Productivity Commission Inquiry into Competition in the Australian Financial System.

RESPONSE TO DRAFT REPORT

Westpac Banking Corporation
March 2018

Note: In this submission, a reference to 'Westpac', 'Group', 'Westpac Group', 'we', 'us', and 'our' is a reference to Westpac Banking Corporation ABN 33 007 457 141 and its subsidiaries, unless it clearly means just Westpac Banking Corporation.

Table of contents

Executive summary

Westpac welcomes the opportunity to respond to the Productivity Commission's draft report into Competition in the Australian Financial System (Draft Report).

In this second submission to the Inquiry (Second Submission), Westpac has sought to build on analysis and commentary in our initial submission (First Submission), and our statements to the Commission's public hearing in February 2018. Insights from our First Submission are generally not repeated, but are referred to where relevant.

From the wide range of policy options presented in the Draft Report, Westpac's Second Submission focuses on responding to the Commission's draft findings and recommendations in the following areas:

- State of competition in the Australian financial system;
- The residential home loan market;
- The payments system; and
- Improving customer outcomes.

State of competition in the Australian financial system

Banks play a critical role in supporting the nation's economic growth by taking deposits, facilitating payments and providing loans. Competition and stability settings must therefore work together so that the financial system is capable of supporting the economy and protecting customers over an economic cycle, not just in the good times.

In this regard, Westpac does not agree with the Commission's draft finding that competition has suffered at the expense of stability since the Global Financial Crisis (GFC). Rather, Westpac believes that strong prudential oversight, combined with regulatory reform in Australia over the past decade, has helped to deliver a more stable and resilient financial system in which banks have continued to compete vigorously.

Indeed, competition in Australia's financial system is vibrant and multifaceted. Westpac and the other major banks are leaders in driving many important technological innovations in the financial system, which lifts productivity and supports economic growth. At the same time, emerging competitors are increasingly utilising new technologies to fundamentally disrupt existing business models.

These competitive dynamics mean that customers have access to world-leading digital innovations in banking, while enjoying significant choice in terms of products and providers, lower fees and costs, and improved service.

For these, and other, reasons, including those set out below, we also strongly disagree with the Commission's draft finding that the major banks hold substantial market power, either unilaterally or collectively. For example:

- Across each product segment, the major banks' conduct is constrained by the three other major banks, a number of smaller banks and other market participants;
- The supply of retail banking products is not highly concentrated;

- The major banks face competitive pressures from the arrival of new entrants and potential new entrants;
- The major banks' net interest margins are not high by international standards, and have fallen over time; and
- Customer satisfaction is close to historically high levels.

Our Second Submission includes a report from an external economist (Economist's Report), which considers this draft finding in detail and concludes that the major banks do not, individually or collectively, hold substantial market power. A copy of the Economist's Report is attached at **Appendix 1**.

Ultimately, we consider that Australia's financial system, combined with its robust regulators, has proven to be competitive and well-calibrated to deliver fundamental banking services through the economic cycle.

The residential home loan market

Westpac is supportive of measures that further improve competition, enhance transparency and promote better customer outcomes in the residential home loan market.

In particular, we agree in principle with the Commission's draft proposal to enhance consumer protections in the broker market. We acknowledge the work of the Combined Industry Forum (CIF) in developing a package of industry-led measures designed to improve customer outcomes in mortgage broking, including a "good customer outcome" standard that complements the existing responsible lending laws.

To avoid potential detriment to customers, we believe this standard should apply to all aggregators and brokers, regardless of ownership structure.

Westpac considers that measures to enhance transparency around broker commissions, fees, costs and ownership structures will also help consumers to make more informed choices, which in turn, will lead to better consumer outcomes. Through the CIF, the industry is continuing to drive development and implementation of these reforms.

Similarly, while we support measures to increase mortgage rate transparency, we think this will be better achieved through the open data regime rather than the Commission's proposed online comparison tool.

With respect to lenders mortgage insurance (LMI) refunds, we agree that extending the period over which LMI premiums are refunded should be explored, however, we consider that there may be some challenges in implementing this change (including impacts on reinsurance costs for the industry) and further industry consultation will be required.

The payments system

Westpac does not support the Commission's draft proposal to ban interchange fees.

The revenue stream from interchange fees helps to fund network costs, while supporting issuers to invest in innovation and build security and fraud protection systems, which delivers benefits to both customers and merchants.

Removing the revenue stream from interchange fees would likely lead to less incentive for system participants to introduce, or invest in, innovative technologies.

We also note that interchange fees have been the subject of a number of reviews and inquiries over the past decade. We believe the RBA's recent changes to interchange regulation are appropriate and will further contribute to the downward trend in merchant service fees.

Improving customer outcomes

As illustrated in our First Submission, customers have more choice in banking than ever before – there are, for example, nearly 4,000 different mortgage products on offer from over 100 different providers.

However, the Draft Report suggests that customers continue to face information and switching barriers. In Westpac's experience, customers can and do switch, and the threat of switching drives Westpac to compete strongly to retain existing, and win new, customers. That said, we agree that it can be difficult for customers to meaningfully compare the wide range of products and services in the market.

Industry initiatives, such as open banking, the New Payments Platform and comprehensive credit reporting will further support and enhance customer choice by giving customers better access to their financial data, while facilitating increased sharing of information across lenders. Westpac is fully supportive of these reforms.

Guide to reading Westpac's Second Submission

In this submission, Westpac's response to various policy options raised in the Draft Report is set out directly under an extracted grey box of the Commission's relevant draft finding, recommendation or information request.

SECTION 1

State of competition in the Australian financial system

1.1 Competition and stability

DRAFT FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST

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

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

Banks play a critical role in supporting the nation's economic growth by taking deposits, facilitating payments and providing loans. Competition and stability settings must therefore work together so that the financial system is capable of supporting the economy and protecting customers over an economic cycle, not just in the good times.

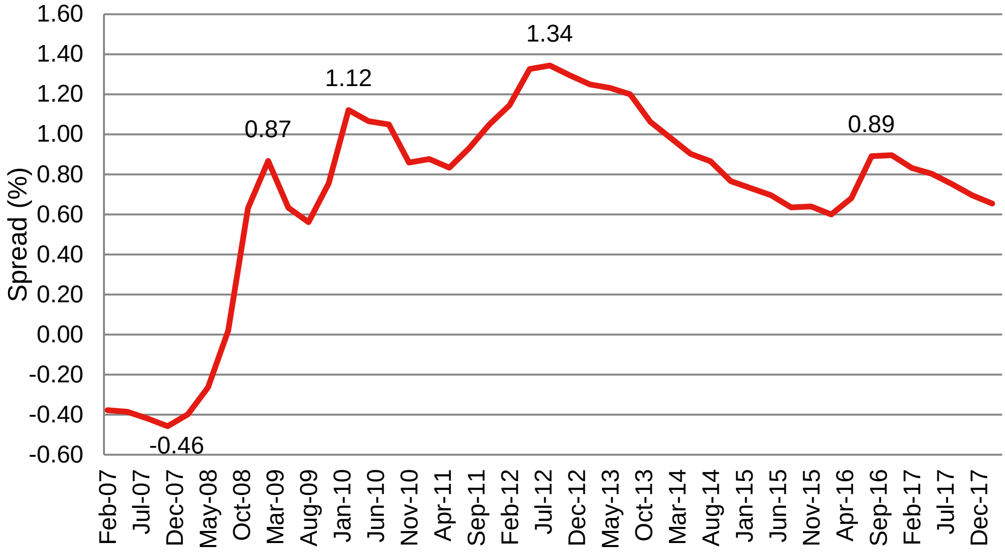
In this regard, Westpac does not agree with the Commission's draft finding that competition has suffered at the expense of stability since the Global Financial Crisis (GFC). Rather, Westpac believes that strong prudential oversight, combined with regulatory reform over the past decade, has helped to deliver a more stable and resilient financial system, while vigorous competition across the banking industry has continued.

The impact of the GFC was a stark reminder that when stability and competition settings are misaligned, there can be significant ramifications across the economy, with widespread social and economic impact. Prior to the GFC, many countries placed too much emphasis on competition and growth. When the reset occurred, economies contracted and unemployment increased.

In contrast, Australian banking policy has held firm on both competition and stability. Since the GFC, Australian banks have boosted capital levels, and materially strengthened both liquidity and funding bases. New regulatory requirements, aimed at improving our funding base, have resulted in intense competition for customer deposits.

As illustrated in Figure 1.1, term deposit spreads have moved from being priced around 45 basis points below the equivalent swap rate in 2007 to approximately 80 basis points above the swap rate in 2017. This demonstrates that the banks continue to compete vigorously for deposits, and this has impacted customer deposit pricing.

Figure 1.1: Household term deposit spread to BBSY (Westpac brand consumer, quarterly spot)



Source: Internal data

Deposits are the foundation that give banks the ability to lend and we consider that the intense competition for deposits that exists in Australia has not been reflected in the Draft Report.

Ultimately, we believe that Australia's financial system, combined with its robust regulators, has proven to be competitive and well-calibrated to deliver fundamental banking services through the cycle. The regulatory framework developed since the recession of the early 1990s has both fostered competition and prevented another severe downturn. The adverse consequences that can arise when competition and stability are unbalanced are a significant consideration when any reform is considered.

1.2 The major banks

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

Australia's banking sector is a strong oligopoly with a long tail of smaller providers…

DRAFT FINDING 3.1 THE MAJOR BANKS' OLIGOPOLY POWER

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

As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability without losing market share…

Westpac disputes the Commission's draft finding that the major banks hold substantial market power.

As one of Australia's major banks, Westpac faces intense competition from the other three major banks, as well as from a range of smaller institutions. Across the key markets of deposits and mortgages, together with the small to medium enterprise (SME) segment, the competitive nature of the industry drives Westpac to compete to attract new customers and retain existing customers. We do this through service, continued investment in our technology offering, and price.

The supply of retail banking products is also not highly concentrated, when assessed in accordance with standard objective measures of concentration used by major competition regulators around the world.[1] This is a strong indicator that no one or more bank has substantial market power.

Westpac and the other major banks are leaders in driving many important technological innovations in the financial system, which lifts productivity and supports economic growth.

These competitive dynamics mean that customers have access to world-leading digital innovations in banking, while enjoying significant choice in terms of products and providers, lower fees and costs, and improved service.

At the same time, we also face competitive pressures from the arrival of new entrants (and the threat of potential new entrants). Many of these emerging competitors are utilising new technologies to fundamentally disrupt existing business models.

As outlined in our First Submission, Westpac has spent the decade since the GFC boosting liquidity funding and capital resources in response to regulatory requirements aimed at making banks safer. While having to hold more liquidity, more stable funding, and capital in reserve comes at a cost, that increased cost of capital (and carry cost of liquidity) has not been completely passed on to the customer. This is a key reason why return on equity (ROE) has structurally fallen since the GFC, and is evidence of a competitive market. We also note that:

- Major banks' net interest margins are not high by international standards, and have fallen over time;
- Major bank returns and profitability (as measured by ROE) are in line with other leading banking systems internationally, and their returns are at the mid to lower end when compared with Australia's largest companies on the ASX 200; and
- Customer satisfaction is close to historically high levels.

Figure 1.2 below provides an internal analysis of Westpac's ROE over a 10 year time horizon from FY07-FY17 broken down by:

- Net interest margin (NIM);
- Non-interest income on assets;

[1] Such as the Herfindahl-Hirschman Index. This is discussed further in section 4.2.4 of the Economist's Report.

- Costs on assets; and
- Impairments on assets.[2]

The analysis shows:

- Non-interest income on assets has fallen significantly over the period, down from 116 basis points in 2008 to 78 basis points in 2017, and down from 98 basis points to 78 basis points since FY13. NIM, however, has remained flat – this suggests that customers are not paying more for banking products or services;
- Leverage has declined from 19.9x in FY07 to 12.8x in FY17;
- The impact of capital vs return on assets; and
- The cyclical nature of impairments.

Figure 1.2: Westpac ROE – ROA analysis 2007-2017 (based on AIEA[3])

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Net interest assets/AIEA	2.16%	2.05%	2.32%	2.22%	2.22%	2.17%	2.15%	2.08%	2.08%	2.13%	2.09%
Non-interest assets/AIEA	1.29%	1.16%	0.99%	0.94%	0.90%	0.95%	0.99%	0.98%	0.92%	0.82%	0.78%
Operating expenses/AIEA	(1.55%)	(1.44%)	(1.33%)	(1.30%)	(1.30%)	(1.28%)	(1.29%)	(1.27%)	(1.26%)	(1.24%)	(1.21%)
Impairment charges/AIEA	(0.16%)	(0.26%)	(0.65%)	(0.27%)	(0.18%)	(0.21%)	(0.14%)	(0.10%)	(0.11%)	(0.16%)	(0.11%)
Other impacts (tax/NCI)/AIEA	(0.53%)	(0.45%)	(0.42%)	(0.49%)	(0.50%)	(0.50%)	(0.53%)	(0.51%)	(0.49%)	(0.47%)	(0.47%)
ROA (AIEA)	1.20%	1.06%	0.92%	1.10%	1.15%	1.14%	1.18%	1.18%	1.14%	1.08%	1.07%
Leverage (AIEA/Equity)	19.9	21.1	15.2	14.7	13.9	13.6	13.5	13.9	13.9	12.9	12.8
ROE	**23.84%**	**22.31%**	**13.96%**	**16.14%**	**16.00%**	**15.49%**	**15.93%**	**16.41%**	**15.84%**	**13.99%**	**13.77%**

Our observations on the competitive nature of the banking sector are supplemented by the Economist's Report, which considers the Commission's draft finding that the major banks hold substantial market power.

The Economist's Report concludes that the major banks do not, individually or collectively, hold substantial market power for the following reasons:

- Each of the major banks faces competition for each retail product from at least the three other major banks offering similar products;
- The supply of retail banking products is not highly concentrated;
- There have been numerous examples of new entrants into particular retail banking products, and so banks can be said to face competitive constraints from potential new entrants; and
- The conduct of the major banks does not appear to reflect substantial market power, ie:

[2] Average interest earning assets.
[3] AIEA is average interest earning assets based on cash earnings.

- The pace of innovation and improvements in the quality of services offered by the major banks is high;
- Consumer satisfaction with (customers' own) banks is high and improving.

A copy of this report is attached at **Appendix 1**.

More broadly, Westpac supports the significant reforms the Government is implementing to boost competition. These include making it easier for new participants to enter the market and improving data sharing. Westpac considers that the impact of these reforms should be tested after a few years, allowing sufficient time for the reforms to be implemented.

1.3 Cost of funds

DRAFT FINDING 5.1 COST OF FUNDS FOR DIFFERENT SIZED BANKS

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

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

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

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

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

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

Importance of a strong banking system

Westpac considers that the Draft Report did not adequately acknowledge the importance of a strong banking system in importing capital into the country. Banks play a critical role in importing debt capital to fund Australian assets and support economic growth.

As noted by the Reserve Bank of Australia (RBA):

> For more than a century, Australia's high level of investment relative to saving has been supported by capital inflows from the rest of the world. These net capital inflows are the financial counterpart to Australia's current account deficit. Foreign investment has been instrumental in expanding our domestic productive capacity and has been attracted by the favourable risk-adjusted returns on offer here.[4]

[4] Guy Debelle, Deputy Governor, Reserve Bank of Australia, *'Recent Trends in Australian Capital Flow'*, Speech delivered in Sydney, 6 April 2017, https://www.rba.gov.au/speeches/2017/sp-dg-2017-04-06.html.

The Australian major banks play a key role in these capital flows, collectively borrowing between A$120 billion and A$150 billion from long-term wholesale capital markets each year, plus approximately another A$175 billion in offshore short term debt.[5]

The major banks are successful in attracting this capital due to their strong and diversified financial and risk characteristics.

As noted in the Draft Report, investors recognise the "fundamental characteristics of each bank" including "size, ability to manage risk and balance sheet strength".[6] The stability of the Australian financial system, the strong and active regulatory supervision that exists and Australia's sound economic position also contribute to their confidence in investing in Australian major bank debt.

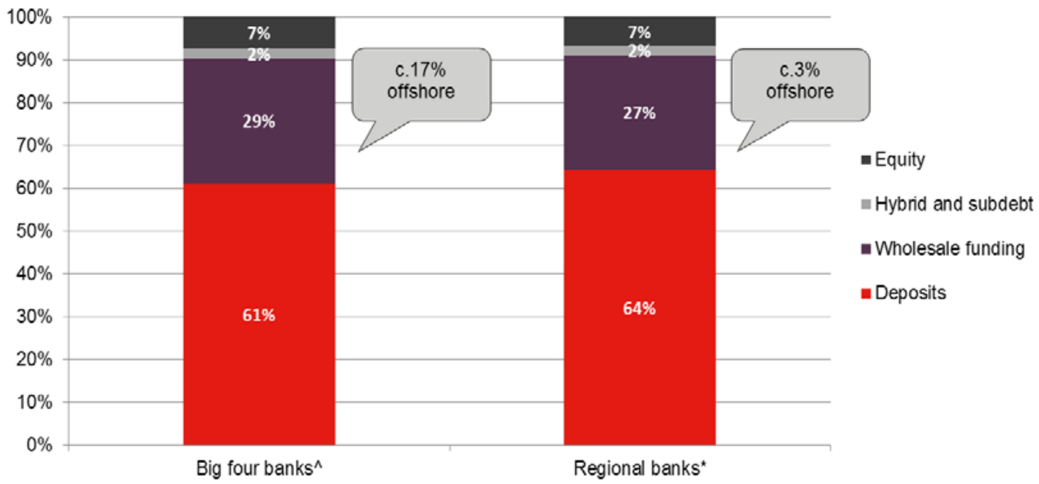
Profitability (as measured by ROE) is another component factored into the credit rating determinations and investor appetite for Australian major bank debt. If Australian banks were to experience further diminished profitability (as measured by ROE), for example, as may be expected in an economic downturn, this may have a negative impact on investor sentiment and would likely lead to a reduction in the amount of capital offshore investors are willing to invest. These factors would severely constrain the ability of ADIs to extend credit to consumers and businesses.

Deposit funding and deposit competition

Deposits are the main form of funding for both major banks and regional banks.

As illustrated in Figure 1.3 below, the four major banks source approximately 60% of their total funding from customer deposits, while the regional banks source up to 73% of total funding from customer deposits.

Figure 1.3: Australian banks' funding mix (%)



^ Figures on big four banks are as at Sep-17, except for CBA which is at Jun-17.

* Includes Suncorp-Metway, Bank of Queensland and Bendigo and Adelaide Bank. Figures for regional banks are as at Jun-17, except for BOQ which is at Aug-17.

[5] Source: Australian major banks' annual reports and investor discussion packs.

[6] Draft Report, p 437.

With the Government's Financial Claims Scheme providing a guarantee for all deposits under $250,000, there is generally no competitive difference for these deposits. However, the size of the deposit pool in Australia is limited and not large enough to fund total lending. This is because a large proportion of savings in Australia are directed to superannuation and other forms of investing, often due to tax considerations.

The ability to attract deposits in order to fund assets is therefore a significant constraint on the growth of ADIs, whether large or small.

Access to wholesale funding

With ADIs competing for a limited deposit pool, wholesale funding (despite being a smaller component of total funding) becomes important.

Access to wholesale funding differs significantly between major banks and regional banks. This is primarily because investors in wholesale markets are less willing to allocate funds to regional banks due business model fundamentals, including being smaller and more concentrated than the larger banks.

Accordingly, regional banks are more heavily reliant on securitisation to satisfy wholesale funding needs. As noted by the RBA:

> RMBS have provided an alternative to bank deposits as a source of funding for residential mortgages. This has been particularly important for smaller authorised deposit-taking institutions (ADIs) and non-ADIs that have limited access to deposit funding or term funding markets.[7]

While securitisation can provide sufficient funds when markets are functioning well and investors are willing to invest, this asset class has, at times, been adversely affected by a loss of confidence, as clearly evidenced in the GFC.

Credit ratings

As outlined in our First Submission, we acknowledge that wholesale debt ratings for the major banks include an uplift that reflects the rating agencies' view that Government support will be provided under extraordinary circumstances, given the systemic importance of the major banks to the financial system.

To refute the assumption of implicit support, the Government would need to explicitly state that it will not provide support to the major banks in extraordinary circumstances. Alternatively, an APRA-introduced total loss-absorbing capability (TLAC) or resolution regime would diminish the perception of Government support for S&P Global Ratings.

Should the major banks' credit rating be downgraded, there is the potential for the higher cost of funds to translate into a cost to customers, while any loss of capacity in wholesale

[7] Reserve Bank of Australia, 'Structural Features of Australian Residential Mortgage-backed Securities', RBA Bulletin, June Quarter 2015, https://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-6.pdf.

markets may have the potential to result in credit rationalisation. The outcomes of any credit rating downgrade depend heavily on the economic and market conditions at the time such a downgrade occurs.

SECTION 2

The residential home loan market

2.1 Mortgage brokers

Consumers are attracted to the broker channel for a variety of reasons, including:

- Obtaining assistance, from an industry consultant, in comparing price and features of mortgage products;
- An expectation that the broker will be better positioned to negotiate rates with lenders on their behalf;
- Assistance through the mortgage process, from application through to settlement; and
- Convenience and availability of brokers.

While we prefer serving our customers directly through our Westpac business, we acknowledge that customers will often choose brokers. Brokers and other mortgage intermediaries are therefore important in enabling Westpac to provide mortgage solutions to customers who prefer this form of service.

Westpac seeks to support customers who choose to deal with us either directly or through brokers. Our resourcing is then set based on that customer demand.

DRAFT FINDING 8.1 INTEREST RATES FROM BROKERS VS OTHER CHANNELS

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

At Westpac, on a like for like basis, there is no differentiation in pricing based on channel. Headline pricing and discretionary discounts available to customers are set at the same level regardless of the channel the customer is originated through.

At an aggregate level, on average, loans originated through the broker channel have a lower interest rate than those issued via direct channels. The lower average interest rate for broker customers has been driven by several factors, including average deal size and a different product mix between the two channels.

For example, Westpac internal data over the past six months shows broker-originated loans had a relatively higher proportion of fixed interest rate loans and basic loans (less featured variable product).

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

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

Westpac supports initiatives that lead to good outcomes for customers.

In its response to ASIC Report 516 into mortgage broker remuneration,[8] the Combined Industry Forum (CIF) took steps to improve the standards that mortgage brokers must meet by introducing the following new definition of "good customer outcome":

> The Customer has obtained a loan which is appropriate (in terms of size and structure), is affordable, originated in a compliant manner and meets the customer's set of objectives at the time of seeking the loan.

While the "good customer outcome" standard complements the existing responsible lending laws, it also introduces a heightened standard that, we believe, is better aligned with community expectations.

We believe that such a standard should apply to all aggregators and brokers regardless of ownership structure to avoid potential detriment to consumers. If it is not applied consistently in this manner, some customers will receive less protection than others based solely on the ownership of the aggregator or broker.

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

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

As noted above, we believe that any standard should apply to all aggregators and brokers, regardless of ownership.

As currently framed, the draft recommendation uses the "best interest" language from the Future of Financial Advice (FOFA) regime in the *Corporations Act 2001* (Cth) (Corporations Act) (where there exists a concept of advice or recommendations), rather than the language and requirements of the suitability regime under the *National Consumer Credit Protection Act 2009* (Cth) (NCCP), which does not require a "best" product recommendation, but rather that the credit contract is "not unsuitable". In our view, any alteration of legislative standards currently in place to ensure good customer outcomes (including the drafting of any new

[8] ASIC Report 516, Review of mortgage broker remuneration, March 2017, http://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf.

obligations) must be carefully considered to minimise complexity and avoid overlap with existing requirements.

For mortgage broking to be governed by the "best interest" test would be challenging, given mortgage broking is driven by factors different to financial advice, including the extent of product comparison and enquiry and the weighting given to price or rate. In addition, borrowing tends to be more heavily influenced by a customer's subjective priorities, shorter term behaviours and life events, whereas financial advice on insurance and investments tends to have a longer term focus.

As outlined above, we recommend adopting the "good customer outcome" principles.

Enhancing transparency in the broker channel

DRAFT FINDING 13.1	**MORTGAGE BROKER COMMISSION STRUCTURES WEAKEN CONSUMER SWITCHING**

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

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

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

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

- Trail commissions
- Trail commissions that increase over time
- Commission clawback.

INFORMATION REQUEST 8.2	**SHOULD CONSUMERS PAY BROKER FEES FOR SERVICE?**

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

Westpac believes that measures to enhance transparency around broker commissions, fees and costs will help consumers to make more informed choices, which in turn will lead to better consumer outcomes.

We note that brokers help consumers navigate the process of obtaining a mortgage – that is, facilitating price discovery and guiding customers through the lengthy credit approval process. Many of these aspects have been, and will continue to be, impacted by technological developments, which have helped to improve the customer experience.

Commission structures have recently been considered by the Sedgwick Review and ASIC's review of mortgage broker remuneration. In December 2017, the CIF handed its report to Government, which included a package of industry-led measures to directly address the ASIC Report proposals, while taking into account the third party recommendations in the Sedgwick Review. Through the CIF, the industry is continuing to drive development and implementation of these reforms.

Consistent with the Sedgwick Review, Westpac is in favour of greater transparency and clearer disclosure of the commissions and fees paid to brokers and the effect of those commissions and fees on the ultimate charge to the customer. The Commission may consider whether brokers charging customers directly for their services might enhance transparency and competition for customers. Potential second order impacts of this type of structural change would need to be considered carefully.

We believe that clawback arrangements are an important part of our existing oversight and compliance structures. This is based on the view that any product recommendation is based on a thorough understanding and review of a customer's financial circumstances and therefore, outside of a non-foreseeable life event, a loan submission should reflect the needs of a customer, and particularly so in the first 12 months.

While we believe this is an important part of our oversight arrangements, we are continuing to work with industry to establish a common regime that will see clawbacks applied to the benefit of the customer.

Westpac's commissions to brokers are currently structured as follows:

- **Upfront commission:** Westpac pays a flat 0.65% upfront payment on the amount of the loan at the time of drawdown. The percentage paid remains the same regardless of volume (no payment is made for increases on existing loans for amounts below $50,000).
- **Trail commission:** Westpac pays a flat 0.15% trail on outstanding balances over the life of the loan. No accelerated trail is paid.
- **Commission clawback:** Where a loan is closed within 12 months, 100% of the upfront commission is clawed back. Where a loan is closed between 12-24 months, 50% of the upfront commission is clawed back. After 24 months, no clawback applies.

For Westpac, the average length of a loan is broadly consistent across both channels: 72 months for a first party loan and 74 months for a broker loan.

The upfront commission component is designed to compensate the broker for their work in originating the loan for the customer.

Payment of a trailing commission is intended to promote an ongoing relationship between the broker and the customer. That payment is cancelled if the loan falls into arrears.

Westpac also no longer pays volume-based incentives, bonus commissions or bonus payments to brokers, which further reduces the possibility of brokers making inappropriate loan recommendations because of remuneration structures.

Westpac has publicly advocated, both through the CIF and the media, that brokers should undertake an annual review of their customers to demonstrate customer advocacy and justify the payment of ongoing commissions.

DRAFT RECOMMENATION 8.2 MORTGAGE BROKER DISCLOSURE REQUIREMENTS

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

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

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

Westpac is supportive of reforms that will help customers achieve good outcomes.

In this regard, we note the CIF's commitment to establish a public reporting regime across aggregators, lenders and brokers, while also enhancing disclosure in relation to ownership structures within the home loan market. These reforms respond to the specific proposals in ASIC Report 516 and the CIF has committed to implementation of these aspects of its broader reform package by end 2018.[9] In enhancing disclosure requirements, it will be important not to mandate the provision of additional documentation to customers as this will simply increase complexity rather than improving customer outcomes.

Currently, mandatory documentation required to be produced under NCCP includes a credit guide and written assessment of unsuitability, certain matters are required by law to be included in a credit contract (including an information statement in a form prescribed by regulation) and there are further document retention obligations imposed in relation to assessments of unsuitability.

In this context, we would support a comprehensive review of all documentation provided to borrowers with a view to streamlining both the volume and length of documents provided, thereby offering increased clarity to customers.

---

[9] Combined Industry Forum, 'Improving Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration' https://www.mfaa.com.au/sites/default/files/users/user130/CIF_Report_Submitted_281117_0.pdf.

2.2 Mortgage rate transparency

DRAFT RECOMMENDATION 8.3 COLLECTION OF HOME LOAN INTEREST RATE DATA

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

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

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

DRAFT RECOMMENDATION 8.4 INTEREST RATE TRANSPARENCY FOR HOME LOANS

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

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

The Australian Prudential Regulation Authority should also publish the underlying data in a way that is accessible to third parties such as web application developers, so that these parties are able to develop comparator websites if there is a commercial benefit in doing so. Making data accessible would, at a minimum, require it to be published in a machine readable format.

Westpac believes proposals to increase transparency across the industry are beneficial for consumers. Transparency generally supports competition as it eliminates information asymmetries, enhances consumer choice and allows suppliers to better understand market structure and consumer demand.

In this regard, we consider that the Government's open data reforms will facilitate easier comparison of home loan information and, in turn, support customers to make more informed financial decisions. These reforms should be allowed to work through the system prior to introducing any additional reforms.

In contrast, while we understand the policy intent underpinning draft recommendation 8.4, we consider that the proposed online comparison tool may have limited customer utility and is likely to have some fundamental shortcomings:

- Historical median interest rates are of limited use to customers, since interest rates are dependent on individual circumstances and vary from customer to customer. The proposed tool would also be unable to take into account point-in-time changes in interest rates or promotional rates.
- The insights to be offered by the proposed tool are already largely available to customers through banks' advertised rates or via existing comparison sites, such as Canstar, InfoChoice, Finder.com.au and Rate City. ADIs typically subscribe to these services to both provide and access market research, which provides further insights for customers.
- Given that the proposed tool will only generate indicative interest rate information, it would effectively duplicate the mortgage application process by requiring customers to input much of the same information twice.

More broadly, we note that previous regulatory interventions to mandate the provision of uniform "comparisons" (such as FuelWatch and Grocery Choice) have proven ineffective – this further suggests lowest rate is not the sole driver of choice for customers. As mentioned previously, customers often look beyond price when choosing a home loan, considering aspects such as loan features, as well as the services offered by the lender. In our view, many of these features cannot be easily replicated in an online fee and rate disclosure tool.

2.3 Lenders mortgage insurance

Introduction

To enable effective risk management by the Group, LMI is often required when customers apply for a home loan with a loan to valuation ratio (LVR) of >80%.[10]

In general, and as illustrated by the data below, home loans with >80% LVR are riskier than loans with ≤80% LVR. LMI therefore enables customers who have not saved a deposit of 20% (plus government charges) to purchase a property that they would otherwise not be able to acquire, given the higher risk profile of such loans. Further, given the protection provided by LMI, these higher risk borrowers are able to obtain the loan at an interest rate that is comparable to borrowers who have a 20% or greater deposit.

As at 30 September 2017, the 90+ day delinquency rate for Westpac's overall Australian mortgage portfolio was 0.69%, which was unchanged from FY16. The 90+ day delinquency rate for exposures written at 80% LVR or below was 0.58%, which is much lower than the rate for those written above 80% LVR of 1.05%. In addition to delinquency rates, losses are expected to be greater in the event of default on higher LVR loans, given the reduced capacity of high LVR loans to absorb fluctuations in house prices.

[10] The Group provides certain exemptions for specific borrower groups in accordance with Group policy.

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

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

Westpac does not currently charge a higher interest rate for customers who take out a >80% LVR loan. In fact, based on Group internal data, over the last six months, on a like for like basis, the difference in rates for customers with ≤80% LVR and >80% LVR has been minimal. [11]

DRAFT RECOMMENDATION 8.5	LENDERS MORTGAGE INSURANCE REFUND

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

It is commonplace in the Australian market for LMI premiums to be paid in full at the time of origination of the loan. We note that this differs from some international markets, where annual premiums are payable.

In this context, Westpac agrees that extending the term under which refunds are payable to customers, and providing a refund schedule at the commencement of a policy, could result in better financial outcomes for some customers who refinance or pay out their loans ahead of schedule.

There would, however, be some challenges in implementing this change (including impacts on reinsurance costs) and there would need to be consultation with the industry on this point.

In particular, we note that refunds should not be payable for the full life of the loan but rather the amount of the refund would need to be proportionate to the outstanding insurance risk at the time of the cancellation of the insurance, with allowances for acquisition expenses.

This approach would be consistent with generally accepted practices for other lines of general insurance business.

In this scenario, refunds would:

- Generally be payable for up to 8-10 years after the commencement of the policy (depending on the length of the policy); and
- Not be pro-rated based on elapsed time over this period given the risk of claim under a policy is not uniform over time.

[11] There is an exception to this for RAMS.

We also note that historical pricing of LMI and the related reinsurance arrangements assume no refunds beyond a two year period. As a result, it would be necessary to consider and consult on any changes. This includes needing to negotiate with reinsurers about the possible cost implications of these changes.

SECTION 3

The payments system

3.1 Interchange fees

DRAFT RECOMMENDATION 10.3	**BAN CARD INTERCHANGE FEES**
The Payments System Board should introduce a ban on card payment interchange fees by mid-2019.	
Any remaining fees should be directly related to the costs of operating the system. Such fees should be made transparent and published.	

Interchange fees are the wholesale fees set by card schemes (such as MasterCard, Visa and eftpos) that require small payments from the merchant's bank to the cardholder's bank on every transaction made by a consumer.[12]

The revenue from interchange fees helps to balance network costs, while supporting issuers to invest in innovation and build security / fraud protection systems, which delivers benefits to both customers and merchants. Further, interchange fees fund banks writing off losses on credit card balances, a cost which would otherwise be borne by other stakeholders in the payments system.

Accordingly, Westpac does not support the Commission's draft proposal to ban interchange fees. Removing the revenue from interchange fees would likely lead to less incentive for system participants to introduce or invest in innovative technologies.

We also note that interchange fees have been the subject of a number of reviews and inquiries over the past decade:

- The Murray Financial System Inquiry explored the merits of banning interchange fees, however, ruled it out on the basis of the high transitional costs that would result from such a change.
- In its Review of Card Payments Regulation in 2015-16,[13] the RBA considered a range of policy measures (including the removal of interchange fees) to address efficiency and competition concerns and further improve the transparency of payment costs for merchants. Following extensive consultation, the RBA endorsed the retention of interchange while introducing revised standards relating to the setting of interchange fees and net payments to issuers.[14] The weighted-average caps have

[12] See Reserve Bank of Australia, Questions & Answers, Card Payments Regulation, https://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/q-and-a/card-payments-regulation-qa-conclusions-paper.html.
[13] Reserve Bank of Australia, 2015-16 Review of Cards Payment Regulation, Conclusions Paper, https://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/conclusions-paper-may2016/interchange-fees-and-transparency-of-card-payments.html.
[14] These new standards lowered the weighted-average interchange fee benchmark for debit cards from 12 cents to 8 cents per transaction while maintaining the weighted-average credit card cap at 0.50 per cent.

also been supplemented by new caps on individual interchange rates, which will further reduce payment costs for merchants.[15]

The Draft Report acknowledged that the interchange fee caps imposed under the existing regulatory scheme have improved competitive outcomes in card payments.[16] In Westpac's view, there is no evidence in the Draft Report to explain how banning interchange fees would contribute to increased competition in the payments system.

Importantly, interchange fees in Australia are multilateral in nature and apply to all competitors large and small, new and old, in an equal manner. Another key benefit of Australia's existing interchange framework is that it is transparent and regulated by the RBA. Relevantly, under its governing legislation and the *Payments Systems (Regulation) Act 1998* (Cth), the RBA is required to consider the joint objectives of efficiency, competition and controlling risk when regulating activity in the payments system.

Platform innovations

There are also competing payment mechanisms, such as the New Payments Platform (NPP), which has just launched. NPP delivers fast, data-rich payments between accounts 24/7. As part of its offering, NPP also enables "overlay services", being applications that can plug into the NPP to provide additional features. These services will allow businesses other than banks to participate in, and further improve, the payments network.

We would suggest that the Commission allow more time for that system to become established and for customers to familiarise themselves with the NPP offering before considering any changes to the interchange framework.

Other jurisdictions

The finding of the Draft Report relies in part on the fact that interchange fees for domestic debit card schemes have been set to zero in other jurisdictions, nominating Canada and New Zealand as such jurisdictions.[17] However, in those jurisdictions, the prohibition on interchange fees for domestic debit cards has had some unintended consequences:

- **New Zealand:** The Ministry of Business, Innovation and Employment commenced a review of interchange fees in February 2016, reporting to Cabinet in August 2017.[18] Amongst other findings, that review found that the functionality of EFTPOS was declining compared to other card schemes and that there was also declining use of the EFTPOS scheme.[19] There was a concern that over time, this may lead to merchants having little choice but to accept card scheme products at the going price.

[15] See Reserve Bank of Australia, Payments and Infrastructure, https://www.rba.gov.au/payments-and-infrastructure/payments-system.html.
[16] Draft Report p 299.
[17] Draft Report, p 299.
[18] New Zealand Ministry of Business, Innovation & Employment, 'Retail payment systems: update on next steps', Paper to Cabinet, August 2017, http://www.mbie.govt.nz/info-services/business/competition-policy/retail-payment-systems/document-image-library/cabinet-paper-update-on-retail-payment-systems.pdf.
[19] New Zealand Ministry of Business, Innovation & Employment, 'Retail payment systems: update on next steps', Paper to Cabinet, August 2017, http://www.mbie.govt.nz/info-services/business/competition-policy/retail-payment-systems/document-image-library/cabinet-paper-update-on-retail-payment-systems.pdf, at p 2.

- **Canada:** The domestic debit card scheme, Interac, has made public submissions that the zero fee arrangement to which it is subject inhibits its ability to make investments and pricing decisions to compete with other card schemes.[20] Interac has described its governance structure as "dysfunctional".

The merits of banning interchange fees (or setting such fees to zero) must be considered in the context of the possible adverse effects that such a ban could have on payments system innovation at a time when Australian consumers are increasingly seeking innovative payments solutions.[21]

3.2 Routing of merchant transactions

DRAFT RECOMMENDATION 10.4	MERCHANT CHOICE OF DEFAULT NETWORK ROUTING
Merchants should be given the ability to choose the default network to route contactless transactions for dual-network cards. As the technology is readily available, this option should be offered from 1 January 2019 at the latest. The Payments System Board should require that neither a scheme, nor any of its participants (including issuers and/or acquirers), can prevent merchants from setting (or asking their acquirers to set) the default route.	

Westpac, in principle, supports this draft recommendation. As outlined in the Draft Report, Australians have a strong affinity for electronic payments. According to ASIC, Australia has the fourth highest number of non-cash payments per person and the highest level of contactless card use in the world.[22]

Part of the success of contactless transactions in Australia has been the degree of speed and uniformity of cardholder experience at all terminals. The process is simple, quick and secure for both merchant and customer.

Our merchant customer base is a key part of our overall Business Banking franchise. In servicing our merchant customers, like with all our customers, we are motivated to be as competitive on price as possible. Any routing options that make it fundamentally cheaper for our merchants to transact would therefore be attractive and competitively important to implement. Accordingly, we are supportive, in principle, of draft recommendation 10.4.

It is important, however, that changes to the payment network are not driven solely by lowest cost considerations. As noted in our response to draft recommendation 10.3 above, a significant decline in network income would likely result in decreased investment in the payments system. Australia currently has one of the world's most innovative payments systems because there has been an incentive for financial institutions to invest in it, and for new entrants to enter the market.

---

[20] Canadian Senate, 'Transparency, Balance and Choice: Canada's Credit Card and Debit Card Systems', Report of the Standing Senate Committee on Banking, Trade and Commerce, June 2009, https://sencanada.ca/content/sen/Committee/402/bank/rep/rep04Jun09-e.pdf, at pp 26-27.

[21] Draft Report, p 283, 285.

[22] Australian Securities and Investments Commission, 'Fintech: ASIC's Approach and Regulatory Issues', Paper submitted for the Melbourne Money & Finance Conference, July 2016, http://download.asic.gov.au/media/3962105/melbourne-money-and-finance-conference-2016-fintech.pdf.

At a practical level, Westpac is implementing merchant choice of default routing in line with evolving demand. Relevantly, least-cost routing has only recently become an option in Australia. For many years, international card schemes were the only networks to invest in, and offer, contactless transactions, meaning that all contactless debit transactions in Australia were automatically routed through their networks.[23] In contrast, ePAL[24] has only recently introduced an equivalent contactless offering.

Prior to implementing such a change, it is also important that consumers are informed that the choice of payment network routing may affect their rights (ie given that the choice of routing affects which scheme rules a consumer is subject to). The rules of the particular scheme on which a payment is routed will determine a consumer's rights in relation to particular issues, such as chargeback. Before implementing any default network routing reform, there will be a need for consultation to ensure that there are adequate consumer protection measures in place. Such consumer protection measures will need to ensure that the implications of different scheme rules under default network routing arrangements do not adversely impact inadvertent consumers who choose the lowest cost default network route.

More broadly, Westpac is committed to engaging with the RBA and the Payment Systems Board (PSB) on further developments in network routing, including on least-cost routing initiatives. In this regard, we support the RBA and PSB's view that this should be an offering that acquirers can opt in to rather than imposing more regulation.[25]

3.3 The New Payments Platform

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

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

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

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

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

While Westpac acknowledges the point raised by the Commission, the functionality described in the Draft Report would be technically complex and expensive for all parties to implement. It is also unclear who would fund the changes to NPP's basic infrastructure.

[23] Draft Report, p 301.
[24] ePAL is Eftpos Payments Australia Limited.
[25] Media Release: Payments System Board Update: November 2017 Meeting, 17 November 2017, https://www.rba.gov.au/media-releases/2017/mr-17-24.html; Tony Richards, Head of Payments Policy, Reserve Bank of Australia, *'Merchant Payment Costs and Least-cost Routing',* Speech delivered to the Australian Payment Summit, Sydney, 13 December 2017, https://www.rba.gov.au/speeches/2017/sp-so-2017-12-13.html.

Consistent with our earlier comments on the NPP, we recommend that the Commission allow more time for the system to become established and for customers to become familiar with the offering before proposing any material changes to the underlying framework.

3.4 Additional considerations

DRAFT RECOMMENDATION 10.2	MAKING THE EPAYMENTS CODE MANDATORY
The Australian Securities and Investments Commission should amend the ePayments Code to make subscription to the Code mandatory for any entity that intends to send or receive electronic payments.	

Westpac supports the ePayments Code becoming both mandatory and being extended to any entity that intends to send or receive electronic payments. However, in light of security concerns associated with third party access to, and monitoring of, customer bank accounts (discussed further below), we consider that the Commission's draft recommendation should be extended to apply to include any entity that "**monitors**, intends to send or receive electronic payments".

We believe that these measures will help advance consumer protection by establishing minimum standards in electronic payments.

INFORMATION REQUEST 10.1	HOW SHOULD LIABILITY FOR UNAUTHORISED TRANSACTIONS BE SHARED
What would be the costs and benefits of different ways that liability for unauthorised transactions under the ePayments Code may be shared between financial institutions and third parties, including participation in financial dispute resolution schemes? This includes the feasibility of having Code subscribers provide unique access details to third parties approved by customers. We are also interested in stakeholder views about whether the new Open Banking policy (once implemented) could be relied upon as a better alternative for secure, shared access.	

Against the backdrop of domestic and global developments relating to the use, access to and security of data, Westpac recognises the need to ensure that customers are adequately protected from fraudulent activity and other risks relating to their banking data.

We therefore welcome the Commission's invitation to comment on how liability for unauthorised electronic transactions should be shared between financial institutions and third parties.

This issue is particularly relevant given the recent emergence of fintech companies with business models that rely on "screenscraping" technology to access customers' data from their existing banking accounts.

Screenscraping involves customers providing third parties with access to their bank account using the customer's access credentials (such as their online banking username and password). Once access is obtained, data is "scraped" from the online interface, and in some cases, access is used to initiate transactions on a customer's behalf.[26] As outlined in

[26] Farrell Review, p 72. Available at https://static.treasury.gov.au/uploads/sites/1/2018/02/Review-into-Open-Banking-_For-web-1.pdf.

the recent Final Report of the Review into Open Banking (Farrell Review), fintech businesses employing screenscraping technology provide a range of services, including personal budgeting tools, lending to small businesses, and tools to enable consumers to find better deals on gas and electricity bills.[27]

With respect to liability in connection with unauthorised electronic transactions, we consider that an ADI should not be liable to any person for a data breach suffered by a third party data recipient, which impacts a customer's data or transaction activity, where access has been given to that third party. Similarly, we believe that an ADI should not be liable where malicious acts arise from deficient security safeguards on the part of a third party data recipient.

In other words, we support the principle that each party should be liable for their own conduct and not the conduct of other parties, which is consistent with the Farrell Review's recommended allocation of responsibility for the open banking regime.[28]

We note that the mandatory application of the ePayments Code to entities who monitor electronic payments will go some way to addressing gaps in the current regulatory framework that have arisen from screenscraping. The mandatory application of the ePayments Code to such entities will require the establishment of internal dispute resolution mechanisms and entry into an external dispute resolution scheme. Such measures will help address existing gaps in relation to complaints handling and liability.

More broadly, while screenscraping continues to be a popular feature today, we support the Farrell Review's conclusion that the open banking model is likely to render practices such as screenscraping redundant in the near future, by facilitating a more efficient data transfer mechanism. Accordingly, we consider that the open banking model will be the more appropriate framework for managing security issues associated with shared access to banking data.

[27] Farrell Review, p 72.
[28] Farrell Review, p 67.

SECTION 4

Improving customer outcomes

4.1 Financial advice

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

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

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

In theory, the existing knowledge, skills and resources of Australian financial services licensees (AFSLs) and authorised representatives (financial advisers) would appear relevant in providing advice in relation to credit products, such as personal loans, credit cards and mortgages.

However, financial advisers provide advice that is conceptually distinct from credit assistance under the Australian credit licence (ACL) regime. In particular, financial advisers consider risk of loss of an investor's capital, while credit assistance involves facilitating the distribution of credit products to customers that are affordable and meet their requirements and objectives.

Additionally, financial advisers owe duties to clients to act in their best interests, while credit assistance providers owe duties to lenders to ensure that responsible lending obligations are fulfilled. In our view, this conflict would need to be reconciled, which we assume the Commission will also consider in relation to its proposed duty of care obligation in draft recommendation 8.1.

DRAFT RECOMMENDATION 12.1	RENAME GENERAL ADVICE TO IMPROVE CONSUMER UNDERSTANDING

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

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

INFORMATION REQUEST 12.2	RENAMING GENERAL ADVICE AND MERITS OF FURTHER CHANGES

In implementing draft recommendation 12.1, we request feedback on:

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

We also seek information on the merits of:

- Redefining the activities that are currently regulate under general advice and providing a more customised regime for some activities
- Removing licensing and regulatory obligations currently associated with some or all forms of general advice.

Westpac believes there is merit to draft recommendation 12.1, as the concepts of "general" vs "personal" advice have the potential to confuse both retail and wholesale clients.

While we are supportive of recommendations to improve customer understanding, we note that industry consultation and consumer testing will be needed around the appropriate labelling and scope of a new "general advice" category, supported by a carefully considered transition regime (greater than 12 months) given the implications of such a change. In particular, it will be important to consider the appropriateness of the current laws in light of rapidly evolving technology to ensure that any reforms are technology neutral and therefore suitable in an increasingly digital world.

4.2 Customer switching

DRAFT RECOMMENDATION 13.1	DATA ACCESS TO ENABLE SWITCHING

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

Westpac supports an economy-wide open data regime, in which consumers are provided with a comprehensive "access right" to customer data. We acknowledge that open data will need to be rolled out across industries in the private and public sectors in a phased approach but consider it important to apply across the whole economy, to enable the policy objectives to be achieved (in particular, ensuring its application to global technology companies operating in Australia).

Westpac has recommended that open data should be implemented in a manner that enables safe data sharing and protects consumers. Within "open banking", this will require an implementation model where the impacts on the financial system, customers and the broader economy are mitigated (eg privacy, security, liability and fraud issues). In other words, an open banking regime should, in our view, support competition and innovation (and provide broad data access rights) while protecting the identity, security and privacy of individual customers and not undermining investment in data.

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

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

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

Westpac has recently undertaken consumer research to better understand the number of customers that consider Westpac to be their primary bank, but who also hold a deposit or mortgage product with another provider. This analysis revealed that a high proportion of our customer base also hold products (transaction accounts and mortgages) elsewhere.

We have also discovered that if a customer holds multiple accounts, this does not necessarily indicate that that customer has, in effect, "switched" accounts, as they may have opened a new account without closing an old one. Because of this, the extent to which customers hold multiple accounts should not, in our view, be treated as a metric to measure the extent to which customers are able to switch accounts.

Importantly, we see plenty of evidence of customer switching in the market. [29] At the same time, satisfaction levels amongst customers are close to historically high levels. This suggests that customers that want to switch are able to do so – that is, they are not hampered by, or struggling with, switching barriers. By the same token, it suggests that those that are not switching do not want to switch to begin with, rather than being deterred by 'red tape'.

For example, in credit cards, around 8% of customers switch every year (as illustrated in our First Submission) and there are often incentives to switch that make the effort worthwhile (eg attractive balance transfer rates, zero annual fees, etc). In mortgages, in FY17 we saw mortgage refinancing from an external bank to Westpac (excluding RAMS) at approximately 19% of all new loans.

Across savings and investment products, our research indicates that barriers to switching between financial institutions are low. Indeed, surveys have found that consumers consider it is comparatively easier to change banks than in other regulated industries, such as energy.[30] However, many customers use multiple institutions and product types (eg at call vs term deposits) depending on their saving needs.

---

[29] Galaxy Research from 2017 stated that three million people switched banks over the last three years and 68% of those said it was an easy process. See http://www.ratecity.com.au/home-loans/mortgage-news/will-join-3-million-aussies-switching-banks; https://www.ausbanking.org.au/media/media-releases/media-release-2017/banks-explore-options-to-make-switching-easier. Treasury has reported that switching occurs at a rate of around 8-10% per annum in Australia. See Australian Government, The Treasury, *'Banking services: Cost effective switching arrangements'*, 2011, http://banking.treasury.gov.au/content/reports/switching/downloads/switchingarrangements_aug2011.pdf.

[30] Australian Energy Market Commission, '*2017 AEMC Retail Energy Competition Review*', 25 July 2017 at p 27, https://www.aemc.gov.au/sites/default/files/content/006ad951-7c42-4058-9724-51fe114cabb6/2017-AEMC-Retail-Energy-Competition-Review-FINAL.pdf.

Therefore, switching data is not necessarily a good metric of competition – what matters is the ability to switch. For this reason, it would be expected that actual switching rates would be lower when compared with other regulated industries, such as energy, where a consumer would only hold one account at a time.

Industry initiatives, such as open data and comprehensive credit reporting will further support and enhance customer choice by giving customers better access to their financial data, together with increased sharing of information across lenders.

4.3 Add-on insurance

DRAFT RECOMMENDATION 14.1 DEFERRED SALES MODEL FOR ADD-ON INSURANCE
The Australian Securities and Investments Commission should proceed as soon as possible with its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships.
Following implementation, the Australian Government should establish a Treasury-led working group to extend the deferred sales model to all add-on insurance products in a practical timeframe.

Deferred sales

Westpac has committed to becoming a signatory to the new Banking Code of Practice, under which we have agreed not to offer consumer credit insurance (CCI) products to customers until four days after they have taken out a credit card in branch or via a call centre.

Westpac supports measures to help ensure greater customer understanding of add-on insurance and would therefore be supportive of Treasury leading a working group to consider extending the deferred sales model to other add-on insurance products.

Westpac is also frequently asked to fund CCI through the underlying loan, and in this context we believe that any deferred sale model must consider how the credit process operates in the current regulatory environment, including the need to have a single assessment process and finance contract.

Financing add-on insurance

Over the last two years, Westpac has taken a number of specific actions in respect of financing add-on insurance products that we believe contribute to improved customer outcomes. In particular, we have implemented a revised lending policy that incorporates changes in respect of financing certain point of sale insurance products, which came into effect on 1 August 2016. This included that we ceased financing premiums relating to:

- CCI, which contained a life insurance / risk component;
- GAP insurance, where the LVR is <75%. This includes implementation of an automated system control to prevent submission of applications where the LVR is <75%;
- Walk-away insurance (ceased from January 2015); and

- Vehicle purchases where the total amount of add-on insurance financed is more than 25% of the total amount financed. This includes implementation of an automated system control to prevent submission of applications where the total amount of insurance financed would exceed the 25% threshold.

Westpac continues to examine our policy settings and monitor the effect of our current actions (as well external regulatory developments and insurance industry initiatives) when deciding whether to maintain or make further changes in the future.

Conclusion

Australia’s financial system is competitive, strong and well-regulated.

Westpac believes that strong prudential oversight, combined with regulatory reform in Australia over the past decade, has helped to deliver a more stable and resilient financial system in which banks have continued to compete vigorously. Our First Submission and this Second Submission have outlined several key indicators to support this view.

In competing to retain customers and win new business, Westpac and the other major banks are leaders in driving many important technological innovations in the financial system, which lifts productivity and supports economic growth. At the same time, emerging competitors are increasingly utilising new technologies to fundamentally disrupt existing business models.

These competitive dynamics mean that customers have access to world-leading digital innovations in banking, while enjoying significant choice in terms of products and providers, and lower fees and costs.

We acknowledge, however, that there are improvements that can be made to the financial system to deliver even better outcomes for consumers and we support a number of the Commission’s draft proposals in this regard. In our view, encouraging continued competition is good for not only individual customers, but also the wider economy in the long run.

More broadly, Westpac supports the significant reforms the Government is implementing to boost competition. These include making it easier for new participants to enter the market and improving data sharing. Westpac considers that the impact of these reforms should be tested after a few years, allowing sufficient time for these reforms to be implemented.

In preparing its Final Report, it is vital that the Commission acknowledge the value that strong banks play in underpinning the economy, while also recognising that competition and stability settings must work together. This will ensure that the financial system is capable of supporting the economy and protecting customers over an economic cycle, not just in the good times.

Westpac looks forward to continuing to work with the Commission, Government, regulators and industry on initiatives to support competition and promote better customer outcomes, while ensuring the stability and resilience of the Australian financial system.

Appendix 1

HOUSTONKEMP Economists

Competition in the Australian Financial System

A report for Westpac Banking Corporation

3 April 2018

HoustonKemp.com

Report authors

Greg Houston

Bronwyn McDonald

Luke Wainscoat

Dylan Frangos

Nick Twort

Contact Us

Sydney
Level 40
161 Castlereagh Street
Sydney NSW 2000

Phone: +61 2 8880 4800

Singapore
8 Marina View
#15-10 Asia Square Tower 1
Singapore 018960

Phone: +65 6817 5010

Disclaimer

Contents

Figures

Tables

Executive Summary

This report has been prepared at the request of Westpac Banking Corporation to consider the Productivity Commission's (PC's) draft finding that Australia's major banks hold substantial market power, as set out in its draft report on competition in the Australian financial system (the PC draft report).

Our report assesses:

- whether the major banks hold substantial market power in retail banking markets, either unilaterally or collectively; and
- the approach taken by the PC in reaching its draft finding that the major banks hold substantial market power.

Major banks do not hold substantial power in any retail banking market

On the evidence available and on applying the usual principles of competition economics,[1] it is highly unlikely that the major banks hold substantial market power in any retail banking market, either unilaterally or collectively. Our conclusion in relation to the existence of substantial market power for any one firm is primarily derived from the observations that:

- each of the major banks faces competition for each retail banking product from at least the three other major banks offering similar products;
- the supply of retail banking products is not highly concentrated;
- there have been numerous examples of new entry or expansion into particular individual retail banking products, and so banks can be said to face competitive constraints from potential entry; and
- the conduct of the major banks does not appear to reflect substantial market power in retail banking, ie:
  - the pace of innovation and improvements in the quality of services offered by the major banks is high; and
  - consumer satisfaction with (customers' own) banks is high and improving.

Further, the potential for coordination between the major banks is highly unlikely in relation to their single largest retail product – mortgages – such that it is not plausible to suggest that the major banks hold any form of collective market power.

Problems with the PC's approach

Our approach and interpretation of the evidence in relation to market power differs from that of the PC in some important respects, which we summarise below.

Competition framework

The definition of workable competition – the antithesis of substantial market power – applied by the PC is open to interpretation but appears to go beyond the usual workably competitive standard.[2] In particular, the PC has said that the key features of workable competition in Australia's financial system must include:[3]

[1] See, for example, Posner, R, and Landes, W. *Market Power in Antitrust Cases*, Harvard Law Review, vol. 94, no.5, 1981, pp 937-96; and Motta, M, *Competition Policy: Theory and Practice*, pp 101-137.

[2] See appendix A2 for a full discussion of workable competition.

[3] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 69.

an open digital information capacity for consumers to assess how prices or features vary between products and choose (including switching to) preferred products

consumers actively supported by public advice or private advisers to conveniently make informed decisions regarding aspects such as risk (including credit worthiness)

an Open Banking regime that gives consumers perpetual access to their data that is useful to other providers, with the capacity to see it safely moved from one provider to another

Although these features may boost competition under certain circumstances, there is no reason to think that the presence of any of them is *necessary* for competition to be workable. A market will be workably competitive if enough customers understand the products available sufficiently well to be able to choose the best products available, such that firms cannot act independently of preferences and constraints imposed by their customers or their competitors.

Assessment of market power

The PC has not defined the market or markets in relation to which it draws its draft conclusion that the major banks hold substantial market power. This shortcoming risks not taking proper account of important competitive constraints.

In progressing towards its final report, we would encourage the PC to define one or more markets in relation to which its conclusion that the major banks have substantial market power applies, or to demonstrate that the major banks hold substantial market power under any reasonable market definition.

The PC's draft conclusion that the major banks hold substantial market power draws on a number of apparently critical observations, being that:

- the major banks have structural advantages including:[4]
  - lower operating costs as a result of their scale and scope;
  - very well-known brands and substantial geographic reach;
- retail banking markets are highly concentrated, and consumer outcomes are poor;[5]
- price competition is rarely evident;[6] and
- the major banks have been able to pass on cost increases to their customers.[7]

We describe below why these observations are either inaccurate and/or insufficient to imply that the major banks hold substantial market power in retail banking markets, ie:

- regarding **structural advantages**:
  - the major banks have some advantages over smaller banks, but they also have some disadvantages – the PC does not present sufficient evidence to conclude that the major banks have substantial net structural advantages, eg, the major banks are currently earning similar returns to the smaller institutions, which is not consistent with the conclusion that major banks have significant structural advantages;[8] and
  - even if it were true that the major banks have structural advantages over other banks, this does not imply that each of them holds substantial market power – a bank with lower costs than all other

[4] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 105.

[5] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 105.

[6] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 7, 166.

[7] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 105.

[8] See: Figures C.21 and C.23, Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 529-530.

banks may be able to set a price above its own cost and up to the level of those rivals with higher costs;[9] but

> there are four major banks that the PC has said all have similar structural advantages – this is unlikely to result in any individual major bank having market power because they all face three substantial competitors with similar cost structures and products;

- regarding **concentration and market outcomes**:
  - our analysis shows that, although throughout its report the PC frequently describes concentration as being 'high', Australian retail banking markets would not usually be considered highly concentrated by Australian or foreign competition authority standards;
  - consumer outcomes are not obviously poor, and do not appear to reflect any retail banking market characterised by substantial market power, ie:
    - Australian retail banks are relatively efficient, in that they have a low cost to income ratio compared to overseas banks;[10]
    - consumer satisfaction appears high;[11]
    - the pace of innovation and improvements in the quality of services offered by the major banks is high; and
    - levels of profit in the banking industry are not out of the ordinary for Australian firms, though we note that it is very difficult to draw conclusions regarding market power from measures of accounting profit in the banking industry;
- regarding the **PC's view that competition between the banks, particularly on price, is weak:**
  - the theory of harm being referred to by the PC is not clear; and
  - the claim is not obviously supported by evidence - absent reference to any counterfactual, 'efficient' prices or margins, a lack of positive evidence that consumers have significantly benefitted from price competition over time, does not imply that price competition is absent; and
- regarding the ability of **banks to pass on increases to their costs:**
  - widely accepted principles of competition economics predict that the extent to which industry-wide changes in costs are passed on to customers will typically *increase* with the degree of competition; and
  - it follows that the PC has drawn the incorrect conclusion regarding market power from its observation that the major banks pass on industry-wide cost increases to consumers – to the extent the PC's observation is correct, such conduct is more likely to be indicative of intense competition, rather than the existence of market power.

[9] The structural advantage and use of market power is not harmful where the firm has improved its product or reduced costs to gain the advantage.

[10] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 531.

[11] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 109.

1. Introduction

This report has been prepared at the request of Westpac Banking Corporation to consider the Productivity Commission's (PC's) conclusion that Australia's four major banks hold substantial market power, as set out in its draft report on competition in the Australian financial system (the PC draft report).[12]

The focus of our report is the PC's draft finding that Australia's four major banks hold substantial market power. In particular, the PC states:[13]

> **Draft Finding 3.1 The Major Banks' Oligopoly Power**
>
> Australia's four major banks hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is further supported by regulatory settings, which contribute to the major banks structural advantages.
>
> As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability – without losing market share.
>
> The smaller banks and non-bank financial institutions follow the pricing trend set by the major banks, where they can. Size and scope, combined with regulatory advantages for the major banks, mean that competition from smaller institutions is not likely to prove sufficiently disruptive to offer consumers a market that is strongly competitive on prices.

Our report assesses:

- whether the four major banks hold substantial market power in retail banking markets, either unilaterally or collectively; and
- the approach taken by the PC in reaching its draft finding that the major banks hold substantial market power.

The remainder of our report is structured as follows:

- section two provides an overview of key aspects of the Australian financial system, that are most relevant to our analysis;
- section three begins with a critique of the approach taken by the PC in assessing whether the major banks hold substantial market power, and then describes our framework for addressing this same question;
- section four examines the state of competition in retail banking markets, using the framework set out in section three;
- appendix 1 contains additional industry context;
- appendix 2 sets out some general comments on market power and workable competition;
- appendix 3 sets out the process for becoming an authorised deposit-taking institution (ADI);
- appendix 4 highlights evidence of entry and expansion in retail banking markets;
- appendix 5 sets out historic comparisons between major banks' return on equity and ASX benchmarks; and
- appendix 6 sets out the methodology underpinning the new entrant analysis.

[12] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018.

[13] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 32.

2. Industry context

This section sets out some essential background in relation to Australian financial services that, in turn, are important to an assessment of market power. We have organised this by reference to:

- trends in the Australian retail banking industry;
- key market participants;
- consumer behaviour; and
- retail banking business models.

We provide additional relevant background on the Australian retail banking industry in appendix A1.

2.1 Trends in the Australian retail banking industry

Retail banking businesses operate in the context of a number of important industry trends and macro-economic conditions, including that:

- a prolonged period of low interest rates has driven up house prices in metropolitan areas, while low real income growth has resulted in increasing debt to income ratios – this has led to a number of banks being downgraded by credit ratings agencies;[14]
- the Australian economy has experienced sustained economic growth for at least the past 20 years and, since banking returns are pro-cyclical,[15] Australian banks have (and can be expected to have) performed strongly;
- although the PC states that the major banks derive profits that are relatively large in an international context,[16] this observation needs to be considered in the context of generally more challenging and volatile economic conditions offshore, as well as the current position in the business cycle;
- Australian ADIs face increasing regulatory burdens and capital holding requirements, while Australia remains reliant on importing foreign capital and has committed to maintaining 'unquestionably strong' capital ratios;[17] and
- the Australian banking sector is experiencing continuous digital innovation – fast-paced innovation and digitisation has completely changed the way that customers and banks connect over the past five to ten years:
  - for example, ATMs, mobile and online banking have led to increased self-service; and
  - correspondingly, there has been less reliance on traditional branch networks and telephone banking services.

The rise of digital interactions and the reduced demand-side emphasis on branch-based banking has led to new business models emerging, eg:

- direct banks that are primarily online, and which do not have a branch presence, have begun to challenge major banks in certain product segments such as savings accounts; and
- platform-based finance such as peer-to-peer lending and equity crowdfunding markets have also emerged alongside this digital shift.

[14] See: https://www.businessinsider.com.au/moodys-downgrades-the-major-australian-banks-2017-6, accessed 8 March 2018.

[15] See: Bikker J and Hu, H, *Cyclical patterns in profits, provisioning and lending of banks and procyclicality of the new Basel capital requirements*, BNL Quarterly Review, 2002, no 221, pp 1-33.

[16] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 12.

[17] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 15.

2.2 Market participants

This section focuses on retail banking institutions, and so does not cover other types of ADIs such as general insurance and wealth management services providers.

2.2.1 Major retail banks

There are four large participants in Australian financial services markets, ie, Westpac Banking Corporation (Westpac), Commonwealth Bank of Australia (CBA), Australia and New Zealand Banking Group Limited (ANZ) and National Australia Bank Limited (NAB).

2.2.2 Other ADIs

Other banks make up around 23 per cent of the retail banking industry[18] and represent a range of different business models and strategies, including:

- other Australian-owned banks – sometimes called 'regionals' – tend to focus on retail banking and usually within a particular geographical area (at least initially), with some attempting to reach new customers in different areas using brokers, the internet, or branch networks,[19] examples of which include:
  - Bank of Queensland, which operates over 190 branches in Australia and has expanded considerably in the past 15 years;[20]
  - Suncorp Bank, which is estimated to have around two per cent of customer deposits (nationally) but is the largest depositor and third-largest lender in Queensland;[21]
  - Bendigo and Adelaide Bank Group, which is the fifth largest retail bank[22] and is based in Victoria;
  - Members Equity Bank Limited (ME Bank), which is owned by industry super funds and initially entered retail banking solely offering home loans, but now offers the full range of personal banking products;[23] and
  - Macquarie Bank (Macquarie), which has recently revamped its marketing campaign for retail customers to counteract the market perception that it is a premium service provider for high net worth individuals,[24] and is fast shaping as a leader of the technological revolution encompassing retail banking, driven by its substantial investments in innovation;[25, 26]
- foreign owned banks operating in Australia, either as locally incorporated subsidiaries or as branches – several foreign banks having built up significant retail banking presences:
  - ING Direct Australia, a subsidiary of Dutch-based ING Group, operates without branches in Australia, interacting with consumers via online banking, telephone and mobile banking, call centres and via ATMs – the PC acknowledges[27] the impact of ING's high deposit interest rates as an example of new entrants providing an innovative banking product and pushing the major banks to compete;

[18] IBISWorld, *National and Regional Commercial Banks in Australia Industry Report,* September 2017.

[19] See: https://www.rba.gov.au/publications/fsr/2006/mar/struct-aus-fin-sys.html, accessed 15 March 2018.

[20] Bank of Queensland, *Submission to the PC*, September 2017, p 1.

[21] IBISWorld, *National and Regional Commercial Banks in Australia Industry report,* September 2017.

[22] See: http://www.bendigoadelaide.com.au/about_us/index.asp, accessed 15 March 2018.

[23] Regional Banks, *Submission to the PC*, September 2017, p 49.

[24] See: http://www.afr.com/business/banking-and-finance/macquarie-trumps-big-four-with-new-open-banking-platform-20170914-gyhbxy, accessed 15 March 2018.

[25] This includes launching the first open banking platform, actively engaging with platforms such as Apple Pay and numerous awards such as the CANSTAR Innovation Excellence award for new digital banking offering.

[26] See: https://www.canstar.com.au/online-banking/innovation-awards-2017-macquarie-bank-new-digital-banking-offering, accessed 21 March 2018.

[27] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 129.

  - RaboDirect, part of Dutch-based Rabobank Group operates as a direct bank in Australia which only offers savings accounts and term deposits – Rabobank also operates a separate, traditional branch network in Australia;
  - Citibank is the local Australian subsidiary of Citigroup Inc (US), a large global bank – Citibank offers retail banking, corporate banking and wealth management services in Australia; and
  - several Chinese banks have set up Australian branches, such as Industrial and Commercial Bank of China, which is ranked the world's largest bank by assets in 2017 by Forbes[28] and has large Australian corporate clients such as Qantas and Westfield;[29]
- direct banks, sometimes described as virtual or online banks:
  - have been able to enter the market using a leaner operating model that connects with customers through online banking, mobile apps and call centres;
  - absent the large operating costs associated with branch networks, these direct banks can offer more attractive interest rates or lower service fees to customers;
  - commonly offer a reduced range of services, such as specialising in term deposits, savings accounts and residential mortgages; and
  - examples of which include some foreign owned banks operating in Australia, such as ING Direct Australia and RaboBank Direct; and
- credit unions and building societies – that have collectively rebranded as 'mutual banks' – have traditionally focused on retail banking and, like banks, are subject to Australian Prudential Regulation Authority (APRA) supervision – the main difference in the business models of mutual banks is that they have a mutual ownership structure, so that customers are also the shareholders, while they are typically more reliant on customer deposits;[30] mutual banks operating in Australia include:
  - Newcastle Permanent, Australia's largest building society with almost $11 billion in assets;[31] and
  - IMB bank, which has around 190,000 members and holds assets of $5.7 billion.[32]

In section 2.1 we noted that there has been a shift in the way banks and customers connect, driven by innovation and digitisation. Many of the emerging business models in retail banking have harnessed the opportunity for a leaner operating model, connecting customers through online banking, mobile apps and customer call centres. Without the large operating costs associated with extensive branch networks, these players can offer more attractive interest rates or lower service fees to customers. They commonly offer a reduced range of services such as specialising in term deposits, savings accounts and residential mortgages.

Non-ADI financial institutions

Non-ADI financial institutions, or non-ADI lenders, are entities engaged in lending activities but which do not accept deposits and, as such, do not fall under the definition of conducting banking business. The three main forms of non-ADI financial institutions that operate in Australia are money market corporations (broker-

[28] See: http://uk.businessinsider.com/the-biggest-banks-in-the-world-2017-4/?r=AU&IR=T/#23-lloyds-banking-group-uk-101-trillion-1, accessed 21 March 2018.

[29] See: https://www.industry.nsw.gov.au/__data/assets/pdf_file/0017/52433/Top-5-Chinese-banks-case-study.pdf, accessed 20 March 2018.

[30] See: https://www.rba.gov.au/publications/fsr/2006/mar/struct-aus-fin-sys.html, accessed 15 March 2018.

[31] See: https://home.kpmg.com/content/dam/kpmg/au/pdf/2017/mutuals-industry-review-2017.pdf, accessed 21 March 2018.

[32] See: https://www.imb.com.au/about-us-about-imb.html and https://home.kpmg.com/content/dam/kpmg/au/pdf/2017/mutuals-industry-review-2017.pdf, accessed 21 March 2018.

dealers), finance companies, and securitisers.[33] In late 2016, it was estimated that the total assets of non-ADI lenders were around six per cent of total Australian financial system assets.[34]

Until recently, this form of lender fell outside of the APRA-regulated entities (although they did have disclosure requirements with ASIC). Under APRA regulation, ADIs (and more recently, non-ADI lenders) are now required to provide information disclosures to APRA.

However, changes proposed as part of the 2017-18 federal budget now give APRA the ability to regulate non-ADI lenders.[35] APRA publishes statistics on its website that we have referenced throughout this report. We note that historical APRA data does not capture non-ADI lenders and therefore can overstate the level of concentration in markets by not presenting the full financial system.

FinTechs and marketplace lenders

FinTechs are said to be playing a substantial role in shaping the future of financial services through the development of innovations in traditional financial services.[36] The industry is rapidly growing, with an estimated 250 companies in 2016 growing to an estimated 600 across Australia in 2017.[37]

Marketplace lenders add to total diversity of finance options available to Australian borrowers. SocietyOne, MoneyPlace, Ratesetter, DirectMoney and Harmoney are all examples of retail marketplace (or P2P) lenders. These platforms connect borrowers and lenders directly and are a relatively recent, growing global finance trend.[38]

Threat of entry by non-banks

Other than ADIs, there has been an increasing trend towards other (non-financial services) businesses extending their remit into financial services. For example:

- credit cards have been offered by supermarkets, eg, Woolworths[39] and Coles[40], and department stores, such as Myer;[41]
- global technology companies have launched digital wallets (mobile payments services), in collaboration with other finance providers – for example, Samsung Pay launched with American Express[42] and Citibank,[43] Apple Pay launched with ANZ and Macquarie, Cash by Optus can be linked to any Australian bank account, while Coles Mobile Wallet is designed for those that have a Coles Mastercard;
- Apple, Google and Facebook are developing peer-to-peer payments via instant messaging services;[44]

[33] Australian Treasury, *Regulation Impact Statement: Treasury Laws Amendment (Banking Measures No.1) Bill 2017 – Non-ADI Lender Rules,* October 2017, p 8.

[34] Australian Treasury, *Regulation Impact Statement: Treasury Laws Amendment (Banking Measures No.1) Bill 2017 – Non-ADI Lender Rules,* October 2017, p 5.

[35] Australian Treasury, *Regulation Impact Statement: Treasury Laws Amendment (Banking Measures No.1) Bill 2017 – Non-ADI Lender Rules,* October 2017, p 8.

[36] see http://fintech.treasury.gov.au/the-changing-face-of-financial-services/, accessed 26 March 2018.

[37] EY, *FinTech Australia Census 2017: Profiling and defining the fintech sector*, 2017, p 10.

[38] https://www.canstar.com.au/p2p-lending/who-offers-peer-to-peer-lending-in-australia/ accessed 26 March 2018.

[39] See: https://cards.woolworths.com.au/, accessed 15 March 2018.

[40] See: https://financialservices.coles.com.au/, accessed 15 March 2018.

[41] See: https://www.myer.com.au/p/creditcard/, accessed 15 March 2018.

[42] See: https://www.americanexpress.com/au/content/samsung-pay/, accessed 15 March 2018.

[43] See: https://www.citibank.com.au/samsungpay/, accessed 15 March 2018.

[44] See: for eg, https://istart.com.au/news-items/2018-year-p2p-social-payment-wars/, accessed 16 March 2018.

- Australia has also seen the introduction of Alipay from China's Alibaba – Alipay has more than 520 million members and has partnered with Australia Post to connect Australian consumers with Chinese retailers;[45] and
- Chinese technology conglomerate Tencent (owner of messaging and social media service WeChat) provides payment services to users through Tenpay and WeChat pay, which accounted for 37 per cent of the Chinese mobile payment market in 2016.[46]

2.3 Consumer behaviour / engagement

Emerging research on consumer preferences and behaviour in relation to financial markets suggests that the historic view of consumers in this context (as passive and disengaged) may be outdated, at least for certain groups. The increased diversity of attitudes towards consumer demand, including the willingness to actively to shop around in Australia does not appear to have been sufficiently acknowledged in the PC's draft report.

Recent research reports suggest that at least some groups of financial institutions' consumers are engaged, eg:

- Accenture (2017)[47] classified around 30 per cent of Australian banking customers as 'nomads', being a group that is characterised by a lack of brand loyalty, a focus on convenience and a willingness to shop around – the report states that 77 per cent of Australian nomads surveyed would be willing to open an account with Facebook, Google or other online service providers if it were on offer, while 60 per cent would consider opening an account with a supermarket or retailer;
- Galaxy Research polled customers on behalf of the Australian Banking Association in August 2017, and found evidence of engaged customers – being consumers who are willing to shop around for the best deal – with the majority of polled customers having relationships with more than one financial institution and around 30 per cent having relationships with three or more;[48]
  - the existence of significant switching activity is echoed by a similar Galaxy Research survey commissioned by the Australian Bankers Association undertaken in February 2017, which found that 17 per cent of those surveyed had switched over the past three years;[49]
- KPMG (2017)[50] runs an annual survey on the attitudes of Gen Y professionals, ie, those aged between 18 and 30, university educated, tech savvy and more globally minded – KMPG found that these consumers are cherry pickers, happy to hold multiple products with multiple banks to get the best offer with the best features for each circumstance;
- KPMG also finds that this trend is on the rise: in 2017, 28 per cent of Gen Y consumers had financial products with three or more banks, compared to just 11 per cent in 2015 – like the Accenture research, KMPG found that the clear majority (84 per cent) of Gen Y professionals would consider banking with a tech giant if they offered a better product or deal; and
- there is some evidence that levels of switching, and customers holding multiple accounts, is common, which would suggest that at least some customers are engaged – for instance, in the twelve months to October 2016 Westpac had approximately 820,000 new customers join and approximately 520,000 customers leave, a trend that is consistent across numerous products offered by Westpac.[51]

[45] See: for eg, https://auspostenterprise.com.au/insights/digitising-services/how-alipay-is-unlocking-ecommerce-growth-in-australia, accessed 21 March 2018

[46] See: http://fortune.com/2017/05/13/tencent-alibaba-china; and https://www.theinformation.com/articles/in-china-tencents-wechat-threatens-alibabas-alipay, accessed 21 March 2018.

[47] See: https://www.accenture.com/au-en/insight-banking-distribution-marketing-consumer-study, accessed 8 March 2018.

[48] Australian Banking Association, *Submission to the PC*, September 2017, p 17.

[49] Australian Banking Association, *Submission to the PC*, September 2017, p 30.

[50] See: https://home.kpmg.com/content/dam/kpmg/au/pdf/2017/banking-on-the-future-edition-3.pdf, accessed 16 March 2018.

[51] Westpac, *Submission to the PC,* September 2017, pp 31-32.

2.4 Banking business models

2.4.1 Economies of scale in banking

Major banks can spread fixed costs over a broader asset base. The PC draft report states that:[52]

> They are also able to grow more quickly, as they operate on a large scale that enables them to expand their customer base.

Although major banks are able to spread costs over a broader asset base, it does not necessarily follow that major banks can also grow more quickly due to their large scale.

In general terms, growth in customer base is a function of, at least, the ability to attract new customers (such as first-time home buyers), to attract ‘switching’ customers of other financial services, and to retain the existing customer base. Although the PC appears to suggest the existence of some form of ‘snowball’ effect, it is not obvious that there is a direct nexus between scale and growth in retail banking.

Last, even if potential growth in absolute terms is higher for major banks, it does not necessarily follow that growth **rates** would be higher for major banks.

Cost of funding

The PC places great emphasis on the lower cost of wholesale funding enjoyed by the major banks. The PC contends that this gives a clear scale advantage to the largest players and confers substantial market power.[53]

We understand that credit ratings agencies typically make an assessment of default risk by combining standalone credit quality with the likelihood of government support in extraordinary circumstances. As at September 2017, Standard & Poor’s applies a three-notch uplift to standalone credit ratings of major banks, while Moody’s applies a two-notch uplift.[54] Fitch does not adjust for implied government support.

These standalone and all-in credit ratings are a factor that influence the price of wholesale funding for banks, which in turn is one factor influencing each bank’s blended cost of funds. However, as noted by the PC, the extent to which market prices for wholesale funding turn on credit quality is not static. Rather, the value of such a cost advantage changes over time.

The Reserve Bank of Australia (RBA) attempted to model the major banks’ funding cost advantage from implied government support over the period 2000 – 2013.[55] It found the advantage to be about 20-40 basis points, but at times as low as ten basis points and not statistically significant.[56] The RBA modelling found that the value of the implied guarantee in terms of cost advantage is counter-cyclical: in times of instability (such as 2009), the value of government support increased, while in 2014 the estimated value of support was not statistically significant.

It is reasonable to assume that, in light of the continued push for banking systems to become more resilient, the value of the cost advantage to major banks is likely to be diminishing. Indeed, the PC concludes that the value of the advantage may now be below the RBA estimates.[57]

[52] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 107.

[53] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 107.

[54] Notching is the process of adjusting credit ratings by either increasing (notch uplift) or decreasing (notch down).

[55] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 10.

[56] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 454.

[57] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 10.

Disadvantages faced by the major banks

The major banks face certain disadvantages, including:

- the Major Bank Levy,[58] which applies to banks with over $100 billion in total liabilities – based on this threshold, CBA, Westpac, NAB, ANZ and Macquarie are the only players that are subject to the new charge; the levy rate has been set at 0.0015 per cent paid quarterly on the balance of the bank's liabilities, subject to some exclusions;[59]
- in 2017, APRA set out its conclusions with respect to the additional capital that might be reasonably expected to be required for the Australian banking sector to have capital ratios that are considered unquestionably strong[60] – it concluded that internal ratings-based (IRB) banks should raise minimum capital requirements by the equivalent of around 150 basis points, while ADIs using the standardised approach to capital adequacy must increase minimum capital requirements by the equivalent of approximately 50 basis points, all by 1 January 2020 at the latest; these APRA changes therefore affect the major banks and Macquarie (ie, IRB banks) to a greater extent than other ADIs; and
- higher costs involved with using and updating legacy systems, ie:
  - whereas new ADIs and technology companies can immediately take advantage of new technology with little cost, the scale with which major banks operate imposes significant costs of moving from old infrastructure to new systems; and
  - consumer expectations to operate nationally, even if it may be more profitable to focus on key high margin or low risk sectors/geographic markets – for example, banks provide around 400 ATMs and almost 400 branches in moderately accessible, remote and very remote areas;[61] this provides banking access to all Australians, regardless of where they live, although it is likely that at least some of these remote areas are unprofitable to serve via branches.

2.4.2 Measures of economic return

As the PC has acknowledged, profitability is essential for banks to maintain their activities and financial stability. Profitability is a bank's first buffer against unexpected losses, as retained earnings strengthen the capital position.[62]

Accounting measures of profit such as return on equity (ROE) and net interest margin (NIM) are frequently used to evaluate profits in the banking sector. Other indicators of interest include cost to income ratios and return on assets.

Return on equity

ROE is calculated as net income divided by shareholders' equity. ROE is primarily determined by performance and leverage, and is measured for a bank as a whole, rather than for a product. Therefore, a strong ROE may reflect a good level of profitability, or more limited equity capital, or both.

Given that ROE is not risk sensitive, and does not pick up measures of sustainability (which are particularly important for banking), it does not serve as a stand-alone performance measure.[63] However, ROE is a commonly used measure of performance since it offers a direct assessment of financial return to

[58] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 155.

[59] See: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2017/June/The_Major_Bank_Levy_explained, accessed 9 March 2018.

[60] See: http://www.apra.gov.au/adi/Documents/Unquestionably%20Strong%20Information%20Paper.pdf, accessed 16 March 2018.

[61] Australian Bankers' Association, *Fees for banking services 2017 report,* 2017, p 5.

[62] See: for eg, European Central Bank, *Beyond ROE – how to measure bank performance*, *appendix to the report on EU banking structures,* September 2010.

[63] See: for eg, European Central Bank, *Beyond ROE – how to measure bank performance*, *appendix to the report on EU banking structures,* September 2010.

shareholders,[64] is easily accessible and is generally able to be compared across companies and sectors. We understand that ROE is considered the more relevant consideration for investors in the wholesale funding market.[65]

The four Australian major banks' ROE have been declining since the global financial crisis (GFC), while for other (smaller) Australian-owned banks, ROE have been increasing, as funding costs have declined.[66] NAB has noted that its ROE for 2017 was equivalent to its cost of equity capital (both at around 11 per cent). This suggests that NAB's economic profit was around zero in 2017, only just covering its opportunity cost.[67] Related, the Reserve Bank of Australia (RBA) estimated banks' cost of equity in 2017 as being around 10 per cent. Cost of equity is the return required to entice investors to purchase and hold bank shares.[68]

Net interest margin

In simple terms, NIM refers to the spread earned between lending and borrowing costs. In this way it can be thought of as a 'price' that reflects the intermediation function of banks. Long term trends in NIM are linked to competition – for example, the RBA among other market commentators has previously noted that competitive forces prior to the global financial crisis drove down banks' NIM materially.[69] If all other factors were able to be held constant, an increase (decrease) in NIM among market participants would likely reflect a corresponding decrease (increase) in competition.

However, movements in NIM are not able to be isolated from changing market conditions and other factors. NIM is not able to reflect bank fees, non-interest income, or operating costs, and is challenging to compare across banks where asset sizes, customer bases and business strategies differ.[70] Therefore it is very difficult to attribute changes in NIM [solely] to competitive constraints, eg:

- the NIM is a blended margin on account lending and borrowing across a range of different products (the proportions of which vary by bank) and is typically only reported at a bank level;
- if a bank makes operational efficiencies reducing its overall cost structure, NIM may be unchanged while the bank has become more profitable;
- if NIM remains the same while the risk of default increases (decreases), then the bank's expected profitability decreases (increases);
- if a bank changes its product mix towards higher margin products and its NIM stays the same, that might reflect an increase in competitive pressures; and
- like ROE, the NIM is therefore not a standalone 'silver bullet' measure of profitability or of competition.

The NIMs of the four Australian major banks have been declining since the GFC, while for other (smaller) Australian-owned banks, NIMs have been increasing. [71]

In section 2.1 we noted the importance of considering measures of economic return in the context of a whole business cycle. Comparisons of ROE and NIM between banks, across groups of ADI and across countries

[64] See: for eg https://hbr.org/2010/03/the-best-way-to-measure-compan, accessed 16 March 2018.

[65] Productivity Commission, *Inquiry into Competition in the Australian Financial System, Transcript of Proceedings*, 28 February 2018, p 39.

[66] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 116-17.

[67] Productivity Commission, *Inquiry into Competition in the Australian Financial System, Transcript of Proceedings*, 28 February 2018, pp 158-160.

[68] Reserve Bank of Australia, *Return on equity, cost of equity and the implications for banks*, Bulletin – March Quarter 2017, accessed 22 March 2018, p 1.

[69] Reserve Bank of Australia, *Competition, efficiency and innovation in banking*, Submission to the Financial System Inquiry, March 2014, pp 52-54.

[70] Hanweck, G and Rue, L, *The sensitivity of bank net interest margin and profitability to credit, interest-rate, and term-structure shocks across banking product specialisations,* FDIC Working Paper 2005-02, 2005, p 1.

[71] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 116-17.

are of limited value, to the extent that they are short-term snapshots that do not take into account the macroeconomic climate.

3. Economic principles for assessing market power

In this section we set out our approach to evaluating market power. Specifically, this section covers:

- a critique of the PC draft report's approach to assessing market power; and
- the economic framework we have employed in assessing market power in retail banking markets, which is then applied in the following section.

Appendix A2 explains the concepts of market power and workable competition.

3.1 Productivity Commission's approach to assessing market power

Our approach and interpretation of the evidence differs from that of the PC in several important respects, ie:

- the requirements for workable competition applied by the PC appear to be too stringent;
- while the framework it sets out for evaluating market power is generally sound, the application of this framework is at times problematic, and relies on evidence that does not always appear to support the conclusions reached, eg, we query the PC's findings that:
  - the major banks having structural advantages over the smaller banks would give each of them substantial market power, because each would still face three competitors with similar advantages;
  - retail banking markets are highly concentrated;
  - the observation that major banks pass through cost increases to consumers implies they have substantial market power; and
- the PC does not give sufficient weight to evidence that is contrary to its conclusion of market power, eg, there have been numerous examples of entry or expansion (which appears to be getting easier and more likely), banks are innovating fast, and their customers are satisfied.

We also note that the PC has not defined the market or markets in relation to which it draws its draft conclusion that the major banks have substantial market power. This shortcoming risks not taking proper account of important competitive constraints. In progressing towards its final report, it would be helpful for the PC to define one or more markets in relation to which its conclusion that the major banks have substantial market power applies, or to demonstrate that the major banks hold substantial market power under any reasonable market definition.

3.1.1 Workable competition

On several significant considerations, the PC has set too high a bar for a market to be taken to be workably competitive. Table 3.1 below sets out the PC's standard for workable competition as it applies to each of the three pillars identified by it, ie, provider, consumer and regulator[72] and, alongside, provides our observations on each standard.[73]

[72] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 68.

[73] For a full discussion on workable competition see appendix A2.

Table 3.1: Standards for workable competition

	PC observations on workable competition	Conventional standards for workable competition
Provider	Providers would be able to offer a variety of products that meet the needs of different groups of customers. Pressure from alternative providers would ensure that the differences between products on offer would be clear, with product differentiation and up-selling not able to be routinely used as a means to confuse or lock-in consumers. Prices for different products would vary, but would be driven by costs rather than any attempt to discriminate and seize excessive profits from groups of consumers. Market pressures would be such that there would be little capacity for providers to successfully collude or reach tacit agreements in their strategic decision making, including pricing. Attempts by some providers to artificially raise prices or reduce service quality would simply drive customers to their competitive rivals.	The differences between products on offer should be sufficiently clear that rivals are able to constrain each other, but this does not mean that all consumers need to know every feature of each product. Costs should be the primary driver of variations in prices between products over the long run, but other factors may also be relevant, especially over the short run.
Consumer	Consumers would have access to information on their own interactions with the financial system and on alternative products on offer. The Government's new Open Banking regime should meet the terms of the Commission's proposed Comprehensive Right to allow consumers to use their data held by financial system institutions (PC 2017c). More broadly, information would be presented publicly in a way that would reasonably allow them to readily discern and switch to those products that are of most benefit to their situation. Switching costs would be low. Scope would be limited for consumers to hide aspects of their circumstances in order to secure themselves a more favourable financial product than might otherwise be offered to them.	Information provided to consumers should mean that a firm offering a worse product/price than others is faced with a credible threat of losing customers, such that each firm is constrained by its rivals. However, it is not necessary for all customers to have all information on a product and their use of it, for banking markets to be workably competitive, for example, firm behaviour can be constrained by only the threat of *some* customers leaving in response to a price rise. For some banking products, it is only necessary to compare the interest rate that would be paid, or earned, in order to choose one of the best products – customers do not therefore need to know their entire history of transactions. Switching costs need not necessarily be low – it is possible for markets with high switching costs to be workably competitive and, indeed, many markets in Australia might be considered to have high switching costs. For example, a study for the Australian Energy Market Commission found that switching banks was relatively easy, scoring higher than home phone, mobile, internet, home and health insurance and energy plan industries on consumer reported ease of switching.[74]
Regulator	Regulators would be open-minded towards new financial products and ways of delivering them, with regulation remaining, as far as possible, outcome-oriented. There would be as few as possible (consistent with other regulatory objectives) impediments to entry of new financial products or providers noted in the remainder of this report. Scrutiny of adverse use of market power by any participant or set of participants would be effective and timely. An open digital information capacity for consumers to assess how prices or features vary between products and choose (including switching to) preferred products. An Open Banking regime that gives consumers perpetual access to their data that is useful to other providers, with the capacity to see it safely moved from one provider to another.	Providing relevant information to consumers in a manner that they find easy to use can help to boost competition. However, it is not necessary for every person to have access to information on every product and their entire transaction history for markets to be workably competitive. For example, in most markets in Australia: • many customers would not know the prices of all products; and • consumers would not have access to data detailing their purchase / use history.

[74] Newgate Research, *Consumer research for the Australian Energy Market Commission's 2017 Retail Competition Review: Final Report*, report to the AEMC, April 2017, p 27.

3.1.2 Competition framework

The PC sets out that its competition framework involves asking three questions, ie:[75]

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

In our opinion, it is reasonable to consider whether there is sufficient rivalry, such that each market is workably competitive, but it is not clear what is meant by 'innovation and efficiencies that improve community outcomes'. The reference to 'community outcomes' implies a perspective that is unlikely to be either necessary or sufficient to ensure workable competition. Rather, competition economics principles show a workably competitive market provides greater levels of innovation and efficiency than a market in which participants have substantial market power.

Competition among providers

The PC identifies the key structural indicators of market power as being:[76]

- market concentration; and
- barriers to entry, or contestability.

These are both important aspects of examining whether the structure of a market is conducive to the existence of market power or not, and we examine these in section 4 below. However, the relevance of market structure depends on the market in question and the relationship between concentration and consumer outcomes is not necessarily straightforward. For example, a more concentrated industry can allow firms to benefit from greater economies of scale, leading to a more efficient outcome.

The PC also explains that it is worthwhile considering measures of performance such as net interest margins, return on equity, operating costs and fees in undertaking an assessment of competition.[77] These measures of performance can be relevant to assessing market power since they capture the outcomes of competition. However, we discuss in section 3.2.3 that it is difficult to interpret what profitability measures mean for levels of market power. Further, other measures of performance, such as customer satisfaction and innovation are also relevant to any assessment of market outcomes.

The PC states that price discrimination can be indicative of low levels of competition.[78] Price discrimination is a common practice across the economy, and is not usually considered either harmful to competition or as evidence of substantial market power. The case of perfect price discrimination highlights this point,[79] under which price discrimination leads to the same welfare maximising outcome as under perfect competition.

Consumers driving competition

The PC emphasises that consumers play an important role in placing competitive pressure on providers.[80] It sets out that the extent to which consumers can generate competitive pressure on financial service providers depends upon:

---

[75] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 74.

[76] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 77-78.

[77] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 79.

[78] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 83.

[79] Motta, M, *Competition Policy: Theory and Practice*, p 493.

[80] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 84.

- financial literacy;
- level of engagement;
- product complexity;
- information asymmetry;
- extent of switching;
- basis of decision making; and
- the use of properly motivated agents.

Although many of these may be relevant, it is difficult to say, for example, what level of product complexity may diminish competition to such a point that it is not workable. As noted above, it is only necessary for a certain proportion of customers to place competitive pressure on the relevant firms to ensure that a market is workably competitive.

We discuss switching in section 4.2.6 below. In short, the extent of actual switching is not as relevant as the potential that customers might switch if they are dissatisfied. Put differently, it is the threat of switching that constrains competition, rather than switching itself.

Regulation

As the PC explains, there is very little activity in the financial system that does not come under regulatory scrutiny,[81] and this is able to affect competition in a number of ways, including:

- imposing costs on new entrants;
- affecting the information consumers have on products;
- restricting the products and services that banks can offer; and
- directly affecting costs, eg, in setting capital requirements.

Regulations can sometimes increase or reduce the degree of competition in a market, and policy makers should aim to minimise the detrimental effect they have on competition. However, in our opinion, there is no evidence that regulation has given any firm substantial market power in Australian retail banking markets.

3.2 Our framework for examining market power

The presence and use of market power can be determined by examining:

- the market structure, because this can identify the strength of the competitive constraints on the firm or firms in question;
- the conduct of the firms in the market in question, because firms that use market power will act in a different way to those in a workably competitive market; and
- market outcomes, because firms using their market power are likely to set higher prices and/or offer lower quality products.

3.2.1 Market structure

There is a rich literature on the structural indicators that may be helpful to determine whether a firm has market power. The factors that are generally considered most relevant to market power assessments include:[82]

[81] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 92.

[82] Motta, M, *Competition Policy: Theory and Practice*, pp 115-134; Office of Fair Trading, *Assessment of market power*, 2004, pp 9-25; European Commission, *Commission guidelines on market analysis and the assessment of significant market power under the*

- barriers to entry and/or expansion;
- economies of scale and/or scope;
- market concentration and market shares;
- product differentiation;
- buyer power, transaction and/or switching costs; and
- regulation.

These factors are consistent with those considered in the PC draft report. However, the ways in which these factors may combine to give a firm market power in a dynamic environment is complex and needs to be examined on a case-by-case basis. For example, market concentration is an outcome of the competitive process. A firm could gain a high market share by lowering its costs and reducing its margins. In such circumstances, concentration and competition move together.[83]

3.2.2 Market conduct

Firms that have market power are not as closely constrained by the behaviour of competitors or customers as firms in a workably competitive market. The type of conduct that might be expected of a firm with substantial market power includes:[84]

- the ability to act somewhat independently of competitors;
- potential for collusion between firms or exclusionary tactics;
- little effort put into improving efficiency or cost savings;
- low levels of investment in product development or other areas to improve the product or service provided; and
- low concern for the potential that customers may switch providers.

The type of evidence that we would seek to consider in relation to market conduct includes recent product improvements, customer satisfaction, cost saving / efficiencies, switching in response to new entrants or price changes, and how individual banks respond to the competitive behaviour of others.

3.2.3 Market outcomes

If firms hold substantial market power, the outcomes we might expect to observe include:

- high levels of economic profit that persist over a significant period, achieved through higher prices or by reductions in quality, relative to prices and quality standards that would be observed in a workably competitive environment;
- a lack of innovation; and/or
- poor customer service quality.

Using profitability as a marker for market power

The most commonly assessed market outcome is whether prices, and therefore profits, are consistent with the use of market power.[85]

Community regulatory framework for electronic communications networks and services, July 2002, paras 73-78; European Commission, *DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses*, 2005, paras 28-42 and *Re Queensland Co-operative Milling Association Ltd* (1976) 25 FLR 169.

[83] King, S, *The 2008 ACCC Merger Guidelines: How and Why Have They Changed?* UNSW Law Journal, 32(1), 2009, p 269.

[84] See, for example, Motta, M, *Competition Policy: Theory and Practice*, pp 39-231.

[85] Office of Fair Trading, *Assessment of market power*, 2004, p 25.

Competition authorities typically estimate economic profit by undertaking an assessment of whether profit has been earned over and above that required to meet the cost of capital employed.

This type of analysis is challenging for any market but particularly so as applied to banks, because:

- measures of accounting profit in banking such as ROE and NIM are not the same as economic profit and cannot be estimated on a product basis, eg, the return on equity for home loans;
- economic profit in banking must be viewed over a business cycle because bank profits are pro-cyclical – Australia has not had a downturn in over 20 years, and so it is difficult to view profits over a full business cycle; and
- as noted in section 2.4.2, retained earnings are inputs into the business model and of future profits (since retained earnings is a source of capital), and provide a buffer against unexpected losses.

In the UK, the Competition and Markets Authority (CMA) Investigation into Retail Banking (2015) stated that:[86]

> We considered possible methods that might enable us to form a view as to whether banks were achieving levels of profitability that were in excess of what we might expect in a competitive market. We concluded that there were inherent difficulties with such an exercise which would mean that such an analysis would not be sufficiently reliable to inform our assessment of competition.
>
> In particular, none of the larger banks in the UK treat their PCA or SME businesses as separate and were not therefore able to produce separate profit and loss accounts or balance sheets for these businesses. Moreover, there were particular problems in assessing the profitability of PCAs and SME banking including the appropriate allocation of common and shared costs, equity capital and revenues. We also considered that there were particular issues in estimating a benchmark return on equity (ROE) for standalone PCA and SME products and in making an assessment of profitability over time given the impact of the financial crisis and the consequent market restructurings.

The CMA instead looked at a range of indicators including ROE, NIM, cost income ratios, profit before tax and impairments to get a sense of the overall financial performance of UK retail banking. The CMA also considered whether the largest UK banks had significantly higher average ROE or average NIM than smaller banks.

We set out a further discussion on the practical implementation and interpretation of profitability for the purposes of assessing market power at Appendix A2.2.1.

[86] Competition and Markets Authority, *Retail banking market investigation*, 2016, p vii.

4. Competition in retail banking markets

This section explains why it is highly unlikely that the major banks, either unilaterally or collectively, hold substantial market power in any retail banking market. Our conclusion in relation to the existence of any unilateral market power is primarily derived from the observations that:

- each of the major banks faces competition for each product from at least the three other major banks offering similar products;
- the supply of retail banking products is not highly concentrated;
- there have been numerous examples of new entry into individual particular banking products, and so banks can be said to face competitive constraints from potential entry; and
- the conduct of the major banks does not appear to reflect substantial market power, ie:
  > the pace of innovation and the improvements in the quality of services offered by the major banks is high; and
  > consumer satisfaction with (customers' own) banks is high and improving.

Further, the potential for coordination between the major banks is highly unlikely in relation to their single largest product – mortgages – such that it is not plausible to suggest that the major banks hold any form of collective substantial market power.

In the remainder of this section we explore whether the market structure, market conduct and market outcomes in Australian retail banking are reflective of substantial market power.

4.1 Market definition

The first step in an assessment of market power is to define the market or markets of interest. The purpose of this step is to make competition analysis more tractable, because it focuses the analysis on the most important aspects of competition.

4.1.1 Defining a market for the purpose of competition analysis

Market definition involves the identification of the competitive constraints that are likely to have a material effect on a particular product or service (they are 'in' the market), and those that have a less immediate effect (they are 'out' of the market). However, such bright lines rarely exist in practice, and firms selling products that are out of the market may act as a competitive constraint, albeit to a lesser degree.

The boundaries of a market are conventionally determined by reference to four dimensions, ie:[87]

- the product dimension, ie, the goods or services supplied;
- the functional dimension, ie, the part of the supply chain that is the relevant arena of competition;
- the geographic dimension, ie, the geographic area over which the relevant products are supplied (or could be supplied); and
- the temporal dimension, ie, the time period over which substitution can take place.

A market encompasses the range of business activities, geographic areas and functional levels within which, if given a sufficient economic incentive, buyers can switch to a substantial extent from one source of supply

[87] Australian Competition and Consumer Commission, *Merger Guidelines*, 2008, p 13.

to another ('demand-side' substitution), and/or sellers can switch to a substantial extent from one production plan to another ('supply-side' substitution).

The generally accepted approach to defining markets involves the systematic application and re-application of a three-step process that:

- commences with the 'narrowest' reasonable market definition, taking into account the purpose at hand;
- considers progressively wider dimensions of the potential market to incorporate additional sources of supply, more functional levels, and an increasingly wide geographic area, each of which may form a close constraint on those dimensions in the candidate market; and
- repeating the above process of evaluating each potentially wider definition of the market until the boundaries of the relevant market(s) are ultimately established.

We describe in section 4.1.2 below that the PC has not yet undertaken such an analysis in reaching its draft findings.

4.1.2 The Productivity Commission's approach

The PC recognises that the Australian Competition and Consumer Commission (ACCC) defines markets when it examines market power, and it describes some of the issues in relation to defining markets in the banking industry.[88] However, the PC did not reach any conclusion or preliminary opinion regarding market definition.

The PC's analysis of market power appears to contemplate at least the potential for different products to be in separate markets, eg, measures of market concentration are given for a range of products.[89] However, other analysis is provided at a broader level, eg, measures of profit are expressed on a firm-wide level, representing a mix of different products.[90] Such an approach involves inconsistencies and risks drawing the wrong conclusion.

We have not undertaken a thorough market definition exercise since, in our opinion, the evidence is sufficient to draw the conclusion that the major banks do not hold substantial market power at the level of any individual products. That being the case, the same conclusion would apply if the appropriate market was a wider retail banking market.

As noted in section 3.1 above, we would encourage the PC to define one or more markets in relation to its analysis on market power, in progressing towards its final report.

4.2 Market structure

This section reviews the structure of Australian retail banking markets. Our key findings are that:

- barriers to entry exist, but are not insurmountable;
- the recent history of entry and expansion suggests that competition is workable and dynamic;
- economies of scale and scope exist but may be overstated by the PC in its draft findings; and
- markets are not highly concentrated.

[88] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 74-76.

[89] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 111.

[90] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 116.

4.2.1 Barriers to entry

There is some disagreement regarding the precise economic definition of the term 'barriers to entry'.[91] For the purpose of this report we define a barrier to entry as anything that diminishes the competitive pressure on an incumbent firm in relation to the threat of entry, (ie decreases the likelihood of timely entry by new players) should it use its market power to increase prices or reduce quality.

Contestable markets theory suggests that, if entry is sufficiently easy, low cost and able to be executed in a timely fashion, a firm would not be able to charge high margins, because large profits would attract competitors into the industry.[92]

Throughout this report, we refer to 'barriers to entry' in their economic form as applied to the analysis of competition in markets. Similarly, we define a new entrant into a particular retail banking product to be a provider that previously did not offer that product, and which subsequently began to do so – regardless of whether that firm previously held a banking licence or was active in offering related banking products.

PC's assessment of barriers to entry

The PC sets out a number of examples of barriers to entry in the financial system, including:[93]

- commercial barriers, including the necessity to build brand awareness and trust;
- regulatory requirements, including licensing and operational requirements;
- limited resources; and
- lack of experience with the regulatory framework.

It adds that incumbent firms have significant advantages over new market entrants including brand recognition, existing customer bases and distribution arrangements.[94] The PC recommends a number of steps to reduce barriers to entry,[95] but it does not specifically say whether barriers to entry are currently high or not.

Many of the challenges for new entrants set out above are not barriers to entry, and others may be counteracted by benefits that smaller firms have over the larger rivals. In particular, limited resources and lack of experience with the regulatory framework are not likely to be significant barriers to entry given that there are many foreign banks with large resources, and experience with the regulatory framework can be acquired.

New entrants may not have a range of branches, but this may be a benefit relative to incumbents. A new entrant is not burdened by unnecessary branches in a world in which consumers increasingly use their mobile phone to access banking services.

The PC has said that new entrants have had limited success in spurring competition across financial services,[96] and so entrants alone cannot be relied upon to drive competition in the financial system.

This conclusion appears to misunderstand the nature of the competitive constraint from potential entrants. It is not necessary for *actual* entry to occur in order for the incumbents to be constrained by the *threat* of

[91] See: Demsetz, H, *Barriers to Entry*, Centre for the Economic Analysis of Property Rights, Economics and Law Workshop Papers, 81(17), 1981.

[92] See: Motta, M, *Competition Policy: Theory and Practice*, p 121.

[93] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 80.

[94] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 80.

[95] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 127.

[96] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 121.

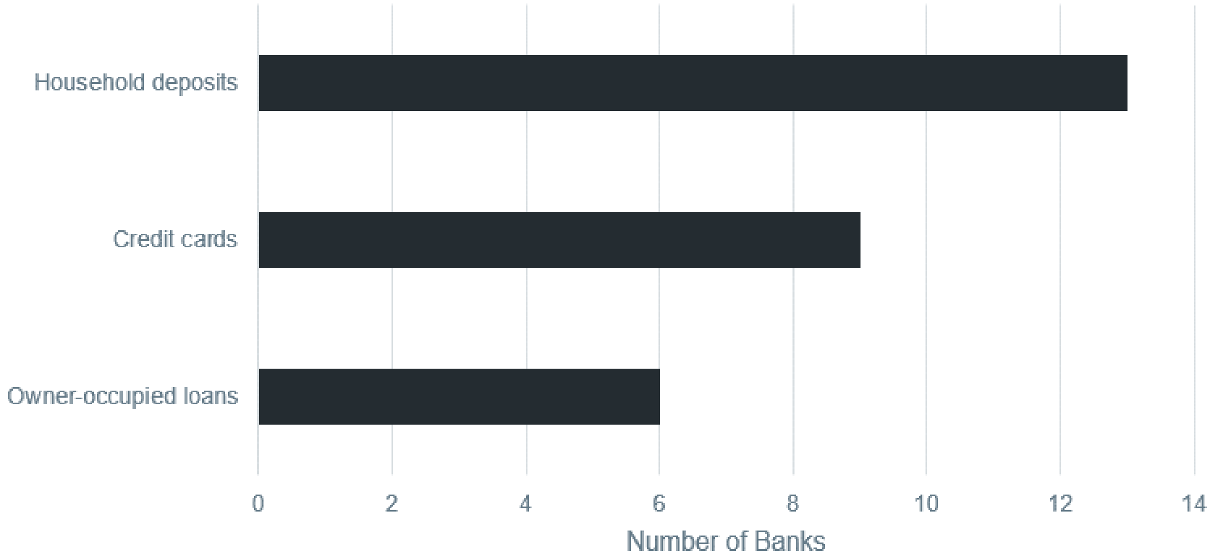
entry.[97] It simply requires that entry would be profitable (and so would be likely to occur), should prices rise substantially above the competitive level for a significant period of time.

In our view, while barriers to entry do exist, they are not so high as to insulate existing competitors from the forces of competition.

History of entry

Most of the main retail banking products for which data are available have seen around five-to-ten new entrants over the last 13 years, as shown in Figure 4.1. The fact that entry has occurred on many occasions indicates that the barriers to entry are not insurmountable, and that firms have expected entry to be profitable.

Figure 4.1: Market participants entering or expanding in selected retail banking products (2005 to 2018)



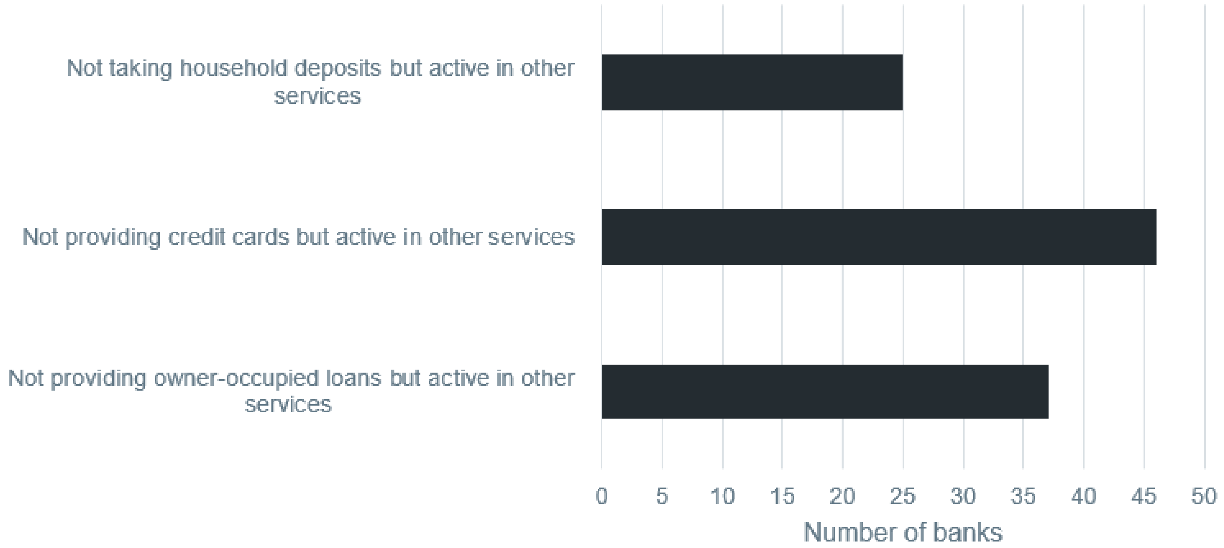
Source/notes: derived from APRA monthly banking statistics back series. An indicator variable is created for entry after January 2005 based on the company ABN. Given there may be various reasons why an ADI may enter the banking statistics without genuinely being a new entrant, a further restriction is that their first reported entry (in the dataset) must be below a certain threshold. This is $5 million for credit cards and household deposits, and $50 million for owner-occupied loans. See appendix A6 for a discussion of the methodology.

Many of these new entrants may have previously provided other retail banking products; indeed, there are a number of banks that would be in a position to expand into new products. For example, Figure 4.2 shows that there are many banks that do not currently offer certain products, and so could presumably begin to supply them relatively easily.[98] Further, an important point to note is that the APRA data pertains only to ADIs, ie, non-ADI lenders that compete with banks by providing products (such as those discussed in section 2.2.2 above) are not captured in these statistics. This caveat applies to our subsequent analysis that uses the APRA data to calculate figures such as product market shares.

[97] Australian Competition and Consumer Commission, *Merger Guidelines*, 2008, p 36.

[98] Product here refers to the retail banking products considered throughout this report – credit cards, owner-occupied loans and household deposits.

Figure 4.2: Number of banks that could expand into supplying a new product



Source/notes: derived from APRA monthly banking statistics back series. For January 2018 reporting, variables for each product market are created to indicate whether a specific ADI has a reported value of zero for a particular product market with positive reports in other product markets. ADIs which are not active in any of the three above products are not included. Banks that, while not active in the retail products above, are active in non-financial corporation deposit taking and lending, are included.

Such evidence of entry, in combination with the potential for further entry, places competitive pressure on the incumbent firms, including the major banks.

Large technology companies such as Google, Facebook, Apple and Samsung have also begun expanding their remit into digital wallets and related products, while there has also been significant growth by Chinese providers Alibaba and Tencent. Combined with the shift towards digital banking and changing consumer demands, the threat of entry by large technology companies seems increasingly credible. For example, in the United States, Amazon announced in March 2018 that it was in early discussions with J. P. Morgan Chase to launch bank-like accounts aimed at younger customers.[99]

Assessment of barriers to entry

Potential barriers to entry for retail banking markets include:[100]

- the regulatory requirements;
- access to essential inputs; and
- an ability to attract customers.

There is a distinction between regulatory burdens that impose costs proportionately on all firms, and those that hit new entrants harder than existing banks. Only the latter are barriers to entry.

We understand that there are a series of requirements for a firm to become an ADI, which is a cost that incumbents have already borne – see appendix A3. Undertaking the process is a barrier to entry to an extent because it involves some sunk cost of preparing the materials and waiting to become an ADI. Given that

[99] See: https://www.cnbc.com/2018/03/05/amazon-in-talks-with-jp-morgan-other-banks-about-branded-checking-account-wsj.html, accessed 8 March 2018.

[100] Independent Commission on Banking, *Final Report*, p 173.

many firms have received a new banking licence over the past ten years,[101] this does not appear to be a significant barrier to entry.

As discussed in the PC's report, regulatory barriers to entry are falling, which should increase the competitive constraint from potential new entrants.[102]

A new entrant requires some essential inputs, ie:

- access to funds – we expect this would be available for an entrant that would be profitable – and this is not 'sunk' in the sense that it can be recovered upon exit;
- a sophisticated IT system – the cost of such a system must be borne by all suppliers, and so this is not a barrier to entry; further, it may be easier for a new firm to build a system from scratch, rather than integrate with an old system as the incumbents must do;
- access to the payment system – we understand that this is available for new ADIs; and
- information on customers – this is available from a number of sources, including credit rating agencies.

A new entrant needs to be able to attract customers in order to grow. This is likely to require some marketing and advertising costs that are sunk, and so would be a barrier to entry to an extent. However, bank branches are becoming less important,[103] and entry may be possible using existing brands from other products, which can reduce costs.

In summary, there are some barriers to entry, but they do not appear to be very substantial and entry occurs fairly regularly, whilst any barriers seem to be falling. As such, we expect the threat of entry to be placing a substantial and growing competitive constraint on the major banks.

4.2.2 Expansion

Expansion by existing firms also places competitive pressure on incumbents. An existing firm can expand relatively easily into local markets.[104] In particular, an existing firm should comply with the regulatory requirements and have access to essential inputs discussed above.

We set out some examples of firms gaining and losing share by existing firms across a range of banking products in appendix A4. For example, Figure 4.3 below shows some examples for home loans, such as Macquarie Bank increasing its share from around 0.5 per cent at the beginning of 2013 to two per cent in 2015. These shares are in the stock of loans, and so Macquarie Bank's share of new customers must have been much higher. These degrees of expansion would not be the norm in a market burdened by substantial market power by one or more participants, but rather are consistent with a competitive market with firms reacting to the threat of losing customers to rivals.

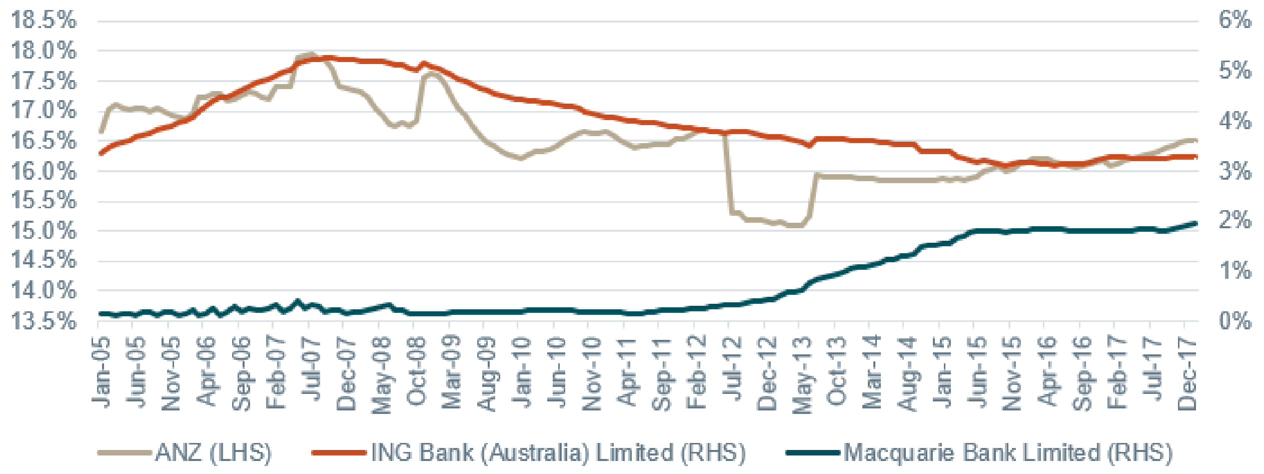
[101] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 122.

[102] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 124.

[103] See: Figure C.12, Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 522.

[104] This is consistent with the ACCC's conclusion from 2008 that barriers to expansion for existing retail banks are comparatively low. Australian Competition and Consumer Commission, *Westpac Banking Corporation – proposed acquisition of St George Bank Limited: Public Competition Assessment*, August 2008, para 73.

Figure 4.3 Examples of firms gaining and losing share in the supply of owner-occupier home loans

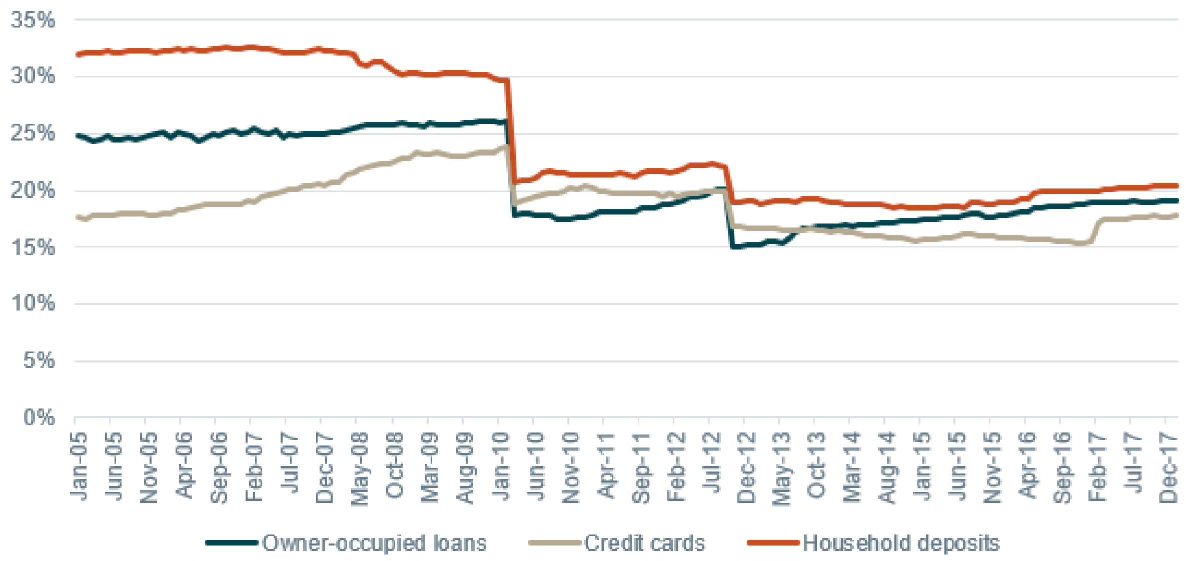


Source/notes: derived from APRA monthly banking statistics back series. Each firm's product market share is calculated as the individual bank's activity in the relevant product divided by the total activity in the relevant product. This product market share calculation is repeated over each period shown.

Figure 4.4 below shows that the share of supply for non-major banks has varied considerably over time across three retail banking products. Non-major banks have been able to expand in a number of periods and products, such as in credit cards from 2005 to 2010 and in owner-occupied home loans in the last five years. This demonstrates that the non-major banks can and have gone through periods of expansion, suggesting that this could happen again if the major banks did not offer competitive product or services.

The observed significant dips in the market share of non-major banks in January 2010 and July 2012 reflect two mergers, being Westpac's acquisition with St George Bank and CBA's acquisition of the Bank of Western Australia (BankWest). We note that there is a lag between the date when these transactions occur and the date the target entity is removed as an individual item inthe APRA data.

Figure 4.4 Share of retail banking products by non-major banks



Source/notes: derived from APRA monthly banking statistics back series. The product market share is reported activity in the particular product market by banks other than the majors divided by total activity in that particular product market.

4.2.3 Economies of scale and scope

As discussed in section 2.4.1, economies of scale and scope exist in aspects of retail banking. Fixed costs such as regulatory burden and investment in innovation can be spread over a larger asset base. Where economies of scale exist, a concentrated market structure is efficient as it allows these economies of scale to be realised and passed on to consumers.

The PC's logic that economies of scale and scope necessarily confer substantial market power to the major banks is questionable, because:

- other ADIs have different operating models which may mitigate the cost advantage – the introduction of dynamic, leaner operating cost models may challenge the economies of scale and scope of the major banks, since these new players may have significantly lower (operating) cost bases;
- smaller players' ROE and NIM have been converging with larger players in recent years, which may suggest that economies of scale and scope are overstated; and
- the scale advantage held by any one of the major banks is mirrored in the cost structure of the other three major banks, and there is nothing to suggest that these four major banks would not compete amongst one another – no one player obtains a cost advantage that insulates it from the competitive process.

4.2.4 Market concentration

The PC highlights market concentration in its draft report,[105] and refers to this metric repeatedly throughout its report as being high, eg:[106]

> In retail banking, market concentration is very high in many product markets.

In contrast, our analysis shows that retail financial services markets are not highly concentrated, because:

[105] Productivity Commission, *Draft report into competition in the Australian financial system,* 2018, p 2.

[106] Productivity Commission, *Draft report into competition in the Australian financial system,* 2018, pp 2, 3, 99, 105, 111.

- four large players, each with around 15-30 per cent market share, and a fringe of small players, would not typically be considered *very highly concentrated*;
- using a standard accepted economic measure of concentration (see discussion of the Herfindahl-Hirschman Index below), we show below that the market would not be considered highly concentrated; and
- none of the major players have sufficient market share to be considered dominant under usual circumstances.

The PC points to several quotes that acknowledge the limits of implying market power from market concentration: [107]

> ... four large banks could still compete very actively among themselves (Bullock 2017, p1)
>
> Market concentration can be a by product of competition, if more efficient firms grow at the expense of their less efficient competitors (Murray et al. 2014b, p. 2.4)

On the evidence available, there is no reasonable basis for the suggestion that market concentration has conferred substantial market power to the major banks.

Concentration, market shares and dominance

The relevant markets are characterised by four large players with similar market shares and a small fringe that compete in different segments of the sector. Considering the economies of scale and scope discussed above, this degree of market concentration would not typically be considered a major concern.[108]

Applying conventional principles for evaluating whether any one firm has substantial market power, a market share of 15-30 per cent would not usually be sufficient to invoke a presumptive theory of harm on the basis of firm size or dominance. For example, the European Commission states that: [109]

> If a company has a market share of less than 40%, it is unlikely to be dominant.

The Herfindahl-Hirschman Index

The PC draft report frequently refers to the cumulative concentration of the four major banks as being high. Although it notes that the ACCC measures concentration with reference to market shares, concentration ratios and the Herfindahl-Hirschman Index (HHI), and discusses these in Box 2.3 of the draft report, the PC does not draw any conclusions or put any weight on these measures.

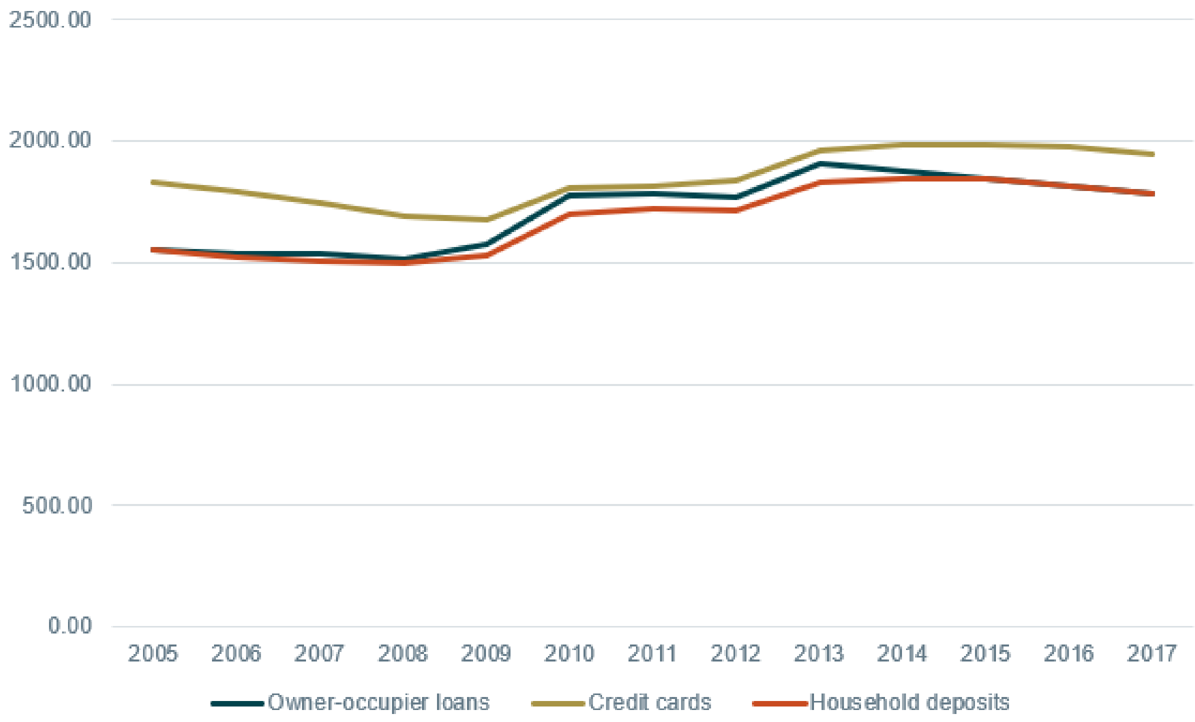
Figure 4.5 below shows the HHI for select banking products from 2005 to 2017. As noted previously in section 4.2.1, the HHIs in the figure are upward biased, since the data source (APRA monthly banking statistics back series) does not include all ADIs (or non-ADIs) that offer these banking products, and so the market shares underpinning the HHI calculations are likely to be (slightly) overstated. This is reinforced by the fact that, as noted in section 4.2.1, non-ADI lenders have not been included in these statistics.

[107] Productivity Commission, *Draft report into competition in the Australian financial system,* 2018, p 79.

[108] See: for eg, https://www.accc.gov.au/system/files/Merger%20guidelines%20-%20Final.PDF, accessed 14 March 2018.

[109] See: http://ec.europa.eu/competition/antitrust/procedures_102_en.html, accessed 15 March 2018.

Figure 4.5: HHI index of selected retail banking products



Sources/notes: derived from APRA monthly banking statistics back series. The HHI is the sum of the squared market share of each firm. The market share is calculated by dividing an individual entity's activity in a particular market by the total activity in that particular market.

Despite the acknowledged upward bias, the HHI for each market appears stable over the period 2009 – 2017 and in all cases falls below 2000. Given the noted overstatement in estimates, it would seem non-controversial to conclude that the HHI in Australian retail banking markets is below 2000.

In Australia, the HHI is used in the context of mergers to assess both absolute post-merger concentration and the merger's impact (delta) on concentration. The ACCC merger guidelines state that:[110]

> The ACCC will generally be less likely to identify horizontal competition concerns when the post-merger HHI is:
>
> - less than 2000; or
> - greater than 2000 with a delta less than 100.

Although the framework for merger assessment is slightly different from the current context, it is relevant as an indicator, and suggests that market concentration has been overstated by the PC draft report.

Further, none of the similar thresholds for high concentration applied by the UK, US and European Commission competitive authorities are met – see Table 4.1 below.

[110] Australian Competition and Consumer Commission, *Merger Guidelines*, 2008, p 35.

Table 4.1: HHI thresholds

Country / Authority	Indicative HHI threshold	Application to Australian retail banking markets
UK / Competition and Markets Authority[a]	An HHI exceeding 2000 may be regarded as highly concentrated An HHI exceeding 1000 may be regarded as concentrated	Australian retail banking markets are not considered highly concentrated (HHI < 2000), but are considered concentrated (HHI > 1000)
United States / Department of Justice[b]	An HHI exceeding 2500 suggests high concentration An HHI between 1500 and 2500 suggests moderate concentration	Australian markets considered to be moderately, not highly concentrated based on these HHIs
Europe / European Commission[c]	The Commission is unlikely to identify horizontal competition concerns in a merger with a post-merger HHI below 2000 and a delta below 150.	Australian retail banking markets are not highly concentrated

Sources: a) Competition and Markets Authority, *Merger Assessment Guidelines,* September 2010, p 40. b) See: https://www.justice.gov/atr/herfindahl-hirschman-index, accessed 14 March 2018. c) European Union, *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings*, Official Journal of the European Union, 31 March 2004, para 20.

Based on the indicative HHI thresholds, the Australian retail banking markets would be characterised as neither highly nor very concentrated under international standards.

It is important to emphasise that HHI thresholds do not establish safe harbours, or shortcuts to competition analysis. However, they do help to set the comments on concentration in Australian retail banking markets in context, and suggest that the PC's contentions in relation to concentration are overstated.

4.2.5 Product differentiation

Most retail banking products are very similar. There is differentiation in the services that banks provide with their products, and there is differentiation between some of the detail of particular products.

As well as competing on price, the major banks compete on service quality and innovation, but any advantage that one bank has is likely to be short-lived as others catch up. It follows that, at any one moment in time, the major banks offer products that are fairly similar. This limited product differentiation strengthens the competitive constraint that each of the major banks places on the others.

4.2.6 Buyer power

One of the three core pillars in the PC's model of competition is the role of consumers in putting competitive pressure on providers.[111] Part III of the PC draft report is dedicated to exploring whether consumers are able to exert competitive pressure.

The PC draft report contends that because information on financial products is complex, confusing, hard to compare and time-consuming to obtain, consumers tend not to actively shop around or switch.[112] The concern is that a lack of engagement or consumer inertia, and/or barriers to switching for consumers, leads

[111] See: Figure 2.2, Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 74.

[112] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 347-348.

to reduced incentives for banks to compete on price, quality and innovation, since the response from consumers to these differences may be weak.

However, we describe in section 2.3 that emerging research suggests that consumer behaviour and attitudes are varied within the Australian population. Although many consumers may lack engagement and awareness of finance options, this is neither static nor true for all consumers.

The diversity of attitudes and the changing makeup of consumer demand in Australia does not appear to have been sufficiently acknowledged in the PC's draft report.

Further, it is not necessary that all consumers actively shop around, for competition to occur. To achieve the benefits from competition, the credible threat of consumer switching by a sufficiently large subset of consumers is sufficient to ensure banks have the right incentives to compete on price and quality.

To understand why only a subset of consumers is needed to incentivise competition, consider the incentives of a bank that would like to increase its prices, or reduce its quality. It has to trade off the increased profits derived from higher prices, or lower costs associated with delivering lower quality, with lost profits through customers switching to a different bank:

- if the lost margins on the subset of consumers that would switch away from the bank is sufficiently large to outweigh the gains from a price increase or quality decrease, and the bank believes that this switching would occur (ie the threat is credible), it will constrain competition; and
- the more people that would switch, the greater is the constraint.

It can be difficult to assess whether or not market conditions generate sufficient credible threat of switching to stimulate competition, particularly given that the threat of switching is not necessarily reflected in switching rates.

The suggested regulatory reforms that lower barriers to switching (such as the open banking regime), alongside the growing subgroup of consumers that are transaction-based, have less loyalty to traditional providers and are more willing to hold multiple accounts, is likely to increase competitive tension.

4.2.7 Regulation

Retail banks face significant regulation on many fronts, including in relation to the products they can offer, the information they must provide to consumers and the capital they must hold. However, such regulations do not confer substantial market power on any major bank, because they are all affected equally.

The PC states that prudential regulation substantially limits the scope for traditional price competition in banking.[113] Its reasoning is that this regulation determines the cost of funds for ADIs, which is part of the cost to ADIs of offering loans.[114] Further, the PC states that the major banks have a funding advantage over smaller banks as a result of regulatory measures that vary disproportionately with the size of the bank.[115]

These regulatory measures do not give any individual firm market power because:

- regulations that impose costs equally across all banks have no effect on the relative competitive strengths of banks, and so do not affect market power; and
- regulations that apply equally to the major banks mean that each faces at least three competitors with the same regulatory costs, which ensures that none has substantial market power.

[113] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 32.

[114] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 9.

[115] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 10.

The PC has also said that ADIs' ability to set home loan prices competitively is constrained significantly by regulatory limitations and interventions, and their effect on the cost of funds.[116] It adds that the RBA sets the cash rate and prudential requirements affect how much capital banks must hold.[117]

In these observations, the PC appears to be conflating the level of prices with the level of competition. The PC is correct to observe that regulations affect the costs of the major banks. But an industry-wide increase in variable costs does not affect the degree of competition between the incumbent firms. There is no reason why regulations that affect the underlying cost of provision of a service should affect the intensity of competition.

Similarly, the PC says that the regulators are 'price leading' by publicly setting regulations that help to determine the cost of providing home loans.[118] In our opinion, this is a mischaracterisation. The setting of the cash rate and prudential regulations determine part of the cost of providing home loans. The regulators are not suggesting a price in any way, and firms that experience the same costs for a part of their cost base can be expected to compete like any other firm. Indeed, many firms in Australia have similar cost bases, because the price of inputs will be the same.

4.2.8 Vertical integration

In relation to retail banking, the PC has said that the major banks have increased vertical integration and that this could have affected smaller players' market access[119] and/or it could prevent the vertically integrated firm offering consumers the full range of options (including those from competitors).[120]

We do not offer any observations in this report on the potential for conflict of interest or other consumer issues that do not relate to market power.

Vertical integration in mortgage broking

Mortgage broking is one area where there exists some vertical integration between some mortgage brokers and lenders. Brokers provide advice to consumers on home loans, assist with the application process and submit the loan to the lender on the consumers' behalf.

Brokers tend to be aligned to either aggregators (83 per cent) or a retail franchise networks (17 per cent).[121] Aggregators operate as an additional layer – acting as intermediaries between brokers and lenders. Lenders pay commissions to both aggregators and brokers.

Some lenders have ownership interests in aggregators and brokers, which could give rise to conflicts of interest for brokers. The PC notes that this conflict of interest may lead to brokers promoting certain loan options on the basis of their ownership structure. It is estimated that around 70 per cent of broker-originated loans come from lender-owned aggregators, although it does not appear that any one lender owns a majority of downstream broker aggregators.[122]

The PC has also noted[123] that the broking industry has recently committed to making clearer disclosures on ownership structures to mitigate this conflict of interest.

[116] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 165.

[117] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 165.

[118] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 165.

[119] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 185.

[120] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 7.

[121] Royal Commission, *Some features of the Australian mortgage broking industry: background paper 2*, 2018, p 9.

[122] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, p 214.

[123] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, p 227.

In our opinion, there is no substantial risk of rivals being foreclosed and/or the major banks having substantial market power in circumstances where:

- there is sufficient competition at each level of the supply chain (eg, firms offering mortgages and brokers) such that competition would be workable even if all firms were vertically integrated, and no one firm has the ability profitably to exclude others;
- barriers to entry are low, and there does not appear to be any reason that smaller lenders could not also vertically integrate into broking; and
- there is no evidence of reduced access, eg, mortgage brokers now supply over half of all new home loans.[124]

Vertical integration in warehouse funding

One source of funding for ADIs is to repackage pools of mortgages into residential mortgage-backed securities (RMBS) and sell these to institutional investors.[125] Although securitisation has made up a small part of the funding composition of banks since the GFC (as shown in Figure 4.6 below),[126, 127] smaller ADIs are more reliant on securitisation as a source of funding than are major banks.

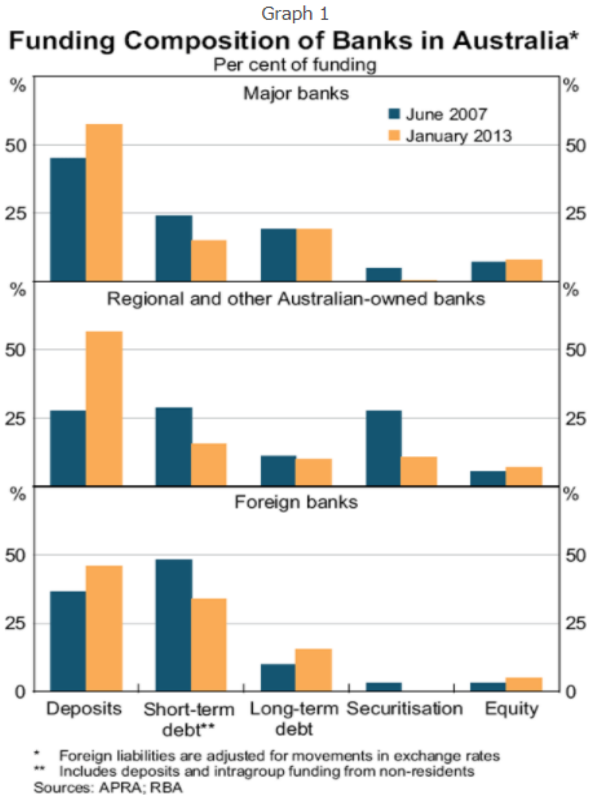
[124] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 212.

[125] Reserve Bank of Australia, *Structural features of Australian residential mortgage-backed securities*, Bulletin – June Quarter 2015, p 1.

[126] Reserve Bank of Australia, *Developments in banks' funding costs and lending rates*, Bulletin – March Quarter 2013, p 2.

[127] Reserve Bank of Australia, *How have Australian banks responded to tighter capital and liquidity requirements?* Bulletin – June Quarter 2017, accessed 22 March 2018.

Figure 4.6: Funding composition of Australian banks



It is widely considered that the ability of smaller ADIs to raise funding in capital markets through RMBS has promoted competition for residential mortgages.[128]

Major banks offer warehouse loans to smaller banks to cover cash flow timing differences, since ADIs must fund the mortgages before they receive the gains from RMBS. The PC has noted that for some lenders (small ADIs), their largest competitors are also a source of funding and a potential buyer of these mortgage-backed securities.[129]

In our opinion, the major banks would not be able to foreclose their smaller rivals by raising the price of warehouse lending above the competitive level because:

- each of the major banks do not have substantial market power in offering warehouse lending; and
- as evidenced in the graph above, RMBS is a material but not primary component of banks' cost of funding.

Further, there is no evidence of smaller banks being foreclosed because they appear to offer mortgage rates similar to – and not uncommonly, lower than – larger banks in residential mortgages[130] (at least on headline and package rates), suggesting that the major banks are not pricing warehouse loans in such a way as to limit access.

[128] Reserve Bank of Australia, *Structural features of Australian residential mortgage-backed securities*, Bulletin – June Quarter 2015, accessed 22 March 2018, p 1.

[129] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 194.

[130] Pricing data collected by Westpac from various publicly available sources.

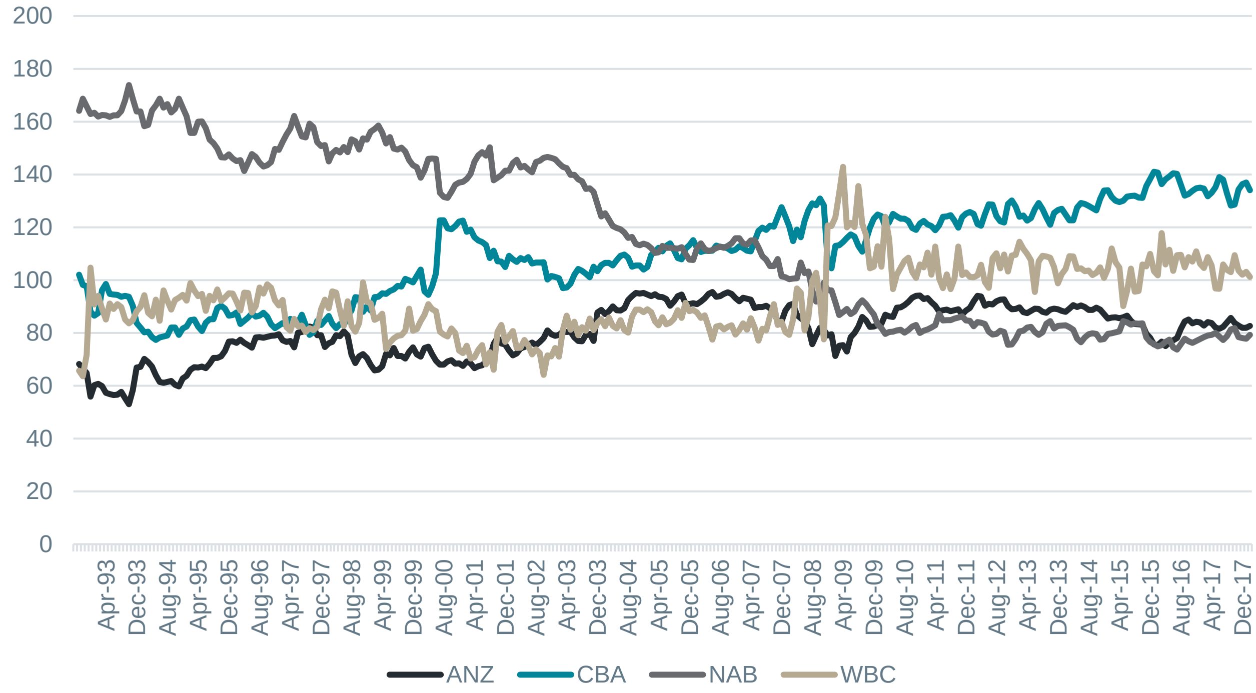
4.3 Market conduct

4.3.1 Competition between major banks

There are various indicators of competition between the major Australian banks in different segments and over time. Figure 4.7 below shows that the relative market capitalisations of each of the major banks have varied significantly over time. For example, for a long period from the mid-1990s to around 2010, NAB's market capitalisation has fallen significantly relative to the others.

The changing fortunes of the major banks shown in Figure 4.7 is consistent with long term dynamism and competition in the banking sector.

Figure 4.7: Changes in relative market capitalisation over time



Source: derived from Bloomberg historical market capitalisation. The index of 100 is the average market capitalisation of the big four Australian banks for that period since 1992. Observations with an index value above 100 had a market capitalisation above the average of the big four Australian banks for that year and vice versa.

Variety in market share across product segments

We set out in section A1.3 (Figure A 4.1 and Figure A 4.2) that the major banks do not have the same share of supply for each product. For example, CBA has the largest share of owner-occupier household loans, whilst NAB currently appears to be the largest player in business banking.

Responsiveness to price changes

The PC notes that institutions tend to follow each other's lead in setting fees.[131] The draft report refers to the example of CBA removing foreign ATM fees, and other banks following suit – with the conclusion being that in a competitive market, other banks would previously have considered removing foreign ATM fees.

[131] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 113.

Any form of price (or non-price) competition has to be initiated by one or other party. There is no economic basis for the observation that observed instances of such changes should have been made earlier. Further, evidence that firms react quickly to their competitors is consistent with a competitive market, and not with market conditions where firms have substantial market power.

4.3.2 Competition with other market players

Each smaller ADI has its own set of commercial incentives and a varying ability to compete directly with major banks. However, there is evidence that many ADIs compete with major banks, for example:

- direct banks such as ING are able to pass on their cost advantage to consumers by offering strong interest rates on deposits, lower interest rates on debt and/or lower fees[132] – the PC notes that ING drove up savings rates in the late 1990s, attracting significant share of consumer deposits; major banks responded by increasing their own savings rates;[133]
- Suncorp Bank, as noted in section 2.2.2, is the largest deposit-taker and third-largest lender in Queensland; and
- Macquarie appears to be actively seeking to expand in retail banking, with its new advertising campaign and digital banking offering which uses the same technology used by Netflix and Apple to give customers a premium service.[134]

4.3.3 Price competition

In its draft report, the PC refers on a number of occasions to price competition being less than desirable and/or 'rarely evident'.[135] It draws this observation by reference to two primary indicators, being:

- the spread between the cash rate and house lending rates – which has increased slowly over the past decade,[136] ie, an increased 'price' on house lending; and
- the spread of bank deposit rates to the cash rate[137] – which increased following the GFC in response to increased demand for deposits and has been fairly stable or slightly declining over the past five years or so, ie, an increased price (or decreased negative price) on deposits.

On these observations, the PC suggests that competitive pressures have chilled.

In our opinion, none of these measures is capable of revealing the presence of market power or, conversely, workable competition. Holding all else constant, long term trends in margins such as the spread between the cash rate and house lending rates, and bank deposits and the cash rate may well reflect changes in competitive dynamics – however, it is well documented[138] that the cash rate is not equal to a bank's cost of funds.

In the face of changing external factors such as regulation, where changes in margin/increases in price at least partially reflect increases in the total cost of funding,[139] it is difficult to draw robust inferences from these observations, particularly where (as noted in section 4.4.1 below) profitability measures are declining – which may suggest that observed increases in 'price' are not converted to increases in profit.

---

[132] See: https://www2.deloitte.com/cn/en/pages/financial-services/articles/direct-banking-exploration-commercial-bank-transformation-development.html, accessed 16 March 2018.

[133] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 129.

[134] See: http://www.afr.com/brand/chanticleer/macquarie-joins-banking-arms-race-with-netflixlike-weaponry-20160831-gr59ld#ixzz599GAawS5, accessed 9 March 2018.

[135] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, p 7.

[136] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, pp 166-167.

[137] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, p 161.

[138] Reserve Bank of Australia, *Developments in banks' funding costs and lending rates*, Bulletin – March Quarter 2017, p 45.

[139] As noted by the PC at p 166, ADIs have faced increasing costs as a result of the changing prudential regulatory environment.

The PC notes that:[140]

> In a competitive market, profit margins would be slim at sustainable levels, as no provider would have sufficient market power to keep its margins thick without losing market share.

The difficulty with this approach is to identify what a workably competitive, 'slim' and sustainable margin should be, taking into account the relevant external conditions at any one time. Without the ability to compare to any form of benchmark, it is hard to draw any conclusion on such measures of price or the intensity of competition.

In the absence of establishing whether, or the extent to which prices or margins are greater than efficient levels, the PC appears to be developing a proposition that because there is limited evidence of long term declines in price or margins, consumers have not benefited, ie:[141]

> price competition itself hasn't resulted in any kind of substantial shift in favour of consumers, and to the extent you use different benchmarks you can find different numbers, but it does not appear to be the case that that's - we have a strongly price competitive market from our perspective.

The particular theory of harm being referred to is not clear, and is not obviously supported by evidence. We note that:

- absent reference to any counterfactual, 'efficient' prices or margins, a lack of positive evidence that consumers have significantly benefitted from price competition over time, does not imply that price competition is absent;
  - even in a theoretical, perfectly competitive market, prices are not always expected to drop over time;
  - as the PC has noted, ADIs' cost of funding has increased,[142] and these costs should be recovered; and
  - firms have invested heavily in innovation, for which they should recover their costs;
- there is some anecdotal evidence of banks competing on price, eg,
  - in June 2017, all the major banks decreased their standard variable mortgage rates;
  - in 2015, a Citi economist reported two year fixed rate and variable rate loans at 'record lows';[143]
  - ANZ lowered its standard variable mortgage rate by two basis points more than the RBA reduction in the cash rate in May 2013. The other major banks passed on the full reduction;[144]
  - in 2013, Westpac offered a 'cash-back rebate' for new customer mortgages borrowing more than $500,000, while during the same period CBA offered home owners $700 to switch bank;[145]
- there is no economic support for the PC's implicit proposition that price competition should be preferred on welfare grounds to other forms of competition, such as in relation to quality and innovation – yet there is plenty of evidence that Australian retail banking customers have benefited from leaps and bounds in innovation, such as mobile banking.

The PC's view that competition between the banks, particularly on price, is weak, is not supported by the evidence it presents.

[140] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, p 166.

[141] Harris, P, Transcript of Proceedings, *Inquiry into competition in the Australian financial system*, 28 February 2018, p 157.

[142] Productivity Commission, *Draft report into competition in the Australian financial system*, January 2018, p 166.

[143] https://www.theguardian.com/business/2015/jan/12/mortgage-rates-record-lows-lenders-inflation-interest, accessed 25 March 2018.

[144] http://www.abc.net.au/news/2013-05-10/anz-announces-interest-rate-cut/4681424, accessed 27 March 2018.

[145] Australian Financial Review, *Banks act to cash in on mortgage demand*, September 23, 2013.

4.3.4 Innovation and investment

Australian banks are generally regarded as some of the most innovative providers of banking services and payment systems globally.

Examples of significant innovations in Australian retail banking markets include:

- mobile banking and apps – all four of the major Australian banks (as well as many of the smaller ADIs) provide mobile banking solutions for customers, with 70 per cent of Australians preferring to bank via an app on their smartphone than use a browser;[146]
  - CBA and Westpac have scored in the top 10 of over 50 banks worldwide, in the 2017 Forrester benchmark for mobile banking, based on user experience, functionality and responsiveness to customer expectations.[147] Westpac ranked first in the 2016 Forrester global benchmark for mobile banking;[148] and
  - mobile banking has given customers convenient and 24-hour access to their accounts, with the ability to check balances, transfer funds between accounts, and make payments;
- banks continue to develop the user-friendliness of their mobile interfaces, eg, Westpac is developing Quickzone capabilities for basic tasks that can be done without logging on;[149]
- Australian banks were also some of the first in the world to integrate fingerprint authentication into their apps, allowing customers to easily and securely log in with their fingerprint;
- PayPass and NFC payments - the introduction of near-field communication (NFC) technology to smartphones allowed institutions to give customers the ability to pay for purchases using their mobile phone or wearable such as an Apple Watch or Fitbit – this technology has also allowed ‘tap and go’ payments with credit and debit cards using MasterCard’s PayPass and Visa’s payWave technologies; and
- cardless cash - banks have made it possible to access cash from ATMs without the need for a debit card, by using ATMs and their mobile phones to access their account – this alleviates problems faced by customers when cards are lost or stolen. ANZ, Westpac and CBA have all introduced forms of cardless cash, while NAB does not.

NFC technology introduced new players into the industry, including Apple with Apple Pay and Google with Google Pay (previously called Android Pay). These non-banks have expanded choices for customers in how they choose to pay for purchases. Ongoing collaboration with fintechs include:

- to upgrade existing customer platforms;
- banks are co-operating with technology companies to provide services together; and
- aggregators are seeking to help customers choose and access banking products from a range of banks.

The PC concluded that fintechs are collaborating with the incumbent banks rather than competing against them, and so fintechs are unlikely to provide the basis for vigorous competition against incumbent banks in the near future.[150]

The PC’s conclusion appears to assume that the incumbent banks do not compete against one another in relation to innovation. In contrast, the fact that the major banks are working with fintechs itself is evidence of competition in innovation. Each bank is trying to get an edge over its rivals. A fintech that is able to work with an existing bank to improve that bank’s service or reduce its costs will have a significant and positive effect

[146] Deloitte, *Mobile Consumer Survey 2016: the Australian Cut*, 2016, p 25.

[147] See: https://www.rfigroup.com/rfi-group/news/westpac-cba-top-mobile-banking-survey, accessed 16 March 2018.

[148] See: https://go.forrester.com/blogs/16-07-19-we_have_a_new_mobile_banking_leader_westpac_tops_forresters_global_benchmark_in_2016/, accessed 7 March 2018.

[149] Westpac, *Submission to the PC*, September 2017, p 28.

[150] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 138.

on competition by allowing that bank to improve its offering relative to its rivals, which can be expected to lead to the other major banks doing the same with consumers benefiting from this competition.

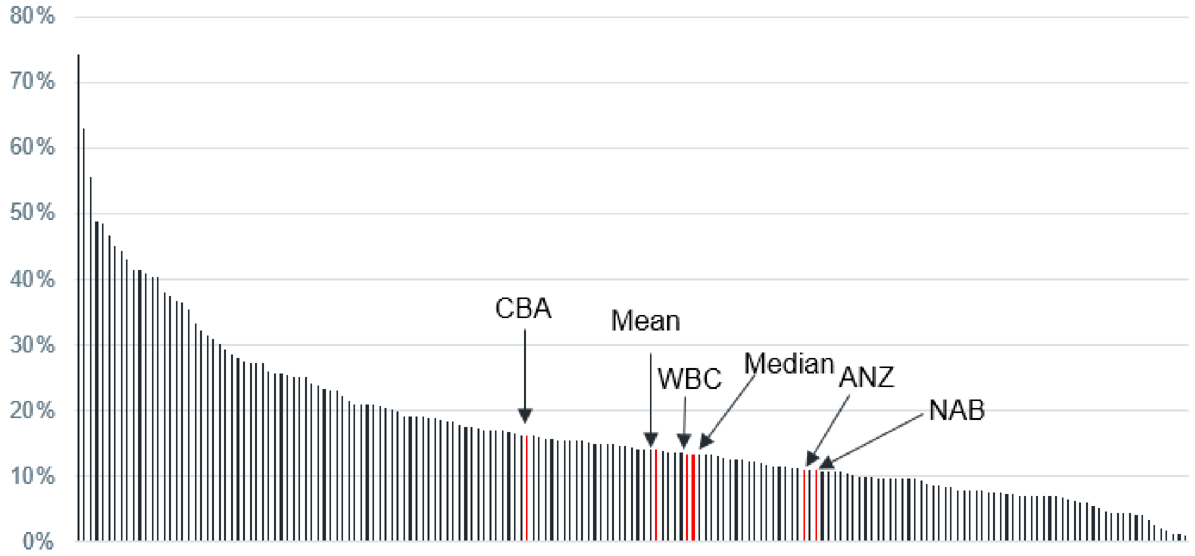
4.4 Market outcomes

4.4.1 Evidence on profitability in Australian retail banking

With the caveats we identified in section 3.2.3 in mind, we note that:

- the ROE and NIM of major banks have been falling;[151]
- ROE and NIM of major banks have been converging with that of other ADIs in recent years;[152] and
- the ROE of major banks are not out of line with other large listed companies, as shown in Figure 4.8 below.

Figure 4.8 ROE of ASX200 companies as at 31 December 2017



Source: Bloomberg data. Notes: the ROE is the return on common equity. The list of companies is those included in the ASX200 as at 31 December 2017. The ROE figure is the last reported annual figure as at 31 December 2017.

These data may or may not be sending a genuine signal about competition in banking markets.[153] However, to the extent that the data provide any indication, this signal would be that competitive pressure is present, rather than absent.

4.4.2 Cost pass-through

The PC has said that the substantial market power held by the major banks has given them the ability to pass on cost increases.[154]

[151] See: Figures C.21 and C.23, Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 529-530.

[152] See: Figures C.21 and C.23, Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 529-530.

[153] For completeness we also consider the ROE of ASX200 companies over the period 2002-2017, see Appendix A5.

[154] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 32.

The extent to which changes in costs are passed through to banking customers depends on a number of different interacting factors, including:

- which firms are affected and to what extent;
- the level of demand, and how it changes with prices; and
- the extent to which cost increases with output.

For the most part, models of competition predict that the extent to which industry-wide changes to costs are passed on will *increase* with the degree of competition. For example, prices are equal to marginal cost in a perfectly competitive market, in which case the prices set by all firms move perfectly in line with costs when there are industry-wide cost shocks. By contrast, a monopoly will increase its prices by less than an increase in its costs.[155]

In our opinion, the PC has drawn the incorrect conclusion regarding market power from its observation that the major banks pass on industry-wide cost increases to consumers. To the extent that observation is correct, it is more likely to be indicative of competition, rather than market power.

4.4.3 Discounting of home loans

The PC states in its draft report that the vast majority of home loan customers do not pay the relevant standard variable rate (SVR), and that the average discount has increased over time.[156] The cost of providing a mortgage for a bank depends on:

- a range of factors that are the same across all customers, eg, the cost of funds and the bank's own costs in providing the underlying services, eg, branches; and
- a range of factors that affect the risk of customer default, including, income, expenditure, number of children, home address, occupation and credit history.

It follows that a fundamental attribute of home loans (and indeed, other loans) is that the efficient level of interest rate will vary across customers. The same can be said for insurance.

Offering discounts from the SVR is the principal mechanism by which each customer is provided with a price that reflects their risk, as well as other factors. Other mechanisms could be adopted as an alternative to discounts, such as having no published prices at all, or having a minimum interest rate with various, tailored additions being applied to individual customers.

The existence of discounts may or may not represent competitive behaviour. Indeed, a monopolist offering loans would also want to set a lower interest rate for customers with a lower default risk. On the other hand, firms operating in a perfectly competitive market would set prices at the lower, efficient level, but this would also vary across customers.

4.4.4 Customer satisfaction

Where competitors have substantial market power, the incentive to deliver quality service to consumers is low and so customers are often not satisfied with the service they receive.

Recent surveys regarding customer satisfaction in the Australian finance sector do not appear to indicate the existence of substantial market power. Such studies include:

[155] This holds for most, but not all demand functions.

[156] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, pp 233-234.

- the Australian Banking Association released new research in January 2018[157] on customer attitudes on Australian banks – the key findings are consistently positive and reflect a positive trend in consumer attitudes over the past six months, and include:
  - the clear majority of people consider that their bank is improving regarding customer focus;
  - over 85 per cent of people thought that banks helped to make decisions in the best interests of customers, up from 74 per cent; and
  - trust in customers' own bank and in the overall industry has also improved; and
- Roy Morgan's Single Source survey[158] of customer satisfaction with banks indicates that there has been a positive long-term trend in customer satisfaction in the major banks, with 78.7 per cent of respondents fairly or very satisfied with the major banks, a significant increase above 55.3 per cent in 2001.

The PC also noted that customer satisfaction with their own banks was high.[159] These data on customer satisfaction in Australian retail banking markets do not suggest that the major banks each hold substantial market power, but rather are consistent with banks facing competition with one another.

4.5 Coordinated market power

The preceding sections have focused on conditions that are consistent with unilateral market power that arises from a single firm facing weak competitive constraints. By contrast, coordinated market power considers whether a group of firms acting in a coordinated manner collectively face weak competitive constraints from outside the group.

The PC draft report appears to conclude that the major banks do not compete with one another, so that competitive pressure is limited to that generated by small players, and threat of entry by global technology companies. However, it does not explicitly suggest that the major banks have coordinated market power.[160]

If the PC is referring to collective substantial market power by the major banks, then such a theory should be made explicit and systematically tested. However, in our opinion it is very unlikely that there could be tacit collusion by the major banks in retail banking markets because:

- the funding cost of providing retail banking products changes often and so tacit agreements would need to be updated regularly;
- prices for certain products vary across consumers, depending on each consumer's financial position and other relevant characteristics – achieving tacit collusion would therefore require that each bank knows and agrees the individual prices charged by the other banks for each customer profile, which is unrealistic;
- the major banks have asymmetric market shares, both over time and across retail banking products, and so sustaining any form of price coordination is more difficult since the economic incentives (say, to cheat on any tacit agreement) are not homogenous;
- there is the threat of entry or expansion from smaller banks (or other players), which constrains any ability of major banks to exercise coordinated market power; and
- the market conduct of major banks is not consistent with firms that hold substantial market power.

[157] Edelman Intelligence, *Banking Reform Program: Report on Consumer Study Wave Two*, January 2018.

[158] See: for eg: http://www.roymorgan.com/findings/7438-satisfaction-with-big-four-banks-improves-in-november-201712180435, http://www.roymorgan.com/findings/7413-satisfaction-with-banks-remains-high-201711240141, accessed 19 March 2018.

[159] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 109.

[160] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018.

A1. Industry context

This appendix provides some additional industry content that is relevant for understanding competition in Australian retail banking markets, including a description of:

- the background to the PC inquiry;
- the Australian banking industry;
- some of the differences in the success the major banks have had in relation to retail banking products;
- switching costs in relation to retail banking;
- the funding profile of the major banks;
- the role of mortgage brokers; and
- the regulatory landscape.

A1.1 Background to the Productivity Commission inquiry

The PC's current inquiry into competition in the Australian financial system was initiated in response to the 2014 Financial System Inquiry, which recommended that a review of the state of competition in the sector be conducted every three years. The Financial System Inquiry noted that while competition appeared to be generally adequate, the high concentration and vertical integration in some parts of the system had potential to limit competition in the future and so should be proactively monitored.[161]

A1.2 Overview of the Australian banking industry

As noted in the PC draft report, the financial system in Australia is large, strong and growing.[162] It is a key contributor to economic activity and growth, and underpins the Australian economy.

ADIs represent the cornerstone of retail banking. ADIs are businesses that have been authorised to carry on the business of banking under the *Banking Act 1959*. As at 30 September 2017, there are 147 ADIs operating in Australia, made up of:[163]

- banks – including Australian owned banks and local subsidiaries of foreign banks;
- Australian branches of foreign banks – these typically do not offer retail banking services due to licence restrictions on accepting retail deposits, eg, Credit Suisse AG;
- mutual banks – building societies and credit unions have collectively rebranded as mutual banks – these businesses are usually owned by their members, and offer traditional retail banking services; and
- other service providers such as PayPal, and payment clearings services companies, eg, Cuscal Limited.

The business models, scope of services provided, geographic coverage and ownership structures of financial services providers operating in Australia can vary significantly within and across these groups.

Retail banking businesses offer consumer products such as transaction accounts, savings and term deposits, credit cards, home loans and personal loans, as well as institutional banking and commercial lending.

[161] Financial Services Inquiry, *Final Report*, 2014, p xxvi.

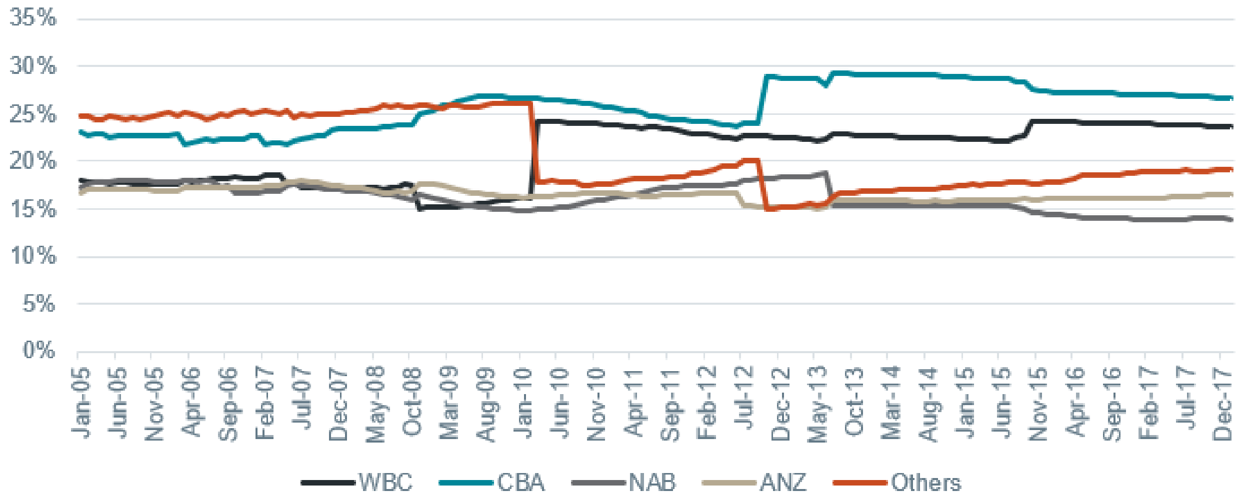
[162] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 54.

[163] See: http://www.apra.gov.au/adi/Pages/adilist.aspx, accessed 1 March 2018.

A1.3 Differences between the major banks

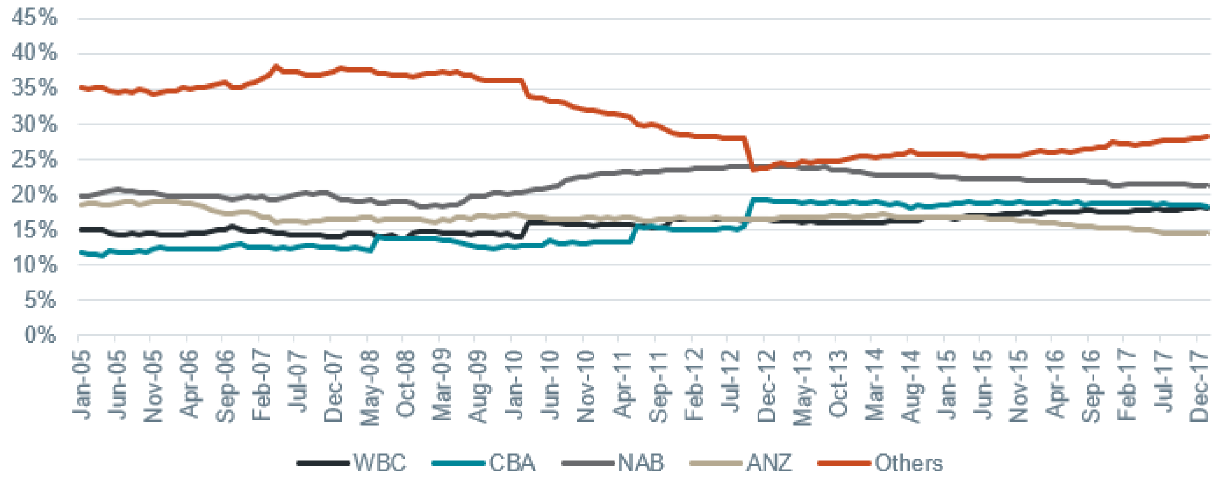
The major banks appear to have different comparative advantages across retail banking products. The share of supply for each of the major banks is not consistent across products, as shown in Figure A 4.1 and Figure A 4.2 below – Westpac and CBA currently hold a larger share of owner-occupier household loans, while NAB has a relatively higher share of business lending, reflecting NAB's emphasis on this product.

Figure A 4.1: Australian banks percentage of total owner-occupier household loans



Source: derived from APRA monthly banking statistics back series.

Figure A 4.2: Australian banks percentage of total non-financial corporations' loans



Source: derived from APRA monthly banking statistics back series.

A1.4 Switching costs

Switching costs are one-time costs that are incurred because a consumer switches a product from one bank to another, including:

- the cost of time, eg, filling out forms; and
- monetary costs, eg, mortgage registration fees and exit fees.

There have been several industry-led initiatives, together with developments at an individual bank level that have helped empower customers to switch quickly and easily.[164] For example, as noted by the PC, [165] the New Payments Platform's addressing service may make it easier for customers to switch financial institutions or products.

A1.5 Funding profile of major banks

The major banks fund lending operations primarily through shareholders' equity, customer deposits and wholesale funding from capital markets. The overall cost of funds is a blended rate that reflects the cost of each component.

Customer deposits make up the majority of bank funding, accounting for approximately 60 per cent of Australian banks funding composition.[166] Following from the global financial crisis, banks have shifted their funding base towards a greater proportion of stable deposits, with less emphasis on short term wholesale funding. Short term wholesale funding is considered the most risky source of funds, because its short duration means it has to be renewed more often, and if market conditions worsen, this renewal becomes more difficult.

More recently, new regulation requiring banks to hold a higher proportion of customer deposits further intensified competition for domestic deposits. As a result, interest rates on term deposits have increased significantly, increasing the cost of funding for banks.

Similarly, shifts from short-term towards longer-term wholesale funding, which is relatively more expensive, has increased the cost of funding.

The major banks share similar funding structures, but differ from regional banks and other players. We note that Australian banks are relatively efficient, in that they have a low cost to income ratio compared to overseas banks.[167]

One of the major differences is the reliance on deposits as a source of finance, with smaller banks being substantially more dependent on customer deposits.[168] This may be a result of the differences in scale of major banks and smaller ADIs. Smaller players (regional and mutual banks) typically target a niche subsection of the industry. This can be along the lines of regional banks targeting their home state (eg, Bank of Queensland) or mutual banks targeting specific professions (eg, Teachers Mutual Bank). The PC notes that this has been relatively successful for smaller institutions which have gained comparatively high market shares, albeit in niche customer groups.[169]

[164] Westpac, *Submission to the PC*, September 2017, p 31.

[165] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 41.

[166] See: Graph 1 RBA, *Developments in Banks' Funding Costs and Lending Rates,* http://www.rba.gov.au/publications/bulletin/2018/mar/developments-in-banks-funding-costs-and-lending-rates.html, accessed 15 March 2018.

[167] See: Figure C.25, Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 531.

[168] Bank of Queensland, *Regional Banks urge timely implementation of Financial System Inquiry recommendations,* 31 March 2015, p 2.

[169] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 4.

A1.6 Mortgage brokers

Mortgage brokers act as intermediaries between lenders and consumers. They help consumers by:

- providing information on a number of different home loan offers from a range of institutions (but not all institutions);
- explaining the various product features; and
- undertaking some of the administration that goes with applying and agreeing to a home loan.

The use of mortgage brokers has grown substantially,[170] indicating that consumers find them to be beneficial.

The use of mortgage brokers can be expected to increase the strength of competition between home loan lenders because, in effect, it increases the range of offers consumers are considering, and their understanding of the options available. It also provides a distribution channel for small banks that would not be able to afford a large number of branches.

A1.7 Regulatory landscape

Banking is one of the most heavily regulated sectors of the Australian economy, with significant regulation at the Commonwealth level, as well as being subject to international regulation (for those entities who operate internationally).

A key objective of Australia's financial regulation system is to ensure financial stability. In this section we give a brief description of the four key regulators in the sector.

A1.7.1 Reserve Bank of Australia

The RBA is Australia's central bank and is required to contribute to the stability of the Australian currency and financial system, full employment and the economic prosperity and welfare of the Australian people.[171] The RBA operates monetary policy in Australia, with their key tool being the setting of the cash rate. The RBA also promotes a safe, efficient and competitive payments system, regulating the system through its Payments System Board.

A1.7.2 Australian Prudential Regulation Authority

APRA is the prudential regulator of the financial services industry in Australia, overseeing banks, credit unions, insurance companies and much of the superannuation industry.[172] APRA and the RBA share overall responsibility for the stability of the financial system. APRA sets prudential standards which establish minimum standards for regulated institutions and have the effective force of law. Such standards include, among other things, liquidity, risk management, governance and capital adequacy.

A1.7.3 Australian Securities and Investments Commission

The Australian Securities and Investments Commission (ASIC) is the national regulator for consumer credit, finance and mortgage broking and other financial services.[173] ASIC also acts as the financial markets regulator, ensuring financial markets comply with legal obligations to be fair, orderly and transparent. ASIC grants financial services and credit licences in Australia, as well as registering auditors and liquidators.

[170] Productivity Commission, *Draft report into competition in the Australian financial system,* January 2018, p 212.

[171] See: https://www.rba.gov.au/about-rba/, accessed 23 March 2018.

[172] See: http://www.apra.gov.au/AboutAPRA/Pages/Default.aspx, accessed 23 March 2018.

[173] See: http://asic.gov.au/about-asic/what-we-do/our-role/, accessed 23 March 2018.

A1.7.4 Australian Competition and Consumer Commission

Although not specifically focused on financial markets, the ACCC plays an important role in financial system competition, through its reviews of competition issues relevant to the sector.[174]

A1.7.5 Other regulatory bodies

There are additional regulatory bodies which have responsibilities for regulation in the financial sector, including:

- the Australian Securities Exchange (ASX), responsible for operating the equity, derivatives and enterprise trading markets;
- the Australian Transaction Reports and Analysis Centre (AUSTRAC) is Australia's financial intelligence agency with regulatory responsibility for anti-money laundering and counter-terrorism financing; and
- the Australian Taxation Office (ATO), which administers Australia's tax and superannuation systems.

Australia's financial regulators work together to achieve their individual aims.

[174] See: https://www.accc.gov.au/about-us, accessed 23 March 2018.

A2. Market power and workable competition

This appendix discusses the meaning of the terms ‘market power’ and ‘workable competition’ in a competition economics context.

A2.1 Market power

Perfect competition is a theoretical construct under which competition is as vigorous as can be conceived. It involves many identical buyers competing to sell a homogeneous product to many sellers.[175] There are no barriers to entry, so that new firms will enter and undercut the incumbents whenever the price of the product exceeds its marginal cost of production.[176] It follows that, under conditions of perfect competition, prices are equal to the marginal cost of production,[177] and so firms do not earn any positive economic profit.[178]

Under perfect competition, every firm sets the same price and all firms increase or reduce their prices together because they all set their price at the marginal cost of production, which is assumed to be the same for all firms.

Total welfare is maximised under perfect competition because:

- prices reflect the marginal cost of providing the product, so that output increases to the point at which the benefit to consumers of increasing production by a small amount is equal to the cost of doing so – this is known to economists as **allocative efficiency**;
- costs of production are minimised because managers of firms have an incentive to do so, and because less efficient firms will not survive – this is known to economists as **productive efficiency**; and
- firms have an incentive to innovate and invest in new and better products that meet changing consumer tastes – this is known to economists as **dynamic efficiency**.

In contrast, a firm with market power has the ability to set and sustain prices above the competitive level.[179] Such a firm may exercise market power through:[180]

- not striving to reduce its costs;
- reducing the quality of its product below the competitive level; and/or
- setting a price above or reducing output below the competitive level.

These actions reduce welfare through the provision of an inferior product and/or a lower level of output, relative to that under perfect competition.

However, the assumptions necessary for competition to be perfect do not hold for the vast majority of real world markets. It follows that an individual firm may be able to set its prices at above their long run economic

---

[175] Morgan, M Katz, and Rosen, H, *Microeconomics*, McGraw-Hill Education, United Kingdom, 2006, pp 368-374.

[176] The cost of production includes the opportunity cost of not using resources for an alternative use.

[177] In economics, equilibrium refers to the circumstance in which it is in no one’s interest to change their production or consumption decisions. In practice, markets are rarely if ever in equilibrium, because the factors that guide consumption and production decisions are constantly evolving.

[178] Economic profit is any amount remaining once economic cost is subtracted from a firm’s revenue. Revenue is the sum of the payments that a firm receives from the sale of its output while economic cost is a firm’s total expenditures on the inputs used to produce that output, measured in terms of their opportunity cost. Perfect competition involves no risks to either buyers or sellers, since it involves an assumption that buyers and sellers both have perfect information. See: Morgan, M Katz, and Rosen, H, *Microeconomics*, McGraw-Hill Education, United Kingdom, 2006, p 220.

[179] See: Motta, M, *Competition Policy: Theory and Practice*, p 40-41; and Werden, *Identifying Market Power in Electric Generation*, Public Utilities Fortnightly, 15 February 1996. The competitive level is that which would eventuate under perfect competition.

[180] Firms may also undertake rent-seeking activities, whereby they lobby for rules that increase their market power. See: Motta, M, *Competition Policy: Theory and Practice*, p 44.

cost without losing all of its customers, and so many firms are periodically able to earn some amount of positive economic profits.

The ability of firms to derive returns on innovation and investment is critical for incentivising such activity.[181] If firms had no prospect of making a return on these investments, then dynamic efficiency would be significantly diminished. Some amount of economic profit, rightfully earned through the process of competition (eg, reduced costs, greater investment, a better product than rivals, etc, is therefore an important driver of competition and efficiency over time.

A2.2 Workable competition

The fact that perfect competition almost never arises has caused economists to discuss the idea of workable or effective competition, ie, the state in which competition is working as well as one might hope in a market economy.

The term 'workable competition' was first coined in 1940 by John Clark as a basis for describing competition in a market that is less extreme than the idealised benchmark of perfect competition, but serves as a realistic standard against which market power can be measured.[182] Clark notes that, in favourable circumstances, existing and potential competitors may provide a check on the tendency of firms to exploit market power over the long run by increasing prices or reducing output.[183]

Workable competition was described by the US Attorney-General's National Committee in its study of anti-trust laws in 1955 as follows:[184]

> The concept of "workable" or "effective" competition can perhaps best be described as the economists' attempt to identify the conditions which could provide appropriate leads for policy in assuring society the substance of the advantages that competition should provide…
>
> The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors, or new or potential entrants into the field, would keep this power in check by offering or threatening to offer effective inducements, so long as the profits to be anticipated in the industry are sufficiently attractive in comparison with those in other employment when all risks and other deterrents are taken into account. The result would be to force the seller who sought to increase his profits above this level by employing a high-price, limit-output monopoly policy either to give it up, or to lose ground to his rivals at a rate sufficient to reduce his profits, thus defeating the policy.

In other words, there are sufficient competitive constraints in a workably competitive market to keep prices and profits in check, at least to an extent.

The Hilmer Committee report on National Competition Policy defined workable competition as a benchmark against which market power could be measured, by reference to the level of prices that could be sustained:[185]

> In markets characterised by workable competition, charging prices above the level of long run average costs will not be possible over a sustained period, for higher returns will attract new market entrants or lead customers to choose a rival supplier or product.

[181] For example, patent laws confer a monopoly over newly developed production technology or products, in order to encourage innovation – of which the most widely recognised example is pharmaceutical patents that are designed to provide incentives for firms to develop new drugs.

[182] Clark, J.M, *Towards a concept of workable competition*, The American Economic Review, 1940, 30(2), pp. 241-256.

[183] Clark, J.M, *Towards a concept of workable competition*, The American Economic Review, 1940, 30(2), pp 246-247.

[184] United States, *Attorney General's National Committee to Study the Antitrust Laws*, Washington, D.C, U.S. G.P.O, p 320, 1955.

[185] Independent Committee of Inquiry on National Competition Policy, *National Competition Policy Review*, 25 August 1993, p 269.

The Hilmer Committee report also implicitly defined the 'long run average costs' as an 'efficient' level of pricing, noting that where workable competition was absent, firms may be able to price above the efficient level. More generally, the report noted that the 'promotion of effective competition and the protection of the competitive process are generally consistent with maximising economic efficiency'.[186]

Similarly, the Australian Competition Tribunal (the Tribunal) has said that a market is sufficiently competitive (a similar concept to workably competitive) to warrant the withdrawal of regulatory intervention if:[187]

> …the market experiences at least a reasonable degree of rivalry between firms each of which suffers some constraint in their use of market power from competitors (actual and potential) and from customers. The criteria for such competition are structural (a sufficient number of sellers, few inhibitions on entry and expansion), conduct-based (eg no collusion between firms, no exclusionary or predatory tactics) and performance-based (eg firms should be efficient, **prices should reflect costs** and be responsive to changing market forces). [emphasis added]

The Tribunal also summarised workable competition to be:[188]

> a market with a sufficient number of firms (at least four or more), where there is no significant concentration, where all firms are constrained by their rivals from exercising any market power, where pricing is flexible, where barriers to entry and expansion are low, where there is no collusion, and where profit rates reflect risk and efficiency.

To summarise, in a workably competitive market:

- the ability of firms to profitably set prices above (or quality below) the competitive level over the long term is constrained by the threat of (actual and potential) competitors, ie, firms cannot act independently of competitors and/or customers;
- there is no need for the government to intervene otherwise to constrain firms' market power; and
- the revenue earned by suppliers over the long term will approximate the efficient expected costs of supplying the product or service.

The converse is true for markets that are not workably competitive, eg, a firm will face weak restrictions in its ability profitably to set prices above the competitive level over the long term. This leads to the same welfare losses as set out above for when there is market power.

A2.2.1 Profitability

In a perfectly competitive market a firm's revenue will be equal to its total costs, implying that the rate of return on invested capital for a business is equal to its cost of capital for that activity.[189] Only when profits rise above this level may evidence be established that a firm has used its market power.

The role of profitability analysis as the basis for conclusions as to whether profits are above the competitive level has been described as a test for 'excess profits', which are defined as the difference between:[190]

- actual earnings before the deduction of interest charge – such as, earnings before interest and taxes or EBIT – of a firm; and
- a 'normal' profit or earnings measure, being the firm's cost of capital multiplied by its capital employed at the commencement of each measurement period (usually, a year).

[186] Independent Committee of Inquiry on National Competition Policy, *National Competition Policy Review*, 25 August 1993, pp 4-5.

[187] Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2, para 48.

[188] Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2, para 37.

[189] Gregory, A, *Excessive prices and the role of profitability analysis | OECD Roundtables Excessive Pricing*, February 2012, p 389.

[190] Gregory, A, *Excessive prices and the role of profitability analysis | OECD Roundtables Excessive Pricing*, February 2012, pp 390-391.

A similar approach to the definition of excessive profits has been adopted by:

- the New Zealand Commerce Commission in its pricing principles developed for Auckland, Christchurch and Wellington airports;[191] and
- the United Kingdom (UK) Competition Commission in its investigation of the aggregates, cement and ready-mix concrete market.[192]

The UK Competition and Markets Authority (CMA) has stated that:[193]

> … a situation where profitability of firms representing a substantial part of the market has exceeded the cost of capital over a sustained period could be an indication of limitations in the competitive process.

The economic and regulatory literature provides a number of insights on the practical implementation and interpretation of profitability analysis for the purposes of assessing market power. These include that:

- the relevant metric for evaluating market power is a firm's economic profits, ie, the difference between a firm's revenues, operating expenses and the *opportunity costs* of inputs used to make its sales, rather than accounting profits;[194]
- the role and estimation of a 'normal' rate of return that would be earned if there was workable competition, which is equal to the opportunity cost of capital;
- the measurement of profitability should be undertaken over the life of an asset;
- care must be taken to allocate joint and common costs appropriately;
- the economic value of a firm's assets should include both tangible and intangible assets, although it can be very difficult to value intangible assets; and
- any excess profits must be substantial and sustained to support a finding as to the exercise of market power, especially when profits can vary over a capital investment or business cycle.

Further difficulties in assessing market power using profitability measures, not specific to banking, including that:[195]

- the identification of firms with market power by reference to rates of profit alone would risk false positives, since there are many reasons other than the possession of market power as to why a firm may be earning abnormally high profits, such as above average levels of innovation, efficiency improvement or the absence of expected negative shocks;
- profit-based measures are subject to many practical implementation difficulties, such as determining the appropriate measure of cost for the purposes of measuring market power from company accounts;[196]
- firms can have different levels of prices for many reasons that may have nothing to do with market power, such as a lower cost of supply than other firms, a better product, or variances in demand or scale across markets; and

---

[191] NZ Commerce Commission, *Final Report | Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports*, 1 August 2002, p 169.

[192] Competition Commission, *Aggregates, cement and ready-mix concrete market investigation | Final report*, 14 January 2014, p 7.

[193] Competition Commission, *Guidelines for market investigations: their role, procedures, assessment and remedies*, April 2013, p 28. At the time of publication, the functions of the CMA were undertaken by the UK Competition Commission; these guidelines have been adopted by the CMA board and were last updated by the CMA in July 2017.

[194] See: Bork, Robert and Sidak, Gregory, *The Misuse of Profit Margins to Infer Market Power*, Journal of Competition Law & Economics, 9(3), September 2013, p 513.

[195] Office of Fair Trading, *Assessment of market power*, 2004, High levels of prices or profits are not mentioned as indicators of market power in: European Commission, *Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services*, July 2002.

[196] Motta, M, *Competition Policy: Theory and Practice*, p 116.

- the effect of market power can be to raise costs, which may mitigate the profit consequences of prices being above the competitive level.

A3. Process for being an ADI / entering the retail banking market

For the purposes of analysing barriers to entry in the market, we describe below the process and requirements for being recognised by APRA as an ADI, required for applicants wishing to carry on 'banking business' in Australia.[197]

Applicants must apply to APRA, with the licensing process generally taking between three and 12 months. The cost of application is $80,000.[198] The application process involves preliminary consultation with APRA, followed by submission of a (draft) application, and finally review of the application by APRA.

Under the requirements of the *Banking Act 1959* (Cth), only corporations can carry on banking business in Australia.

The applicant must have an adequate amount of start-up capital, with the level required being assessed by APRA on a case-by-case basis, based on the scale, nature and complexity of the operations of the applicant, but there is no set minimum requirement. If the applicant is requesting to operate as a bank, they must have at least $50 million in Tier 1 capital.

In addition, APRA sets a prudential capital ratio (PCR) of at least eight per cent of total risk-weighted assets – of which at least half must be Tier 1 capital – and a risk-based capital ratio over and above its PCR. New ADIs may be subject to a higher minimum capital ratio during the first several years of operations, determined by APRA based on the applicant's risk profile.

Under the requirements of the *Financial Sector (Shareholdings Act 1998* (Cth), individual shareholders may not in general hold more than 15 per cent of an ADI's voting shares. It is also a requirement that 'substantial' shareholders of any applicant must demonstrate to APRA that they are 'fit and proper', meaning they are financially sound and established entities. The purpose is to demonstrate that the ADI will be committed long-term to carry on 'banking business'.

APRA requires that the Board must be properly composed and functioning, as well as ensuring that people who have important roles in the proposed ADI are 'fit and proper' for purpose.

APRA sets further requirements regarding:

- risk management, with particular regard to credit, market, liquidity and operational risks;
- compliance, ensuring that applicants have compliance processes to meet APRA's prudential standards and other regulatory requirements;
- information systems, certifying that their systems are adequate for record keeping of all transactions and commitments undertaken by an ADI, including the integrity and security of such systems;
- audit requirements; and
- additional requirements for foreign applicants, where relevant.

[197] See: http://www.apra.gov.au/adi/Pages/how-to-apply-for-an-ADI-authority.aspx and http://www.apra.gov.au/adi/Documents/ADI-Guidelines-11-4-081.pdf, accessed 15 March 2018.

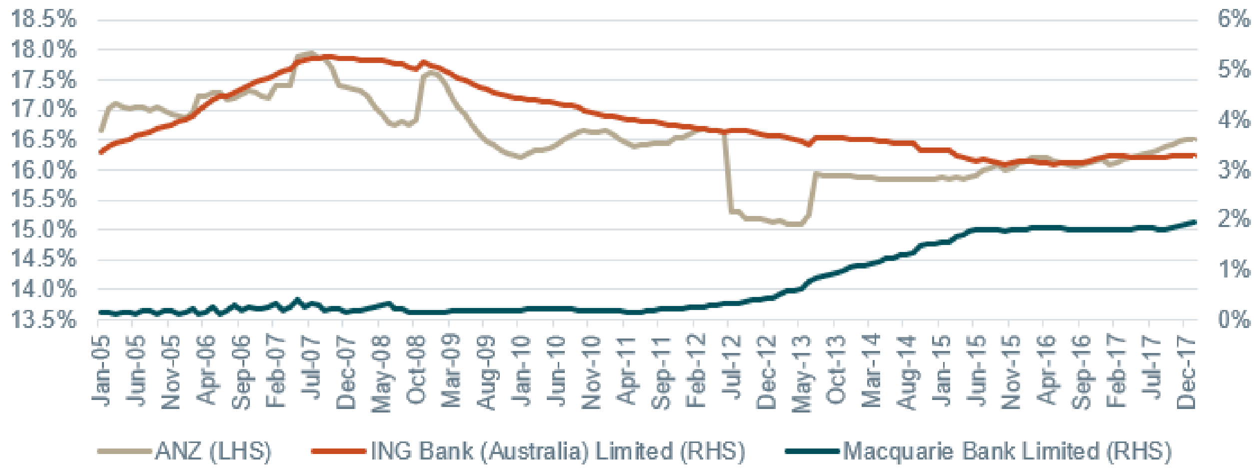
[198] Except where the applicant applies to be authorised as a specialist credit card institution or provider of purchased payment facilities, where the cost is $40,000.

A4. Evidence of expansion

This appendix sets out some examples of recent expansion for various products.[199]

Figure A 4.3 shows three examples of expansion or contraction by individual firms. Macquarie Bank increased its share of owner-occupier loans from close to zero up to around two per cent in just three years. ANZ's market share was very variable from 2007 to 2013, whilst ING's share fell from around five to three per cent over seven years.

Figure A 4.3: Examples of firms gaining and losing share in the supply of owner-occupier loans

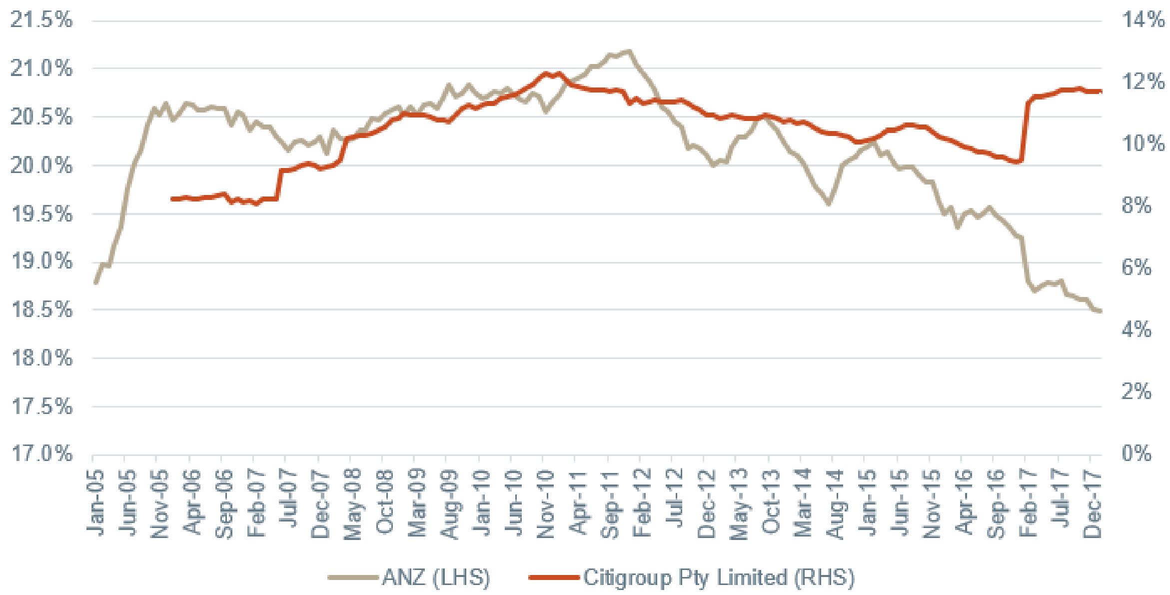


Source/notes: see Figure 4.3.

Figure A 4.4 shows two examples of expansion or contraction by individual firms. Citigroup increased its share from around 8 to 12 per cent in about three years, whilst ANZ's share has fallen from around 21 to 19 per cent over six years.

[199] These products were chosen because they were the only retail banking products for which we had the necessary data.

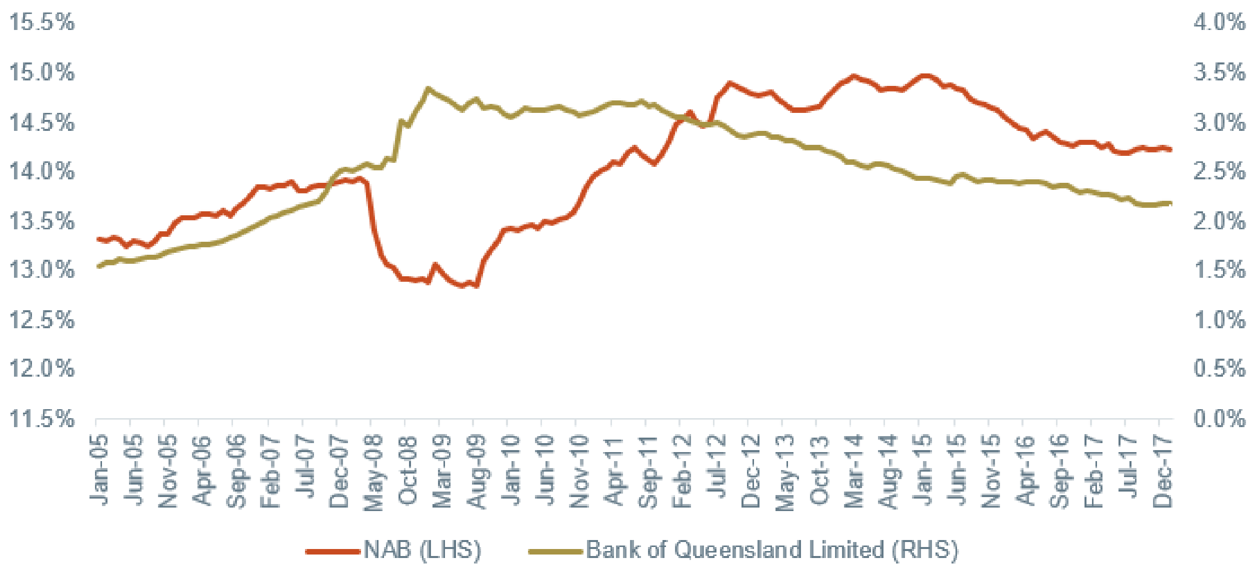
Figure A 4.4: Examples of firms gaining and losing share in the supply of credit cards



Notes/source: see Figure 4.3

Figure A 4.5 shows two examples of expansion or contraction by individual firms. NAB increased its share from 13 to 15 per cent over three years, whilst the Bank of Queensland's share increased from 1.5 to over three per cent over four years.

Figure A 4.5: Examples of firms gaining and losing share in the supply of household deposits

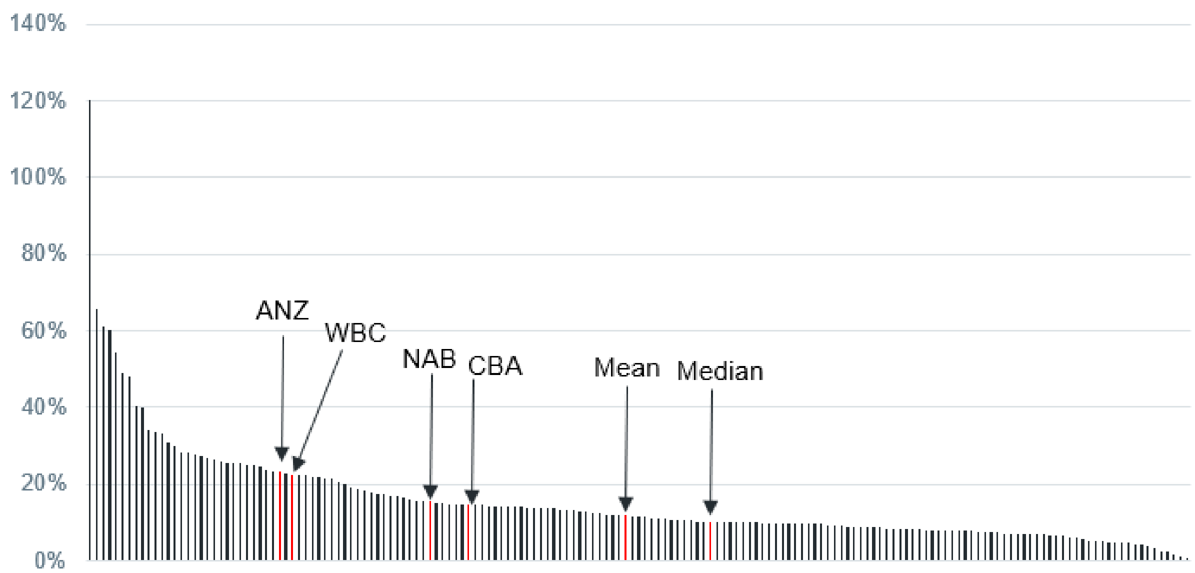


Source/notes: see Figure 4.3.

A5. Historical ROE of ASX200 companies

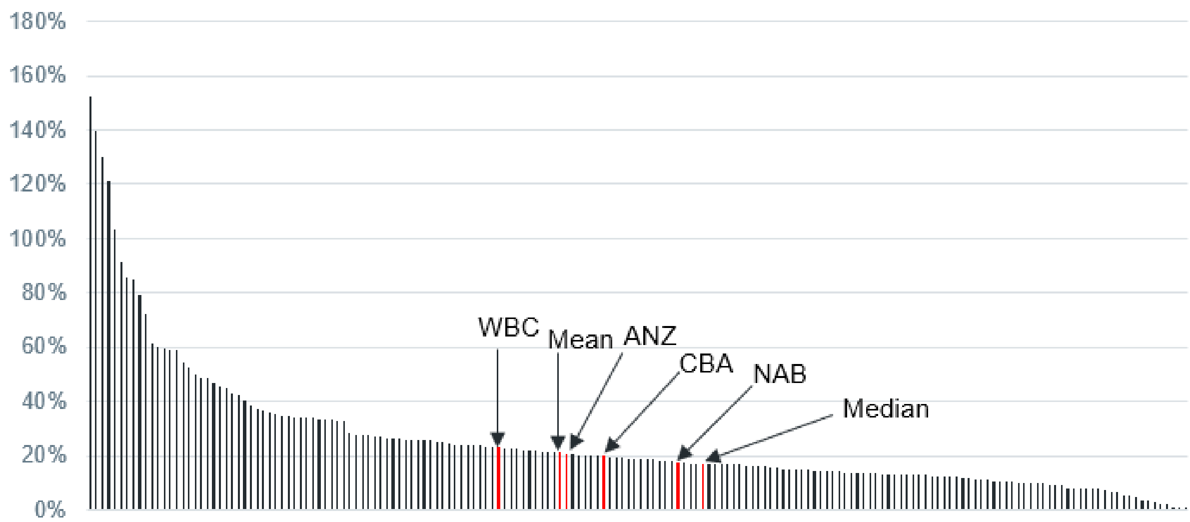
This appendix sets out the ROE of ASX200 companies over the past 15 years in five-year increments.

Figure A 4.6: ROE of ASX200 companies as at 31 December 2002



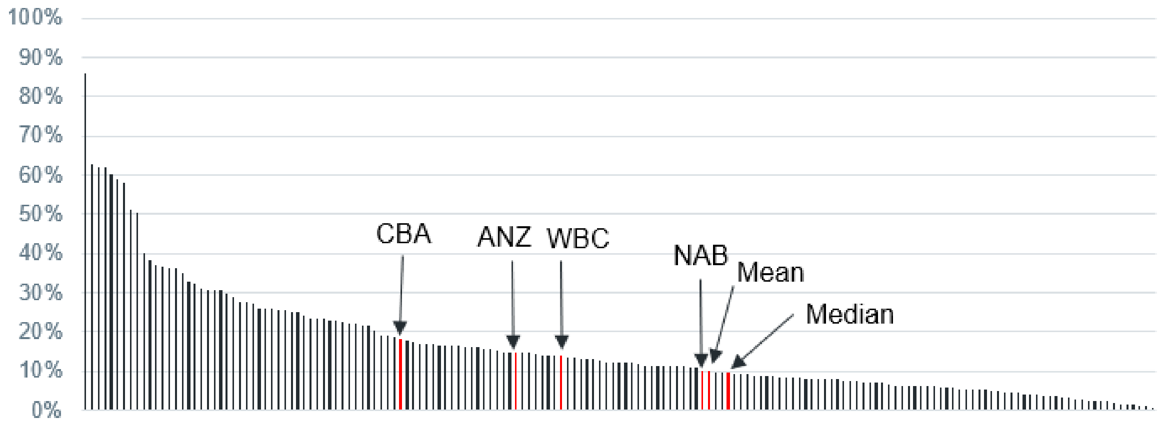
Source: Bloomberg data. Notes: the ROE is the return on common equity. The list of companies is those included in the ASX200 as at 31 December 2002. The ROE figure is the last reported annual figure as at 31 December 2002.

Figure A 4.7: ROE of ASX200 companies as at 31 December 2007



Source: Bloomberg data. Notes: the ROE is the return on common equity. The list of companies is those included in the ASX200 as at 31 December 2007. The ROE figure is the last reported annual figure as at 31 December 2007.

Figure A 4.8: ROE of ASX200 companies as at 31 December 2012



Source: Bloomberg data. Notes: the ROE is the return on common equity. The list of companies is those included in the ASX200 as at 31 December 2012. The ROE figure is the last reported annual figure as at 31 December 2012.

A6. New entrant and expansion methodology

This appendix sets out the methodology used to derive the number of new entrants as set out in Figure 4.1, as well as the number of banks that could expand into the particular retail banking products set out in Figure 4.2. The method is as follows:

- an indicator variable is created, based on company ABNs, to convey whether a company first appears in the APRA monthly banking statistics back series after January 2005;
- as there are various ways a bank may enter the APRA dataset after January 2005, those who have an active indicator for post-January 2005 have their initial reported value plotted;
- based on these plotted values, an appropriate figure for what may constitute an actual new entrant (as opposed to entering the dataset in alternative manner) is formulated, ie:
  - first reported owner-occupied loans must be less than $50 million;
  - first reported credit card loans must be less than $5 million; and
  - first reported household deposits must be less than $5 million; and
- banks that satisfied both the criteria of entering the dataset after January 2005 and their first reported value in the particular market considered was below the threshold above were deemed to be new entrants.

This method was undertaken to ensure a highly conservative approach to estimating the level of new entrants in a dataset that allows for a variety of reasons that banks may enter the dataset.

With respect to the calculation of the number of banks that could potentially expand into the retail banking products considered, the method is as follows:

- the dataset is restricted to January of 2018 (the latest reporting period available); and
- for each of the companies listed as reporting at this date, a variable is created for each of the retail banking products that returns TRUE if, and only if, the reported value of activity in that product is zero and reported activity in another product (the three retail banking products considered throughout the report as well as non-financial corporation loans and deposits) is positive.

HOUSTONKEMP
Economists

Sydney
Level 40
161 Castlereagh Street
Sydney NSW 2000

Phone: +61 2 8880 4800

Singapore
8 Marina View
#15-10 Asia Square Tower 1
Singapore 018960

Phone: +65 6817 5010