capital.	***Govt. commitment:*** *APRA to set framework in place for minimum standards based on international practice beyond 2016.*	-	**Limited domestic progress; contingent on international developments.** • No set timeframe, but progress is expected to "hasten slowly".
Recommendation 30 Strengthening the focus on competition in the financial system	-	• In April, the ARFP comes in effect. • ***Govt. commitment:*** *Develop legislation to include competition into ASIC mandate.*	***Govt. commitment:*** *Task the Productivity Commission to review of state of competition in financial system by end-2017.*	-	**Limited progress.** • Current schedule suggests that implementation could be completed by end-2017.

Source: APRA, ASIC, Australian Government, BCBS, FSB

4 Benefits and costs of selected recommendations

Chapter 3 identified that the progress of implementation for the selected FSI recommendations is varied. Delays to or not completing implementation of the recommendations will adversely affect the ability of the financial system to realise the benefits of these reforms. In this context, we revisit the key reasons for these reforms.

4.1 Benefits and costs of Recommendation 1

The Government response noted that (Australian Government 2015a):

> *"Our banks source a considerable share of their funding offshore, reflecting Australia's position as a net importer of capital. Banks provide close to 90 per cent of the domestic credit that local firms and households receive. Our major banks have also adopted similar business models, with home mortgages accounting for around 60 to 70 per cent of their domestic lending. This creates some concentration of risk in the system.*
>
> *For these reasons, Australia's financial sector regulatory framework needs to be stronger than those of comparable economies."*

In part, setting Australian ADIs' capital levels to be unquestionably strong seeks to ensure that the Australian financial system "remains robust in the face of severe external shocks". That is, to reduce the likelihood or cost of financial crises. Financial crises can have damaging economic and social impacts. The FSI (2014) noted that:

> *"Financial crises tend to be protracted, with unemployment remaining high for years. The average total cost of a crisis is around 63 per cent of annual gross domestic product (GDP), and the cost of a severe crisis is around 158 per cent of annual GDP ($950 billion to $2.4 trillion in 2013 terms)."*

At the same time, the FSI (2014) also noted that an economy with less frequent crises is likely to be less volatile, which *"has welfare benefits and promotes long-term trust and confidence to support investment in the economy."* Less frequent crises would also reduce the perceived benefit of an implicit Government guarantee.

However, there are costs associated with increasing capital levels – it increases the cost of funds for banks, which may be passed on to consumers in the form of higher lending rates or reduced lending in the economy. The FSI (2014) noted that increasing capital requirements by one percentage point, in the absence of other changes recommended in the inquiry such as increasing competition, would lead to an increase in the average interest rate on a loan by less than 10 basis points. Consequently, the FSI refers to RBA research which suggests that this would reduce GDP by up to 0.1%. The FSI (2014) also quoted estimates from other studies – the impact on interest rates has ranged from 5 basis points to 12 basis points, and the impact on the level of GDP is between 1 and 16 basis points. The implications may be broader, for example, if it results in a shift in activity to the unregulated sector.

The FSI also expects the increased use of capital to lead to a permanent decline in the ADI's return on equity (ROE). Some investors may accept that lower ROE is offset by a reduction in risk associated with higher capital strength; on the other hand, some ADIs could seek to take on more risks to maintain investor returns.

On balance, the FSI considered stronger capital to produce a net benefit to the economy.

4.2 Benefits and costs of Recommendation 2

Narrowing mortgage risk rates seeks to support greater competitive neutrality between IRB banks and standardised banks. That is, it would aid competition in the banking sector.

APRA (2016c) provided an estimate, under various assumptions, that the current difference in mortgage risk weights between the standardised and IRB approaches *"equates to a reduction in CET1 capital requirements of approximately $19 billion (14 per cent), in aggregate, for the four major banks' current Australian residential mortgage portfolios."* This is based on an assumption that IRB banks have 25% risk weights, standardised banks have 39% risk weights, and a target CET1 capital ratio of 9%. This estimate is subject to these assumptions and could be different under different parameters, for example, it may be higher if the differential between the CET1 ratios of IRB banks and other ADIs are taken into account.

The benefit for banks of a lower average mortgage risk weight is that they would be required to use less equity, which is more expensive than debt, and means that they would have a lower average cost of funding. Based on various assumptions, APRA (2016c) estimated that the funding cost differential between IRB and standardised banks to be 11 basis points.

At the time, the FSI (2014) indicated that the required quantum of capital to increase the average mortgage risk weights of IRB banks from 18% to 25–30% would be roughly equivalent to a one percentage point increase in major banks' CET1 capital ratios.

The major banks have argued that the IRB approach recognises investments in stronger risk management, and that standardised banks should be supported to achieve IRB accreditation, rather than imposing greater imposts on the major banks (ANZ 2014, Commonwealth Bank, 2014, Westpac 2014). Westpac (2015) has indicated that an increase in IRB risk weights that is not due to an increase in risk would distort the allocation and pricing of credit and therefore affect the efficient allocation of resources in an economy.

The FSI considered the costs of narrowing risk weights to be modest, and are outweighed by the long-term competition benefits.

4.3 Benefits and costs of Recommendation 3

Similar to the discussion in Chapter 4.1, implementing a framework for an adequate loss absorbing and recapitalisation capacity has implications for the strength of the financial system, and reduces the cost of financial crises.

One of the Government's key objectives of implementing this framework is to require banks to take greater responsibility for their own resilience, thus reducing the need for taxpayer-funded bailouts. The experience of the global financial crisis, reinforced perceptions that some financial institutions were implicitly guaranteed by government, as they were deemed 'too big to fail'. As a consequence, the risk of failure (credit risk) of an ADI was implicitly transferred onto the government's balance sheet, leading to market distortions. For example, credit rating agencies factored in this implicit support through higher credit ratings for banks they perceived to benefit from being too big to fail.

The Reserve Bank of Australia (2012) found that this subsidy was worth between $1.9 billion and $3.8 billion. The research found that the size of the subsidy increased during periods of financial stress. The implicit subsidy peaked in 2009 at just over 100 basis points, compared to a 14-28 basis point advantage in 2013.

Reducing the implicit government guarantee seeks to reduce the moral hazard associated with it. The idea is that these institutions and their investors may have less incentive to manage risk. At the same time, addressing this issue assists with improving competitive neutrality by reducing the funding cost advantage for large institutions considered 'too big to fail' compared to their competitors.

On the other hand, the cost of introducing the loss-absorbing and recapitalisation capacity is that activating a bail-in could actually worsen a crisis. This could occur if activating the trigger to call in instruments leads other creditors to reassess the risk that they will take a loss, and consequently led them to withdraw funds. This would create a liquidity problem, causing distress in other banks, and potentially exacerbating a crisis. APRA (Byres 2016a) has noted that the high correlation in the banking sector amongst the four major banks suggests this effect could be amplified, creating systemic risk. This line of thinking led the FSI to recommend caution in this area.

Some major banks have argued introducing a loss absorbing and recapitalisation framework would increase the cost of funding, as the use of bail-in debt instruments would be considered higher risk for investors. Some banks suggest that changes in additional funding costs would be passed onto consumers in the form of higher lending rates. However, the FSI believed that competitive pressure should see banks share some of this cost with investors through a lower cost of equity funding.[4]

4.4 Rationale for Recommendation 30

The Government considers its measures to increase competition as a means to achieving better outcomes for consumers.

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[4] COBA (2014) has suggested another option; they propose doubling the D-SIB surcharge from 1% to 2%. Nonetheless, increasing the D-SIB surcharge could similarly have an impact on the cost of capital and, more broadly, on the economy.

The APRA Chairman, Wayne Byres, noted the benefits of improved competition (Byres 2015b):

> *"Competition delivers lower prices for, and greater choice and variety in, financial products; it encourages innovation; and it promotes efficiency in all its forms (operational, allocative and dynamic). Economics tells us that in the absence of market imperfections – obviously an important caveat – a genuinely competitive marketplace will deliver the best outcomes for consumers."*

When asked whether the banking sector is a well-functioning and competitive market, Chairman Byres (House of Representatives' Standing Committee on Economics (2016b) noted that:

> *"There is no doubt that you could have more competition. There are four banks that have a degree of market and pricing power."*

However, the state of competition is not simply measured by the level of concentration. Chairman Byres (House of Representatives' Standing Committee on Economics 2016b) acknowledged the role of other ADIs in reference to the point that some of the major banks were 'nervous' about offering a tracker mortgage product:

> *"My point was simply that in this country we have 110 APRA regulated entities making housing loans and then there are a range of other non-bank lenders making housing loans. If it were genuinely an attractive product you would have thought someone would have brought it to market…"*

The ASIC Chairman, Greg Medcraft, recognised the *"importance of competition in driving better consumer and investor outcomes in banking and financial services"* and that *"Strong competition from new entrants and incumbents encourages firms to innovate and has positive effects on both price and quality of what is delivered to the consumer and the investor"* (House of Representatives' Standing Committee on Economics 2016a). He also noted that:

- competition in the banking sector is lacking;
- the banking market is *"frankly, an oligopoly"* – a small number of firms have the large majority of market share and exercise market power; and
- competition in the banking market has declined ever since the global financial crisis, and the banking sector is more concentrated.

Furthermore, the Australian Competition and Consumer Commission (ACCC) Chairman, Rod Sims, opined that (House of Representatives' Standing Committee on Economics 2016c):

- there is a lack of robust competition in the banking market;
- banking is a cornerstone of the market economy and if competition is not strong in the financial sector, there are adverse effects for the economy; and

- the market share of the main four banks has gone up over the last 10 to 15 years and their profitability has gone up during that period.

While the FSI (2014) considered that competition was adequate at present, it also recognised that concentrated nature of the banking sector and increasing vertical integration could limit the benefit of competition in the future.

The debate around this issue is not about whether competition is beneficial, but how more competition can be achieved.

Conclusion

Overall state of play
The Government agreed to implement the FSI's Recommendations 1, 2, 3 and 30.

While there has been some progress on all four recommendations, significant work remains. Furthermore, much activity is scheduled over the next 12-24 months on Recommendations 1, 2 and 30, as industry consultation on regulatory and legislative change will be required on many of the outstanding commitments. On the other hand, the phased implementation of TLAC at the international level and absence of a set timeframe for Recommendation 30 means that the process will probably unfold on a much longer timeline. This will have implications for the realisation of benefits identified by the FSI of addressing the "too big to fail" issue.

Table 4.1: Overall state of play

	State of play
Recommendation 1 Capital levels	**Some progress, yet to be completed.** • Steps already taken which have seen an increase in the capital ratios of the Australian major banks. • Current schedule suggests that implementation may be completed in 2018.
Recommendation 2 Narrow mortgage risk weight differences	**Some progress, yet to be completed.** • Still in progress, although interim steps have been taken to narrow risk weights. • Current schedule suggests that implementation may be completed in 2018.
Recommendation 3 Loss absorbing and recapitalisation capacity	**Limited domestic progress; contingent on international developments.** • No set timeframe, but progress is expected to *"hasten slowly"*.
Recommendation 30 Strengthening the focus on competition in the financial system	**Limited progress.** • Current schedule suggests that implementation could be completed by end-2017.

Source: Deloitte Access Economics

Review of the state of competition in the financial system
While progress against the four recommendations will help rebalance the competitive dynamics in the banking sector, it may not be enough to substantially increase financial system competition.

With the PC's proposed financial system competition review expected to be completed in 2017, but with terms of reference yet to be established, we propose potential terms of reference for the inquiry, with a focus on the banking sector.

The FSI's findings provide a starting point:

- competition in Australia's financial system is generally adequate at present, but there is complacency about the level of competition that exists; and
- high concentration and increasing vertical integration within some parts of the Australian financial system have the potential to limit the benefits of competition in future.

Firstly, the review should assess the degree and dynamics of competition in the financial system, recognising that market concentration may not provide a complete picture. It will be important to consider factors such as changes in market structure, the pace of innovation and the ease of customer switching.

The review should also have regard to the competitive dynamics in different product markets (e.g. personal and business loans) and for different consumers groups (e.g. by socioeconomic background).

Secondly, the review should consider the reasons why there is not more competition in the financial system. The degree of competition could be a function of global or local economic conditions, or driven by barriers to entry such as economies of scope or scale. While the FSI began the discussion on how aspects of (prudential) regulation may be affecting competition, it also suggested that more needed to be done. The review should follow up on the FSI's recommendation that regulators examine whether their rules and procedures are creating inappropriate barriers to competition. The review should also extend examination to look more broadly at the Australian policy environment, e.g. taxation policy settings.

At the same time, the degree of competition in the financial system may be the result of a trade-off with other objectives. The IMF (2009), noted:

> *"One has to consider competition as part of a broad set of objectives, including financial sector efficiency, access to financial services for various segments of users, and systemic financial sector stability, and consider possible trade-offs among these objectives."*

Therefore, more competition could be at the expense of other objectives which also benefit the economy. Although in some instances it may not be a trade-off. Nonetheless, the starting point should be competition.[5]

Third, the review should consider practical recommendations to address any identified regulatory or policy impediments to greater competition. The review should also propose practical recommendations to support greater competition where it is warranted.

In considering 'What more needs to be done…' the review should have regard to whether these recommendations would deliver on the intended benefits of competition. The Competition Policy Review (2015), also

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[5] Moves to increase competition in the financial system must be subject to the "public interest test", as outlined in the Competition Policy Review. In other words, competition should be the preferred outcome *except* when it can be shown that competition is contrary to the public interest *and* the only way to secure the public interest is to restrict competition.

known as the Harper Review, identified six attributes of 'fit for purpose' competition policy:

- focuses on making markets work in the long-term interests of consumers;
- fosters diversity, choice and responsiveness in government services;
- encourages innovation, entrepreneurship and the entry of new players;
- promotes efficient investment in and use of infrastructure and natural resources;
- includes competition laws and regulations that are clear, predictable and reliable; and
- secures necessary standards of access and equity.

This provides useful framework for thinking about what a competitive financial system should deliver. Drawing from this, the Government's response to the Harper Review (The Australian Government the Treasury 2015b) noted the following:

> *"Competition policy is about making markets work for the long term interests of consumers. Consumers benefit when businesses compete to deliver new and better products and services at lower prices.*
>
> *Competition also drives businesses to operate efficiently, innovate and invest in new technologies, which allows Australia to better compete in international markets.*
>
> *Competition is also one of the surest ways to lift long term productivity growth, which is what will keep wages growing and improve our living standards."*

Against this background, proposed terms of reference are offered below.

Suggested terms of reference for the Productivity Commission
The PC should conduct an inquiry into the state of competition in the financial system.

In undertaking this inquiry, the PC should consider three questions:

1. **What are the competitive dynamics of the financial system?**
   Including examining trends in:
   a) industry consolidation;
   b) horizontal and vertical integration;
   c) exit of existing participants and new entrants, such as fintechs;
   d) innovation, such as digital disruption; and
   e) customer switching

2. **Why is there not more competition in the financial system?**
   Including considering:
   a) whether regulators' rules and procedures are creating inappropriate barriers to competition;
   b) whether other Government policies are creating inappropriate barriers to competition, such as taxation policy, and have

appropriate regard to other business models including the customer owned model;

c) whether other factors have affected competition, such as other non-regulatory or policy-related barriers to entry and broader economic conditions;
d) the appropriate balance/trade-offs between the objective of competition and:
   - financial system performance;
   - access to financing, including for different segments of users; and
   - systemic stability.

3. **What more needs to be done to support competition?**
   Including considering:
   a) removing barriers to competition by modifying or removing inappropriate regulatory rules and Government policies; and
   b) taking actions to support greater competition, such as:
      - considering additional support for standardised ADIs to achieve IRB accreditation, including technical assistance (see Chapter 3.1.1); and
      - requiring a competition impact statement to be undertaken as part of all regulatory impact assessments (see Chapter 2.4.1).

In considering question 3, the PC should also have in mind the impact of changes on the long-term interests of consumers, that is, consumer welfare.

The PC should draw on the experiences in overseas jurisdictions and the expertise of academics and industry and Government subject matter experts, but also consult widely and broadly, including with participants and consumers.

In summary
Significant work remains to be made in order to complete implementation of the FSI's recommendations. The completion of these reforms is expected to deliver the benefits of a more robust and competitive financial system.

In regards to the capital framework, APRA has noted that 2016 has been the year for finalising the international framework, 2017 is expected to involve significant consultation on domestic application, and 2018 will be the year for implementation. At the same time, next year will be significant for progress in implementing some of the non-capital related recommendations, particularly around strengthening the focus on competition. Therefore industry participants should look to engage with the Government and regulators over the coming year.

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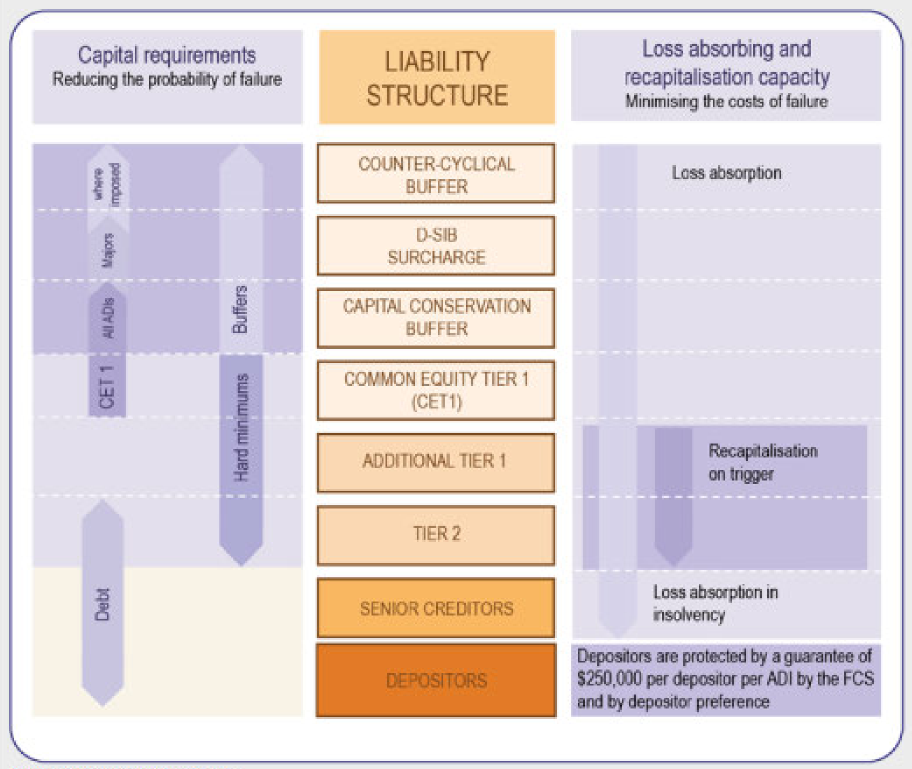
Appendix A: Forms of regulatory capital

The figure below shows the main components of an ADI's liability structure, and the relationship to capital requirements. Capital requirements comprise: (i) buffers; and (ii) hard minimums.

An ADI funds its activities using a mix of debt and equity instruments. The liability structure depicts the order in which losses are cascaded. This means that liability categories closest to the top are riskiest for investors and are the most expensive sources of funding for ADIs.

Figure A.1: ADI liability structure and prudential requirements



RWA: risk-weighted assets.
D-SIB: domestic systemically important bank.
CET1: common equity tier 1.

Source: FSI (2014)

A.2. Buffers

ADI are expected to maintain their capital levels above the levels specified by the buffers, but it can fall below this level subject to restrictions being placed on dividends and bonus payments.

Counter-cyclical buffer: is varied over time in response to market conditions. For ADIs' Australian exposures, it is currently set at a requirement to hold additional CET1 capital equal to 0% of risk-weighted assets. For ADIs' overseas exposures, the additional capital requirement is set at a weighted average of the countercyclical buffers applied by the jurisdictions in which it operates.

D-SIB surcharge: applicable to ADIs designated by APRA to be a domestic systemically important bank (D-SIB), is a requirement to hold additional CET1 capital equal to 1.0% of risk-weighted assets.

Capital conservation buffer: applicable at all times, is a requirement to hold additional CET1 capital equal to 2.5% of risk-weighted assets.

A.3. Hard minimums

ADIs much maintain their capital levels above these hard minimums. If it falls below this, the ADI would likely be declared non-viable.

Common Equity Tier 1 (CET1): comprises of tangible equity such as shareholder’s common equity, retained earnings, and accumulated other comprehensive income and other disclosed reserves. This is recognised as the highest quality of capital, this because it is subordinated to all other elements of funding and it will absorb losses as and when they occur.

Additional Tier 1: refers to other forms of equity capital, such as preference shares, as well as some kinds of debt instruments with similar characteristics that can provide loss-absorption but do not satisfy all criteria as CET1.

Tier 2: includes subordinated debt that has a ‘bail-in’ clause, meaning it can be converted to equity or written off should a set condition be met.

Limitation of our work

General use restriction

This report is prepared solely for the use of the Customer Owned Banking Association Ltd. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for publication by COBA for the purpose of promoting debate about the need for continuing the implementation of selected financial sector reforms outlined in the FSI Final Report. You should not refer to or use our name or the advice for any other purpose.

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Appendix 3: COBA consumer polling on retail banking issues

7 September 2017

COBA consumer polling on retail banking issues

COBA has regularly used reputable consumer polling to gauge the sentiment of Australians on various retail banking matters, including pricing, choice and switching.

The poll results indicate in some areas there is low consumer awareness about key banking products, particularly around pricing and the alternatives available in the market. There are also concerns about the ease of switching between providers.

Below is a summary of findings relevant to the PC inquiry and links to the survey reports.

Credit Cards

COBA has regularly commissioned polling on credit cards, particularly in a high usage time such as Christmas. Polling in December 2016 found a third of young Australians think that the major banks offer the lowest interest rates. This has implications for competition because we know through analysis from Canstar that the customer owned banking sector actually offers credit cards with rates on average more than 5% lower than the major banks.

A similar poll in December 2015 revealed more than half of those surveyed didn't know who offered the lowest rate cards. Given around two thirds planned to use a credit card at Christmas, we think it important that consumers understand the rates they are paying and where the competitive opportunities await.

Switching Home Loans

Consumer polling on switching home loans has also delivered some insights worthy of further investigation from policy makers. A 2017 BLACKMARKET Research poll of 1000 Australians found more than one-third say they haven't switched because the process is painful. One in five gave the reason of paperwork or it not being worth the effort for not switching.

The poll results would seem to back up our argument that Australians want competitive home loans, but they're being let down by the switching system. We have some real concerns for genuine banking competition if people find the process too hard and simply give up. An area for further scrutiny is the amount of time between a consumer asking to switch and their current home loan provider completing the paperwork. We are concerned it is taking up to three months in some cases to switch from a major bank to a customer owned banking institution.

Consumer Attitudes to Banking

The commissioned polling indicates concern about the state of competition in the banking market. We have seen this over several years.

In 2014 an Essential poll found more than half of those surveyed believe there is no genuine competition between the big four banks. There was also considerable confusion about the transparency of 'multi-branding' by the big four. Only 52% of those surveyed knew St George was owned by a big four bank, down to a low of just 29% for RAMS. This was backed up by further polling in 2015 which found 75% think bank sub-brands are not clear enough about their ownership in their advertising and communications. 91 per cent of respondents said transparency and clarity of information is important in helping decide who to bank with.

Similar polling also showed a consumer desire for greater transparency on rates and fees to better inform their choices.

Trust in financial services is a key issue. An Essential Research poll commissioned by COBA found 90% regard trust as an important issue, followed by 87% for ethical conduct. A survey by research firm BLACKMARKET found interest rates, fees and charges, honesty and trust and customer service were the most important features for people when selecting a financial institution. Both of these polls indicate strong support for the customer owned model and diversity of financial institutions.

Millennials and Open API

From time to time COBA has commissioned research to gauge attitudes on particular issues with certain age demographics.

Ahead of introduction of 'positive' credit reporting, i.e. the Comprehensive Credit Reporting (CCR) regime, COBA commissioned research from 18-34 years olds as part of a report into Millennials attitudes to finance.

The polling found that:

- Around two-thirds had not heard of or didn't understand the term 'credit report' and around three-quarters were not aware of the CCR changes;
- 72% liked the idea of getting a better deal because of a positive score;
- Around half said they were going to make more effort because they could see the importance of their credit file in the future.

COBA has taken the pro-consumer position of supporting Open Banking, subject to safeguards and a pro-competitive implementation plan. We sought the views of consumers about Open Banking, with some surprising results.

The poll of 1000 people conducted by Essential Research found:

- 88% say consumers should have the right to control their data; and
- Older respondents are more likely they were to think that consumer banking data should belong to them: 77% of those aged 55+ selected this compared to 64% of those aged 35-54 and 53% of those aged under 35.

These results helped further inform the public debate about sharing data along the lines of the UK model and its potential application in Australia. COBA believes this is one way to put the power back into the hands of the customer when it comes to retail banking.

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