NATIONAL AUSTRALIA BANK SUBMISSION

Productivity Commission Inquiry into Competition in the Australian Financial System

22 September 2017

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1. Introduction

National Australia Bank (NAB) welcomes the opportunity to contribute to the Productivity Commission's (PC) Inquiry into Competition in the Australian Financial System.

Regular reviews on the state of competition in the sector, when undertaken by independent experts, can provide confidence to a broad range of stakeholders, including consumers, business, regulators, government, shareholders and investors — both in Australia and offshore.

In line with the 2014 Financial System Inquiry (FSI) recommendation to undertake a further review of competition in three years, this PC inquiry is an important step in understanding where the system can further improve.

1.1 About NAB

NAB is a diversified financial services organisation, headquartered in Australia, with a subsidiary bank in New Zealand and branches in Asia, the United Kingdom and United States.

NAB plays an important role in the Australia economy. In FY16, NAB:

- Paid $2.6B in tax (fourth largest tax payer in Australia);
- Distributed $5.1B in dividends;
- Had 582,000 shareholders;[1]
- Partnered with 1,700 suppliers; and
- Employed 34,000 people.

NAB's main products and services include:

- Consumer lending, deposits and transaction services; particularly residential mortgage lending, credit cards and term deposits;
- Small and medium enterprise (SME), corporate and institutional debt facilities, deposits, and transaction, custody and traded market services; and
- Superannuation products and services, financial advice, insurance.

As one of Australia's largest banks, NAB also plays an important role in financial intermediation; in particular, importing capital through participation in global wholesale markets.

1.2 Approach to the inquiry

Given the broad scope of the PC's terms of reference, NAB has structured its response around two themes — the state of competition and the regulatory framework. This submission addresses the relevant areas of inquiry as articulated in the terms of reference, and matters of interest voiced in NAB's meeting with the PC in Melbourne in July 2017.

[1] On NAB's Principle Share Register and FY16 Annual Financial Report.

2. Executive summary

A competitive, transparent and resilient financial system is critical to Australia's economic wellbeing; ensuring that consumers and businesses can be supported throughout all phases of the economic cycle.

This has been highlighted over the past decade by the post-Global Financial Crisis (GFC) focus on the increasingly global nature of finance – in regulation and the movement of capital. In addition, the ever increasing impact of technology and innovation has changed the market landscape substantially.

Australia's financial system is overwhelmingly efficient and delivers a competitive market that leads to good outcomes for consumers and businesses. This is evidenced by:

- Customers being able to choose from a wide range of providers, channels, products and services.
- Competitive pressures leading to improved customer price outcomes, (reflected in the long term trend of declining banks' Net Interest Margin (NIM)) and increasing satisfaction with the overall banking system.
- Innovation intensifying the competitive landscape; multiple new entrants and disruptive technologies are challenging existing business models, products and services, and customers have access to more information, choice and mobility.
- Vertically integrated models, which can leverage the size, capital and resources to offer customers more choice and benefits, where the businesses are managed and governed appropriately.

Australia's robust regulatory framework has ensured the financial system's stability and supported the growth of the Australian economy over the last 25 years; the goal of the regulatory framework, and reforms designed to improve it, should ultimately be to ensure financial stability, mitigate systemic risk and promote fair and just customer outcomes. Therefore it is important to consider:

- The impact of regulation and reforms on credit ratings and the ability of banks to compete in both domestic and global markets.
- The distorting effect that reforms can have on the market. For example, APRA lending caps can perpetuate structural differences in the home loan market and potentially promote the migration of customers to the less regulated shadow banking system.
- The importance of promoting practices that improve the management of credit risk, such as the Internal Ratings Based (IRB) approach to credit risk and comprehensive credit reporting (CCR).
- Barriers to entry or innovation in Australia's current banking regulatory framework.[2] Any decision to lower barriers, particularly related to licensing standards, risk management capability, or to increase market participants, needs to weigh the likelihood of improved customer outcomes against the additional risk that may be added to the system through loosened regulation.

[2] NAB notes the PC's separate inquiry into the Australian superannuation system, which will make recommendations to reduce barriers to competitiveness and efficiency of that system.

3. Overall perspective on the Australian financial system

The financial system plays a key role in the Australian economy. It drives growth and raises living standards by channelling capital from diverse sources to businesses, consumers and the community. Well-capitalised, profitable financial institutions with sound prudential and regulatory management have supported Australia's continued economic growth over the previous 25 years, despite several significant external shocks.

The significance of Australian banks as financial intermediaries is seen in the size of net financial claims between different sectors of the economy. Banks are involved in the majority of flows between the financial sector and the rest of the domestic economy, and account for around two-thirds of financial corporation assets and liabilities.

Australia is a net importer of capital and relies on the confidence of credit ratings agencies and international investment; benefiting from the ability of local banks to attract large pools of capital, particularly from the US, Europe and Japan. The continued willingness of international investors to deploy capital in Australia is the result of many factors, including sovereign and state credit ratings; the strong ratings, risk management and healthy profit levels of domestic banks; and high regard for Australia's regulatory framework.

This perception is reflected in The World Economic Forum's *'Global Competitiveness Index'*.[3] The index ranks Australia sixth out of 138 countries surveyed for 'Financial market development' – reflecting high levels of trust and confidence in the financial system. More specifically, Australia is ranked fifth in the 'Soundness of Banks' sub-component. In this way, the strong banking system also contributes positively to Australia's overall competitiveness.

The stability and attractiveness of the Australian financial system is integral to the continuing health and growth of the broader economy. This is inherent in the Australian Prudential Regulation Authority's (APRA) mandate to ensure a "stable, efficient and competitive financial system",[4] and the Australian Securities and Investments Commission's (ASIC) mandate to "contribute to Australia's economic reputation and wellbeing by ensuring Australia's financial markets are fair and transparent".[5]

The mitigation of financial stability risks must be balanced with the impact of regulation on competition and efficiencies in the financial system. Maintaining this balance is an ongoing challenge, with the ultimate benefit of enhanced customer outcomes and economic growth for the Australian community.

As a consequence, the financial system has been subject to a considerable number of inquiries, reviews and industry-led reforms since the GFC, with particular focus on competition, fairness and prudential and financial stability. The findings of these processes have affirmed the strength of the regulatory framework and have not revealed any systemic issues in competition or other matters.

[3] The World Economic Forum index is a comprehensive assessment of the competitiveness of economies worldwide, providing insights into their key drivers of productivity and prosperity.

[4] APRA, http://www.apra.gov.au/AboutAPRA/Pages/Default.aspx.

[5] ASIC, http://asic.gov.au/about-asic/what-we-do/our-role/#priorities.

4. Competition in the financial system

4.1 Competitive landscape: Contestability and concentration

The Australian financial system has a large number of contestants and products and services, with choice of a wide range of providers, channels, and offerings.

- Australia has 148 Authorised Deposit-taking Institutions (ADIs) in 2017, including the four major banks, foreign-owned banks, regional banks, building societies and credit unions, offering a wide range of products and value propositions.
- Numerous non-bank system participants include Australian Financial Service licensees (regulated by ASIC) (e.g. remittance service providers, peer-to-peer lenders, wholesale funders), and new disruptive entrants including financial technology companies (FinTechs).

Table 1: ADIs in Australia over time

Number ofinstitutions	2004	2009	2013	2017
Major banks	4	4	4	4
Other domestic banks	10	10	17	29
Foreign subsidiary banks	10	9	8	7
Foreign branch banks	28	35	40	44
Credit unions and building societies	188	125	95	58
Other ADIs	7	8	7	6
All ADIs	247	191	171	148

Source: APRA

NAB believes a competitive market provides customers with more choice in channels and offerings, and therefore better outcomes. In this spirit, NAB does not oppose regulatory changes that ease barriers for new entrants, provided that such changes are appropriately calibrated to ensure management of risk in the system.

Reflecting this availability in choice, more consumer and small business customers are now using brokers to obtain finance; over 50 per cent of residential home lending in Australia is now originated through broker channels, and over 200 credit cards are available in Australia from approximately 60 providers.[6]

Additionally, many products are seen as fungible if they achieve the same outcome for a customer. For example, a customer may choose between a personal loan and a credit card to finance a purchase. As such, NAB believes that product markets should not be narrowly defined and that competition takes place across multiple product groups.

4.1.1 Profitability measure: NIM

Commentary on banks' competitiveness tends to focus on the increase in absolute returns, particularly net profit. It is often presented as evidence of a lack in competition. However, the increase in absolute returns is a function of many factors, including growth in lending assets

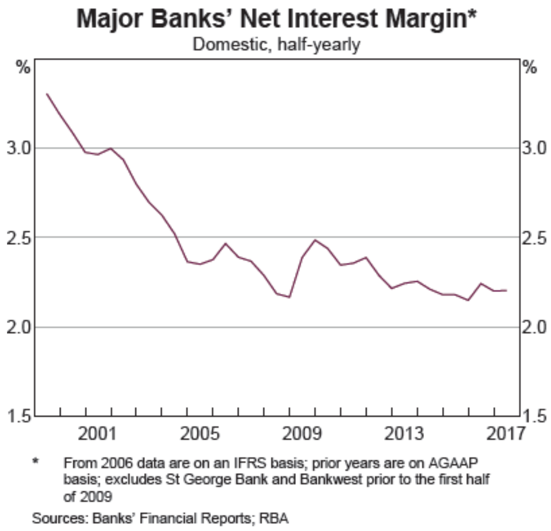
[6] Canstar, https://www.canstar.com.au/star-rating-reports/credit-cards/.

and lower operating expenses, and does not paint an accurate picture of competition in the financial system.

The competitive landscape in Australia is better demonstrated by the long-term trend in NIM.

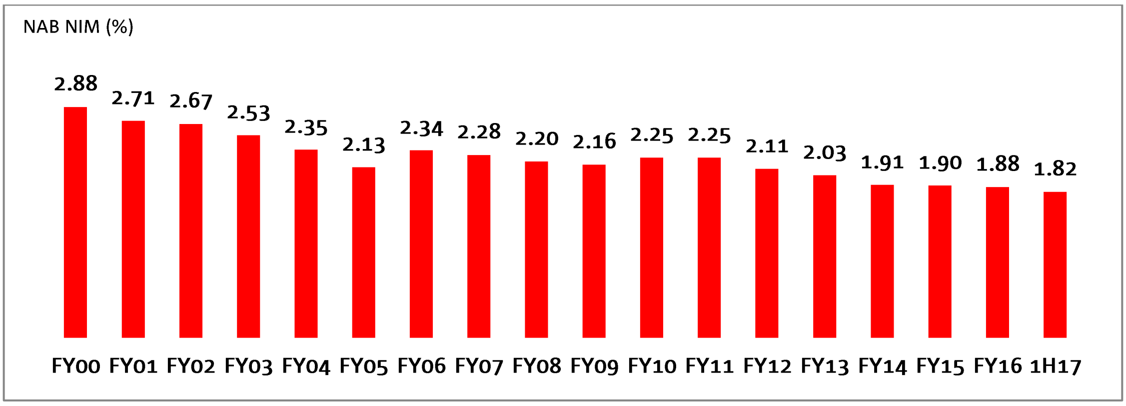
NIM is the difference (or margin) between the rate at which a bank borrows and lends funds. Downward pressure on NIM of the major banks is demonstrative of increasing competitive pricing pressures and eroding margins.

Figure 2: Profitability indicator – NIM



The strength of competition in the Australian financial system has led to a decline in NAB's Group NIM by more than one hundred basis points from 2000, to 1.82 per cent at March 2017. As noted by the RBA, NIM across industry has remained around historic lows since the GFC.[7]

Figure 3: NAB's declining NIM since 2000



Source: NAB Group NIM, 1H17 Investor Presentation

[7] Reserve Bank of Australia, *Submission to the Financial System Inquiry*, March 2014, p158.

4.1.2 Customer outcomes

Customer satisfaction is integral to a sustainable banking model. For many years, banks have used customer satisfaction indicators to understand how customers view the choice, cost, service provision and appropriateness of banking in Australia.

NAB believes customer satisfaction is also indicative of competition in the market. The general upward trend reflects banks' significant investments in innovation designed to improve customer experience and remain competitive.

Figure 4: Customer satisfaction with the banking industry

Source: *Roy Morgan Consumer Satisfaction Report, June 2017, average 6-month sample n=25,040.*

To provide a more detailed analysis of customer satisfaction, NAB uses the Net Promoter Score (NPS) to make the customer the main focus for all NAB employees, including linking staff remuneration to customer advocacy levels. NAB uses the NPS to track customer advocacy in real time and to assess how to improve interactions with customers. Operationally, NAB uses customer feedback to address "pain points",[8] and has implemented initiatives that have addressed over 200 "pain points".

4.1.3 Technology and digital innovation

Innovation has fundamentally changed the nature of banking and customer interactions with banks, intensifying competition in the industry even further. Increasing digitisation has led to better transparency, mobility and customer outcomes as access to information and options improves.

NAB's experience reflects the general trend of customer uptake in digital banking channels, with 169 per cent growth in mobile logins to the NAB mobile internet banking (MIB) app and 71 per cent growth in value transactions made in MIB since 2013. Increasingly, customers are

[8] "Pain points" are root cause problems that negatively impact on the customer experience.

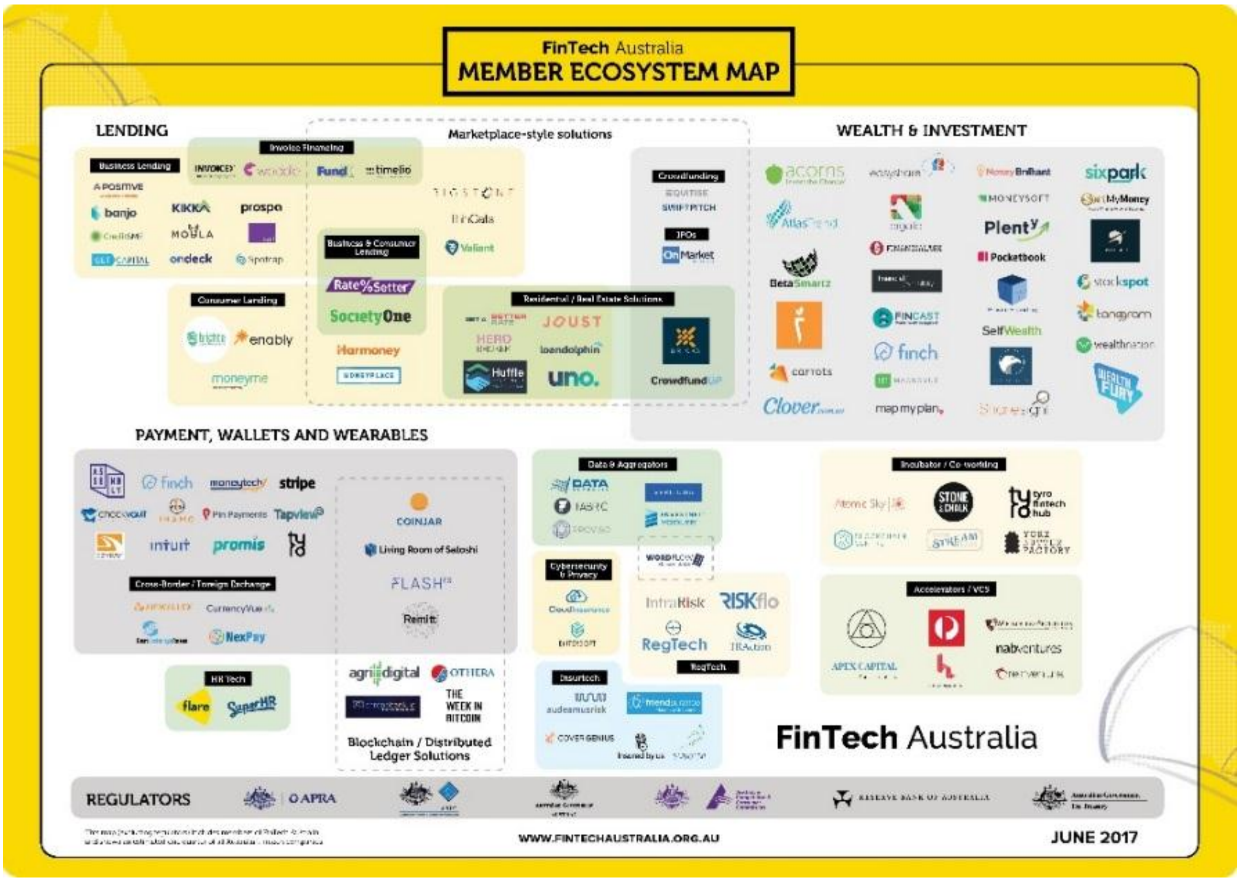
also purchasing bank products online, unassisted by bankers, with 26 per cent of personal loans drawn digitally and 27 per cent of credit cards opened online since October 2016.

Developments in technology are allowing organisations to access a much wider potential customer base, and have led to an increase in new entrants and segmentation in the financial system. In turn, new business models are emerging with the potential to materially impact financial services and further increase competition.

For example, the digitisation and modularisation of financial services has led to a rapid increase in the number of personal finance management tools and digital wallets that help customers manage their money (e.g. Acorn, Mint, Pocketbook and You Need a Budget). Collectively, digital wallets have created more financial awareness among consumers and improved transparency.

Third party mobile wallets (e.g. Apple Pay, Android Pay, Samsung Pay and PayPal) are also changing the competitive landscape. These participants are likely to extend more broadly into financial services, beginning with everyday banking.

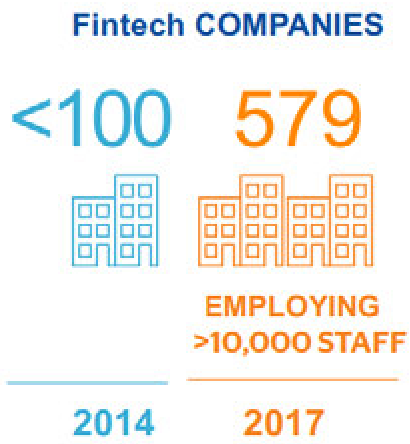
Figure 5: Snapshot of Fintech segments in Australia (2017)



Source: FinTech Australia

A growing number of new entrants are stepping into this environment, from startup FinTechs to global technology companies with extensive networks, established brands and significant capital. These participants are currently 'unbundling' the traditional end-to-end role of banks, stimulating the progressive modularisation of financial services. Disruptive business models include integration of financial services into ecosystems, payments systems, and blockchain technology.

Figure 6: No. of Fintech companies in Australia



Source: KPMG

NAB's submission to the PC's draft report into *Data Availability and Use* notes agreement in principle to sharing customer data with other institutions, subject to appropriate security safeguards. Greater data sharing will enhance competition and improve customer outcomes, and NAB will continue to engage in this issue through the current review into Open Banking in Australia.

The regulatory treatment of differently licensed financial service providers can also affect competition, promoting new entrants and innovative business models. For example, the ASIC regulatory sandbox framework allows FinTechs to test certain products and services for twelve months without an Australian financial services or credit licence.

4.1.3.1 New Payments Platform (NPP)

The rapid evolution of technology and customer expectations is driving three major trends in payments:

i. Frictionless digital payments;
ii. Value add services; and
iii. New banking networks.

The NPP will see these trends delivered to customers, by providing the ability to transact between different financial institutions in real time. As an open platform, NPP will allow partnerships with FinTechs to deliver new services. The introduction of registered alias PayIDs (e.g. phone number, email ABN/ACN) will also make it easier for customers to switch banks.

The NPP reflects significant industry investment in payments technology and will promote innovation and competition. Banks, payment providers and FinTechs will compete to provide services at different points in the value chain, with some focusing on seamless and value-add services such as integrated or embedded payments, and others on enhancing security and trust.

NAB intends to offer a broad rollout of NPP to consumers and businesses to make and receive payments and create PayIDs. Customers will benefit from better customer experiences and more integrated and efficient processing.

The NPP investment, undertaken by participating members, also highlights the benefit that well capitalised organisations with significant resources can bring to innovative banking solutions, as demonstrated by the collaboration of industry and regulators to develop this national piece of infrastructure. Considerable focus has also been paid to ensuring the security standards and governance requirements for NPP participants; reflecting the fact that maintaining customer confidence in the security of financial services is paramount to any innovation in the sector.

4.1.3.2 Investments in innovation

Customers' expectations of and the nature of their interactions with financial services companies are changing. *NAB Labs* is NAB's response to this changing landscape. Investigating current challenges, analysing trends, developing prototypes and iteratively delivering solutions, *NAB Labs* allows disruptive innovation to go to market quickly and efficiently. An example of this is QuickBiz loans, discussed in detail below.

NAB also recognises the importance of new market entrants in challenging the current state of financial services. *NAB Ventures* is NAB's corporate venture capital fund, launched in 2015, with the aim of investing $50M over three years. It takes strategic equity stakes in FinTech start-ups with unique value propositions that may benefit our customers. This can facilitate access to innovative business models and technology for NAB and our customers, while also allowing start-up companies to leverage NAB's distribution channels and expertise in technology, compliance and scaling businesses. To date, NAB's investments include Data Republic, Medipass, Veem, Wave and Basiq.

4.1.4 Vertical integration

As part of our focus on customer outcomes, NAB believes that vertically integrated (VI) business models can offer significant benefits, where they are properly managed and led.

VI businesses give customers more secure, convenient and holistic access to financial services, and in well run and capitalised institutions, more robust consumer protections and remediation when required.

Criticism of VI businesses has focused on the potential for remuneration structures to become conflicted and the selling of in-house products. NAB recognises these concerns and believes that they can be managed through:

- Appropriate governance and remuneration structures;
- Marked-to-market product selection processes;
- Regular market surveillance to ensure parity or better offers;
- Building consumer engagement;
- Reviewing and monitoring advice; and
- Rigorous compliance frameworks.

NAB continues to work with consumers, industry participants, regulators and policy makers to address these issues. NAB has committed to implementing all the final recommendations of the Sedgwick Review into Retail Banking Remuneration Review, supports the Future of Financial Advice (FOFA) reforms legislated in July 2013, improvements to the professional standards and educational qualification of financial advisers which were passed in 2017, and the Life Insurance Framework amendments coming into effect from January 2018.

4.2 Competition for consumer and SME outcomes

In response to the inquiry's terms of reference, NAB has considered the degree and nature of competition along major product lines. It is important to note that while these product lines are distinct, they are also fungible in many circumstances.

There is strong evidence of competition in the consumer and SME segments, demonstrated by:

- Reduced margins and fees;
- Increased investment and innovation in products and services;
- A growing number of competitors; and
- Improved customer outcomes.

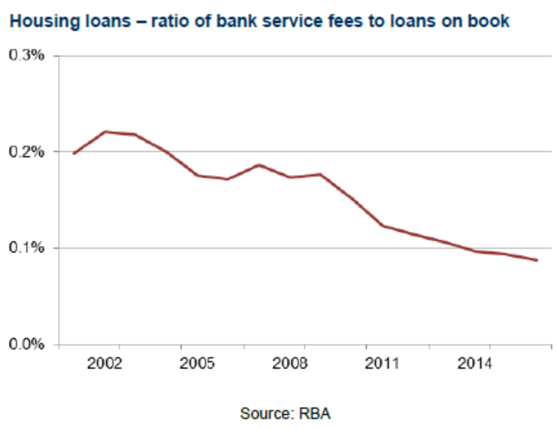
NAB also notes existing consultations and inquiries:

- Treasury Review into Open Banking in Australia;
- Treasury consultation paper on "Credit Cards: Improving consumer outcomes and enhancing competition"; and
- Australian Competition and Consumer Commission Inquiry into Residential Mortgage Products Pricing.

4.2.1 Mortgages for households, including broker services

Residential mortgage lending is a significant proportion of overall Australian bank assets. Currently, prices paid for Australian residential mortgage products are around their lowest in history, in both absolute and marginal terms. Additionally, the ratio of bank service fees to loans is declining.

Figure 7: Bank service fees to loans



The abolition of mortgage exit fees in June 2011 has also seen improved customer outcomes and increased competition, with customers better able to refinance to another financial institution. NAB recognised these benefits, removing mortgage exit fees in 2010 and in some cases paying the mortgage exit fees for customers wishing to refinance to NAB.[9]

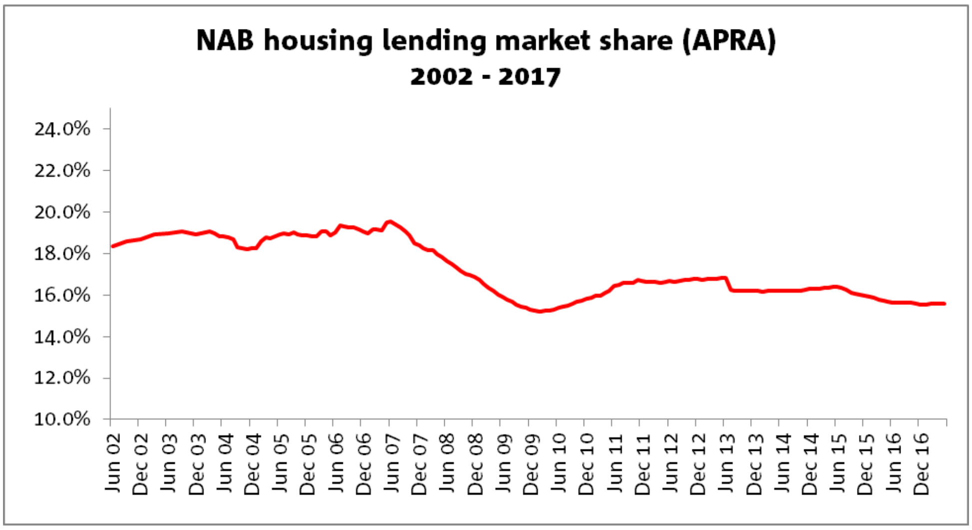
An important competitive dynamic in residential mortgage lending is the nature and number of market participants. Key market participants include the major and regional banks, and non-bank lenders. Peer-to-peer funding is also increasing to meet the borrowing needs of foreign investors following APRA changes to ADI lending caps.

Commentary on the consolidation of market share by the major banks following the GFC has sometimes suggested this consolidation is related to a lack of competition. NAB does not believe this is the case; while the major banks have collectively increased their market share in residential mortgage lending, this is attributable to two specific events around the time of the GFC:

i. The acquisitions of BankWest by Commonwealth Bank and St George by Westpac; and
ii. The disruption to securitisation markets, which affected the ability of non-bank lenders to compete vigorously.

As at March 2017, NAB's market share in the residential mortgage lending market was 15.6 per cent, a decline of 70 percentage points since March 2015.[10] NAB's NIM on residential mortgage lending was also at an historic low as at March 2017.

Figure 8: NAB housing lending market share



Source: APRA

Importantly, headline standard variable rate prices do not reflect actual customer rates. Discretionary pricing is applied to 70 per cent of applications for new NAB-branded residential mortgage products (as at June 2017). 25 per cent of existing (back book) products are re-priced each year.

[9] NAB, *NAB to Continue to Pay the Early Exit Fees for Westpac and CBA Mortgage Customers*, 2011, https://www.nab.com.au/about-us/media/media-releases-2011/nab-to-continue-to-pay-the-early-exit-fees-for-westpac-and-cba-mortgage-customers.
[10] NAB First Half Investor Presentation, March 2017.

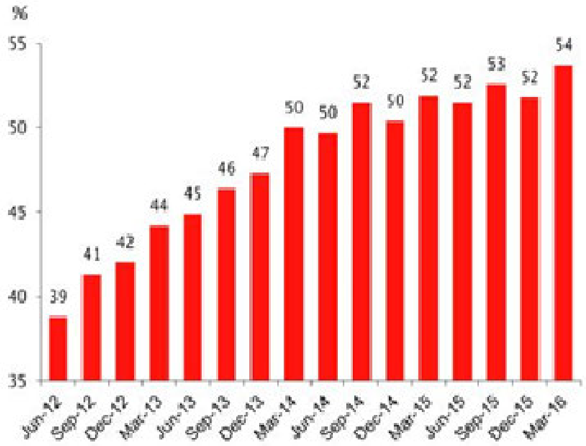
Digital disruption to property transactions is also improving customer experiences and outcomes. NAB is a long term advocate of e-conveyancing, and has worked with PEXA (Property Exchange Australia) since 2013 to offer digital settlement processes. This allows registration and funds disbursement to be completed instantly and offers improved security and transparency. The benefits derived from e-conveyancing have meant that standalone mortgages and refinancing transactions must be lodged electronically in some states, where the mortgagees are ADIs.

4.2.1.1 Mortgage brokers

Brokers play an important role in customer and competitive dynamics of the residential mortgage market.

Broker-originated mortgages are increasing, with 54 per cent of Australian home loans originating via this channel in 2016. Brokers can assist time poor customers to assess mortgage products across different financial institutions and offer a differentiated and competitive value proposition compared with banks. Similarly, the growth of online comparison sites empowers customers to compare mortgage products more easily.

Figure 9: Home loan originations from broker channel



Source: Macquarie Research

In addition, Australia has approximately 16,000 brokers, many of whom are small business owners, which form a significant part of the Australian economy.

NAB is a lender of mortgages sold by individual mortgage brokers to consumers, and also distributes white label mortgages through a NAB-owned business, Advantedge. NAB also owns three VI aggregators, PLAN Australia, Choice Aggregation Services and FAST, which represent approximately 30 per cent of brokers in the market and provide access to approximately 40 lenders and products. NAB's continued investment in aggregator systems and processes supports brokers to run their businesses.

This VI model offers significant benefits to consumers, provided the appropriate remuneration, compliance and governance structures are in place. NAB, and each owned aggregator, has rigorous processes to manage conflicts, including perceived conflicts, to protect the interests of customers and brokers. NAB supports brokers to deliver good outcomes for their customers, including through providing access to systems and technology; support with professional and business development; and assistance with licensing and compliance. Furthermore, NAB does not pay volume-based incentives on mortgages to mortgage brokers.

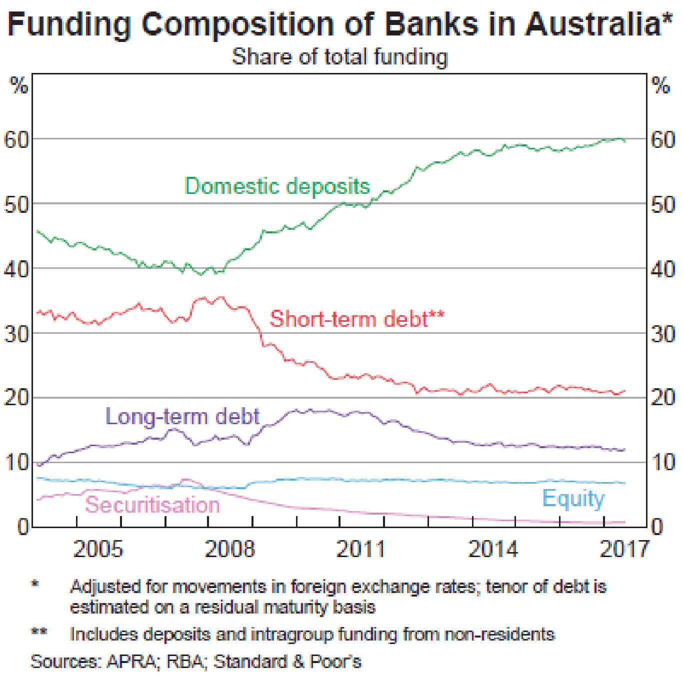
NAB also notes the six recommendations outlined in the ASIC review of mortgage broker remuneration. NAB broadly supports these proposals and is looking at ways to implement them.

4.2.2 Deposits

The GFC has had a lasting impact on the importance that banks (and regulators) place on stable deposits as a critical source of balance sheet funding. Post-GFC regulations (particularly APRA's implementation of the Basel III framework) have led to a premium on the value of consumer (retail) and SME deposits, and on medium and long-term contractual tenor wholesale deposits and term funding.

All Australian banks have thus increased the portion of their assets funded by customer deposits and reduced their reliance on short term wholesale funding, resulting in strong competitive pressure for deposits. The major banks have collectively lost around 84bps in deposits market share since the GFC.

Figure 11: Funding composition of Australian banks



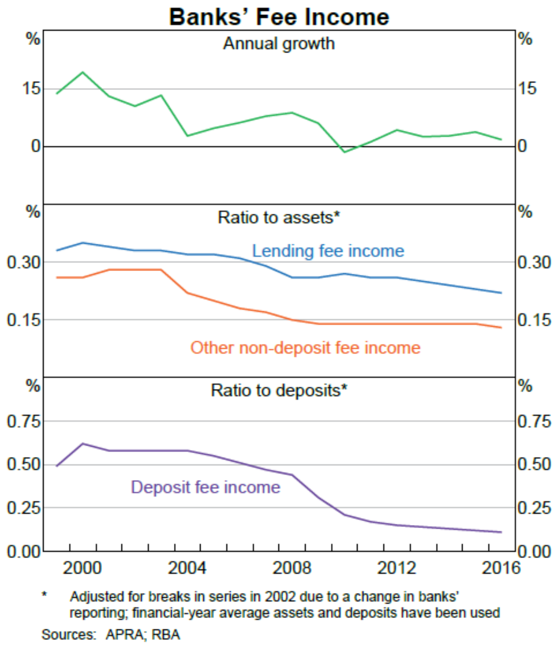
Banks are now competing aggressively on price and service for personal deposits.

In line with the increasingly low interest environment, actual customer rates on deposits have been on a steady decline over the last decade. However, the majority of savings and investment deposit products are now priced above short-term wholesale benchmarks (cash rate and bank bill swap rate), rather than below, as was the case before the GFC. Since 2016, the RBA cash rate has decreased on two occasions from 2.00 per cent in April 2016 to 1.50

per cent (current) in August 2016. NAB's at-call retail savings rates have decreased by a similar amount to cash rate changes, however six month and 12-month term deposits rate have only decreased by 25bps and 0bps respectively over the same period.

Competition for domestic customer deposits has also led to a large shift away from product-focused sales to holistic customer offerings, demonstrating a fundamental shift in banking. This can be seen in the declining ratio of fees to deposits; currently, NAB is the only major bank to offer a fee-free, eligibility-free basic transaction account product to all customers. This reflects the broader the long-term trend of reducing fees across products and services as banks seek to provide a competitive, outcome-focused proposition to customers.

Figure 10: Banks' fee income



4.2.3 SME credit and financial services

As Australia's largest business bank, NAB held approximately 21.5 per cent market share of business lending as at March 2017. NAB has a long history of supporting the SME segment, and in November 2015 committed to lend $2B monthly to Australian businesses.

4.2.3.1 Competition for SME lending

In the years following the GFC, Australia has experienced historically low interest rates, improving economic outlooks and availability of credit. NAB's August 2017 Monthly Business Survey shows business conditions at their highest level since 2008, and an improving trend in business confidence. Despite this, business investment is lower than anticipated, with some commentary suggesting this is due to a less competitive market and SMEs' ability to access finance.

There is evidence that SME financing is competitive, with contestability and innovation across a large number of market participants. There are increasing numbers of new market entrants, including FinTechs such as Spotcap. Additionally, many financing products are transparent and commoditised, giving customers the flexibility to choose a provider. For example, in foreign exchange (FX) trading, the number of non-bank FX and international payment providers has increased from 32 to 72 in the past two years. The NPP will further intensify competition in FX markets, due to the ability to instantly transfer funds between different providers.

NAB believes the lower than expected business investment by SMEs is more likely due to demand-side issues, rather than a lack of competition. In a 2013 report, 89 per cent of SMEs did not see access or capacity to finance as an "issue". [11] Research has also suggested that both "sources of" and "access to" finance are not major concerns for Australian small businesses.[12]

4.2.3.2 Simplifying business lending

There is a need for increased transparency and simplicity in interactions with SME customers, who are often time-poor and rightly prefer to focus on their core businesses. Earlier this year, NAB announced improvements to lending transparency and certainty, through our small business simplification agenda. A key outcome of this agenda is the work underway to simplify and use plain English in small business lending contracts by the end of 2017.

This approach extends to improving product and service offerings with the use of technology, particularly through innovations developed in *NAB Labs*. NAB's QuickBiz platform is a significant step in delivering better outcomes and simpler processes for SME customers.

QuickBiz was launched in response to customer demands for better servicing and transparency. As an online unsecured lending product, it assesses business performance based on cash flow strength to provide fast access to lending. Decisions are made in less than five minutes and funding is available within one business day. In July 2017, Overdraft and Business Cards were introduced to the QuickBiz platform to provide more options to suit small business customers' needs.

4.2.4 Other credit products

4.2.4.1 Credit cards

The credit card market is highly competitive, with an increasing number of participants and a multitude of product features. Many customers are frequently attracted to additional credit card options, such as rewards programs, insurance and global access to credit.

Reflecting the high levels of competition, as at March 2017, the major banks' market share was at 82.4 per cent, a decline of 1.6 per cent since July 2014. As a proportion of the total value of transactions on credit cards, fees have fallen to 0.5 per cent – the lowest level in 10 years.[13]

NAB is continuing to evolve its credit card offerings and end-to-end processes to improve customer experience and compete effectively, including investment in online applications

[11] ABA, Small Business: Access to Finance – Year to March 2013.

[12] S. Holmes and D. Gupta, *Opening Aladdin's Cave: Unpacking the Factors Impacting on Small Businesses*, 2015, http://www.rba.gov.au/publications/confs/2015/holmes-gupta.html.

[13] ABA, *Fees for Banking Services Report*, http://www.bankers.asn.au/images/uploads/ArticleDocuments/163/Fees_for_Banking_Services_2015_Report.pdf.

and closures, digital wallets and the new NAB rewards program. For example, NAB facilitates a customer switching to a lower rate card within 72 hours and, as with all products and services, will support customers though hardship programs when needed.

4.2.4.2 Personal loans

The personal loan market is undergoing significant change and innovation. Participants include auto finance companies, finance companies, banks, credit unions, building societies and peer-to-peer lenders. NAB's market share is 10.7 per cent as at March 2017, a small increase from 10.1 per cent in September 2015.

The growth of risk-based pricing, particularly by banks and peer-to-peer lenders, will create more competition for low-risk customers. New peer-to-peer lenders are emerging, including RateSetter, SocietyOne and Harmony. In January 2016, SocietyOne originated $8.7M of new loans compared with NAB's $89M. This is a significant volume for a new entrant, and will have a material impact on the market, particularly in aggregate with other peer-to-peer lenders.

Similarly, point-of-sale finance is rapidly transforming the competitive landscape. Entrants such as ZipMoney and After Pay replace the need for a credit card, bank-originated loan or other transaction service such as PayPal.

4.2.4.3 Financial inclusion: Affordable finance

Access to affordable finance and consumer protections are vital for greater financial inclusion in Australia. Small-amount credit contracts often have high interest rates, fees and charges, and can sometimes be seen as the only choice by customers with acute, short-term cash flow needs.

To provide alternatives to Australians excluded from mainstream finance, NAB has partnered with not-for-profit Good Shepherd Microfinance and the Federal Government to provide fair and affordable finance for communities around Australia since 2003. $212M in loans has been provided by two schemes:

- The No Interest Loan Scheme (NILS) offers no-interest loans between $300–$1,200 for essential goods and services, such as fridges, washing machines or education expenses
- The StepUP loan provides low-interest loans of between $800–$3,000 with no fees and affordable repayment periods.

Seven Good Money stores around Australia have been established through a joint initiative between Good Shepherd Microfinance, NAB and the relevant State Governments (Queensland, South Australia and Victoria), offering a competitive alternative to pay day lenders. Nationally, Good Money has served more than 33,000 customer interactions, approving almost 6,000 loans valued at over $8.5M since 2012.

One in eight Australians experienced severe or high financial stress and vulnerability in the past year and one in seven Australians have no savings at all.[14] An increasing number of customers often need urgent access to financial services and products, and many are turning

[14] A. Marjolin, K. Muir, I. Ramia and A. Powell, *Why is financial stress increasing? Financial Resilience in Australia 2016 – Part 1*, Centre for Social Impact (CSI) at UNSW Sydney, 2017.

to online small-amount credit contracts. NAB has supported Good Shepherd Microfinance to develop Speckle, an online small loan product that is being piloted in Victoria and Tasmania. Speckle will provide more affordable small loans for people who cannot access NILS and StepUP or mainstream financial services.

5. Regulatory framework and policy

Australia's "twin peaks" regulatory model has played an integral role in preserving Australia's financial stability during external shocks and protecting consumers. However, a safer banking system, particularly with regard to capital ratios, liquidity holdings and risk weights, has resulted in a more expensive banking system compared to similar international markets.

5.1 Domestic market

The impact of reforms on financial stability and credit ratings, particularly those reforms intended to improve competitiveness of the domestic market, need to be considered in any review of financial systems.

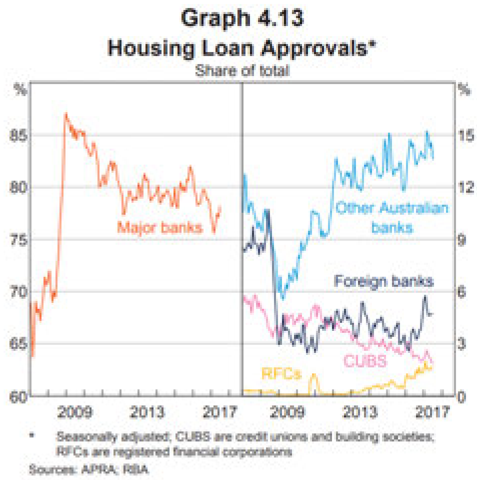
5.1.1 Market structure

5.1.1.1 Shadow banking

The interaction between regulated ADIs and less regulated or un-regulated entities needs to be considered. These entities can affect financial stability throughout the economic cycle and their different regulatory regimes can distort competition. The impact of disruption is only likely to increase, with the possibility of global technology companies developing new banking ecosystems and infrastructure outside of existing regulatory and prudential frameworks.

While data is limited, evidence that shadow banking activities have risen in Australia since 2014 is apparent in the rapid growth in these entities' balance sheets.

Figure 12: Market share of home loan originations (RFCs: Shadow banks)



In times of strong economic growth, shadow banks are likely to increase their share of financial system assets. However, shadow banks lack the support mechanisms of regulated ADIs, such as central bank liquidity support, strong prudential regulation and well capitalised balance sheets. During an economic downturn, investors may withdraw funding in a rapid and disorderly way. This could threaten the safety and stability of the financial system, and the broader economy.

As such, the activities of shadow banks, including peer-to-peer lending, should be subject to appropriate regulation.

5.1.1.2 Sector-wide regulatory changes: APRA lending caps

Certain sector-wide regulatory changes may also entrench structural differences among ADIs.

For example, APRA's focus on residential mortgage lending practices and the introduction of lending caps to reduce risk in the mortgage segment have also perpetuated structural differences in the market. Banks with smaller back-book sizes are at a disadvantage and limited by the extent to which they can gain market share, creating an uneven playing field that can distort competition and customer outcomes.

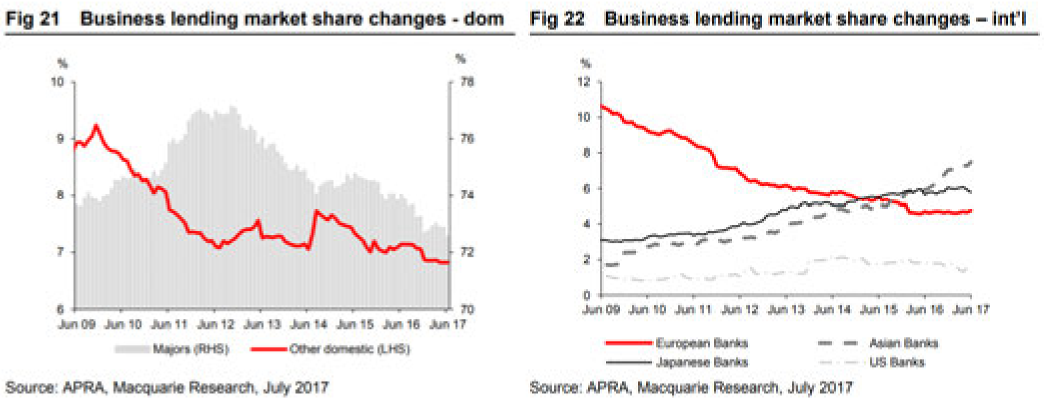
Another consequence is that lending flows from ongoing customer demand may be diverted to less regulated (and potentially unregulated) areas of the financial system, such as shadow banks.

5.1.1.3 International competitors in domestic market

APRA's early implementation of the Basel III reforms, ahead of other international jurisdictions, could to lead to higher costs for domestic products and services. Financial intermediation will be more expensive as banks seek to fund their own balance sheet from international wholesale funding markets.

In addition, lending by foreign-owned banks operating in Australia has almost doubled since 2012, to 11 per cent of business credit in Australia.[15] NAB notes the RBA's observation that foreign bank activity in Australia has historically been "highly pro-cyclical", tending to "exacerbate asset price and economic cycles".

Figure 13: Market share for business lending – domestic and foreign banks



[15] Reserve Bank of Australia, *Financial Stability Report*, April 2017.

5.1.2 Credit risk impact

5.1.2.1 Credit models

Under APRA regulation, Australian banks use a standardised or IRB approach to credit risk. Currently, NAB, ANZ, Commonwealth Bank of Australia, Westpac and Macquarie Bank are accredited to use the IRB approach. NAB believes that the IRB approach promotes better risk sensitivity in the capital framework and that all Australian banks should be incentivised to be IRB-accredited.

Commentary suggests that banks using the IRB model have a competitive advantage when compared with banks using the standardised approach. However, additional imposts not reflected in headline IRB risk weights include:

- The higher capital charge to advanced banks as the Domestic Systemically Important Banks;
- Requirements for advanced banks to hold additional risk-weighted assets (RWA) for interest rate risk in the banking book;
- The higher RWA requirement on IRB banks for undrawn (unutilised) balances, particularly the Credit Conversion Factor used for off-balance sheet exposures, which is higher in IRB modelling compared with standardised approaches;
- Compliance costs in maintaining advanced accreditation; and
- Initial investment in systems and capabilities to obtain advanced accreditation.

Further, recent prudential reforms have a greater focus on banks that use the IRB approach. These include:

- ‘*Unquestionably Strong’*: APRA’s July 2017 announcement of its ‘unquestionably strong’ capital benchmarks, which differentiate between banks using IRB and standardised approaches to capital adequacy, requiring an increase of 150 and 50 basis points to CET1 capital ratios respectively; and
- *Credit Risk Models:* Changes to credit risk models implemented as a result of FSI inquiry recommendations have narrowed the risk weight differences between ADIs using advanced and standardised models.

These reforms have the potential to minimise investment in and adoption of sophisticated modelling and risk assessments, which may reduce efficiencies and increase costs to customers, and distort competition. Accordingly, the incentive to price and manage risk appropriately would also be blunted, increasing systemic risks.

5.1.2.2 Implicit guarantee

NAB notes market commentary around the notion of an implicit guarantee for major Australian banks and the associated lower cost of funds.

As stated in our submission to the FSI, NAB believes that all Australian banks are too critical to ignore.[16] In this context, macro-prudential reforms such as APRA’s implementation of the FSI recommendation on ‘unquestionably strong’ banks will help to ensure the long-term stability and prosperity of the Australian financial system, and nullify any market perception of an implicit guarantee afforded to major banks.

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[16] NAB, *NAB’s response to the FSI’s Interim Report*, p6, http://fsi.gov.au/files/2014/08/NAB.pdf.

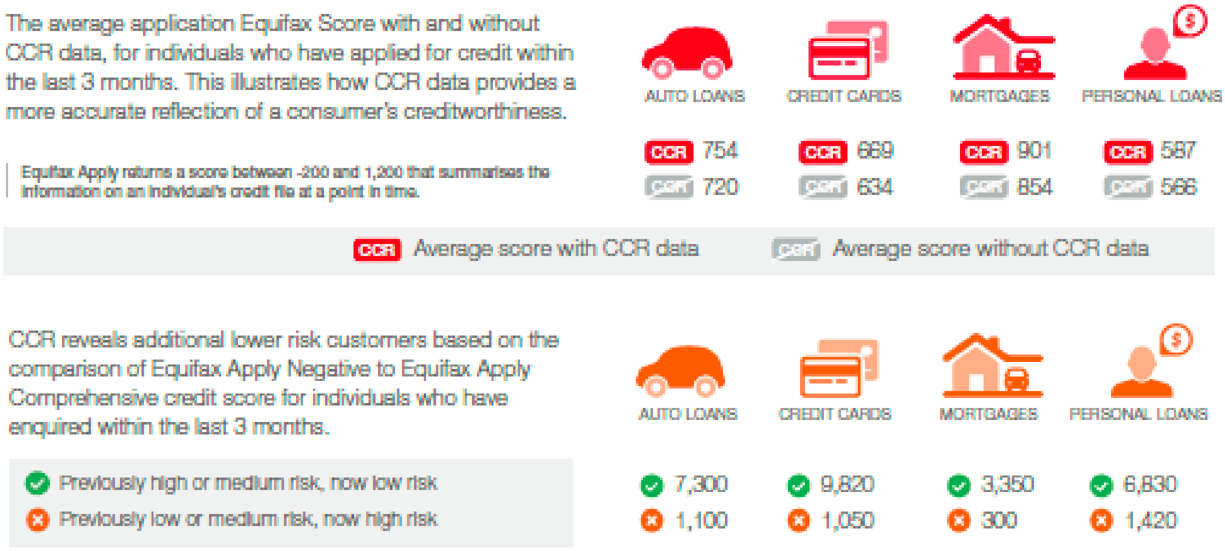
5.1.2.3 Comprehensive Credit Reporting (CCR)

In May 2017, the Government announced that mandatory CCR will be legislated by the end of 2017 if industry participation rates in CCR remain below 40 per cent.

NAB reiterates its support for CCR. A CCR environment with participation by all lenders will promote competition and improve customer outcomes. NAB has led the major banks in the implementation of CCR and has been sharing data in 'private' mode with all three credit reporting bodies since August 2015.

Positive credit reporting will enable lenders to make more informed credit decisions and better price risk, and contribute to better consumer outcomes by improving customer access to credit from major lenders.

Figure 14: CCR impact on consumer outcomes



Source: Excerpts from Equifax's CCR State of the Industry infographic

5.1.3 Barriers to entry

Commentary suggests the existing regulatory framework acts as a barrier to entry and can impede competition.

While there are undoubtedly opportunities to improve the framework and promote further efficiencies, such as changes APRA is undertaking as part of its licensing framework review, the current framework does not prevent innovation or competition among incumbents and/or new entrants. Further, any relaxation of current regulatory requirements should only be considered with an appropriate balancing of perceived benefits against any increased risk in the system.

5.1.3.1 Market participants

NAB notes the policy focus on increasing the number of participants in the Australian financial system through regulatory and legislative reform. This includes phased ADI licensing and regulatory sandboxes. As stated previously, NAB is agnostic of these positions; however, it should be noted that countries which have experienced declining NIM over the last decade have a wide range of banking concentrations and absolute numbers of market participants. This suggests there is no clear correlation between the absolute number of participants, market concentration and strong competition (demonstrated by declining NIM) and that broader market dynamics should also be considered.

Figure 15: NIM over the last decade (L: Australia, R: International)

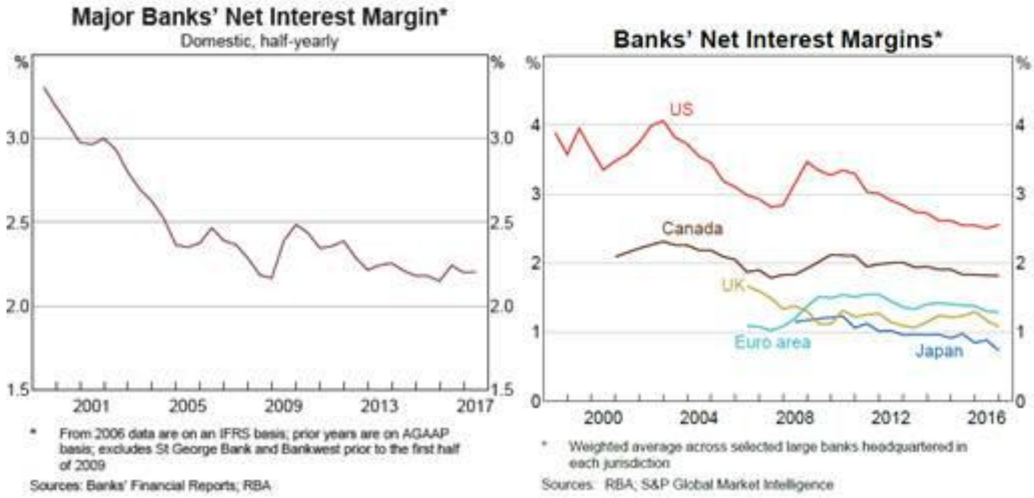


Figure 16: Banking concentration and market participants

	Bank concentration index[1] by country (no. of banks[2])		
Country	**2005**	**2014**	**2015**
Australia	82.1 (51)	70.1 (69)	71.6 (73)
United Kingdom	54.5 (391)	50.4 (359)	48.4 (358)
United States	29.9 (17,883)	36.0 (13,129)	34.9 (12,537)
Canada	86.5 (69)	59.0 (77)	60.3 (75)
Japan	37.2 (1,771)	46.3 (1,417)	45.9 (1,378)

Source: World Bank, BIS CPMI Red Book

5.2 International markets

The approach to implementation of recent reforms in the domestic market, such as the net stable funding ratio (NSFR) and higher capital requirements, has affected Australian banks' cost of funds and their Return on Equity. In combination with other measures such as the Federal Bank Levy, this has impacted their ability to compete with international competitors in the global financial markets.

[1] The Bank Concentration Index measures the concentration as the share of the assets of the three largest banks in total banking sector assets (World Bank).
[2] Banks are defined as "institutions offering payment services to non-banks".

This can lead to the migration of corporate and institutional banking activities to international competitors. Competition in these highly commoditised markets with sophisticated participants is frequently price-driven. Moreover, the size, scale and global operations of many corporate and institutional customers allows them access to financial services, such as debt funding, custodian services, traded markets, derivatives, repurchase agreements and corporate lending, in multiple jurisdictions.

An example of this is NAB's Asset Servicing business, which is one of eight custodian businesses competing in the $3.1T Australian market. Competitors include JP Morgan, Citi, RBC, State Street, Northern Trust, BNP Paribas and HSBC. Over the past five years, NAB has lost approximately 13 per cent market share through aggressive competition.

Client demand for greater investment diversification has also increased competition based on capability following the growth in alternative asset classes, such as syndicated loans, over the counter derivatives and unlisted managed funds.

Competition has driven an increase in post-trade analytical support, including performance and risk attribution to stress test investment. This enables clients to pro-actively manage risk and make improved investment decisions.

5.2.1 Impact of reforms

As further international regulation is progressively adopted locally, the competitive landscape in Australia remains uncertain. For example, full implementation of the remaining elements of Basel III will change the dynamic between standardised and IRB banks, but meaningful assessment of this relationship can only occur when fully implemented.

Importantly, Australian banks' ability to compete effectively in international markets will also be impacted by the extent to which other jurisdictions ultimately implement international regulations, with the impact greater if other jurisdictions do not implement in full.

5.2.1.1 NSFR

The full implementation of the Basel III NSFR reform on the Australian financial system by January 2018, ahead of several international jurisdictions, is a noteworthy example of the potential impact of reforms. Australian banks will be among a few (and potentially the only) banks globally to have NSFR constraints for lending, deposits and markets – especially if the US does not implement NSFR and other jurisdictions follow.

To comply with the NSFR reform, Australian banks have adjusted their funding profiles towards more expensive long-term stable liabilities, such as additional term wholesale funding and stable deposits. The Australian banking system's reliance on offshore wholesale funding more than other international banks adds to the impost. As a result, there is a considerable risk that some products offered by Australian banks in global markets will be less competitive to those offered by non-Australian banks.

6.Concluding remarks

NAB supports an Australian financial system that is efficient, competitive and stable. With changing customer behaviour and expectations; technological advances; and the increasingly global nature of financial services, the system is constantly evolving. The overarching regulatory environment also affects market dynamics, particularly the competitiveness of Australian banks, market structure and management of credit risk.

This evolution requires ongoing reassessment to balance competitiveness with financial stability. In this way, NAB believes it is important for regulation to have a sound basis in ensuring financial stability, while acknowledging the potential for such regulation to impact effective competition. Considered review with broad participation is an important part of this process, and benefits all market participants and their customers.

We note the PC's observation that a number of past recommendations and reforms (domestic and international) are in the process of being adopted or implemented. The proposed reforms should be thoroughly considered in concert to understand their collective impact on Australian financial system participants.

Accordingly, NAB recommends that all proposed regulatory or legislative reforms should be subject to appropriate consultation periods with relevant market participants, and assessed in light of their impact on both competition and financial stability.

NAB believes that the Australian financial system is competitive, and becoming more so. Innovation and the increasing number of new entrants with a customer experience focus means that customer outcomes will continue to be at the center of banking.