Productivity Commission Inquiry into Competition in the Australian Financial System.

Westpac Banking Corporation
September 2017

200 | Westpac GROUP

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

Australia's financial system is strong, competitive and well-regulated. However, Westpac will always support changes that further improve competition, enhance customer choice, and ultimately promote better consumer outcomes.

Strong banks, strong consumer choice

Within the financial system, banks play a critical role in supporting economic growth by taking deposits, making payments and providing loans. The stability and resilience of the financial system through economic cycles is important for economic and consumer outcomes, particularly in periods of economic stress.

Australia's financial system must therefore be competitive and calibrated to continue to deliver these fundamental banking functions through the economic cycle. The Australian banking sector was not bailed out during the Global Financial Crisis (GFC). Unlike many other developed nations, no taxpayer funds were injected into the Australian banks. In fact, the sector paid over $4.5 billion in fees for a wholesale funding guarantee that was never called upon. The wholesale funding guarantee allowed Australian banks to continue to compete with banks in distressed systems for access to wholesale funding, which enabled Australia to continue to grow. The alternative would have been credit contraction, with offshore investors withdrawing funds from the Australian economy.

Accepting that strong and profitable banks are a necessary outcome of a competitive and well-regulated market should therefore be at the heart of any assessment of the competitiveness and strength of the financial system.

Westpac is proud of the strength of the Australian financial system and its ongoing ability to optimise economic stability and growth and contribute positively to the nation.

Competitive financial markets support consumer choice

Competition within Australia's financial system is evidenced by both the significant number of providers and the range of products available to customers.

The four major banks actively compete for customers within a well-regulated market that also allows choice from banks and non-banks, as well as from domestic and international providers. Customers have more choice than ever before.

For mortgages alone, there are 3,993 mortgage products available with low feature, low price products, starting from just 3.25%. Aside from price, providers are competing to provide the best and most convenient service offering, particularly now in the online and digital environment. This choice is a key indicator of a vibrant and competitive market.

In the end, it should be the number and variety of products and services available to meet individual customer needs that guides any analysis of the competitiveness of the financial system.

Westpac acknowledges, however, that with so much choice, it can be difficult for customers to meaningfully compare across the wide range of products and services on the market.

To help facilitate better customer outcomes, Westpac is supportive of Australia moving towards an open data regime in banking. In particular, Westpac considers that open data will enhance customer outcomes by:

- Facilitating better informed decision making and more targeted and tailored product and service offerings;
- Allowing customers greater autonomy with their product and service choices; and
- Promoting innovation and efficiencies in the financial system.

The open data regime complements the Australian Government's proposals to further encourage new entrants and lower certain regulatory barriers.

Collectively, these initiatives will further enhance the customer experience while continuing to promote competition in the financial system.

More broadly, technology is changing the competitive landscape. Banks have always been 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 and seeking to disrupt existing business models, which is welcomed by Westpac.

Regulation works for everyone

Competition in the financial system is also underpinned by a robust regulatory framework. Australia's regulators and successive governments have for the most part ensured that regulation is well calibrated to balance financial stability with competition, consumer protection, innovation and growth. This was particularly evident in Australia's experience through the GFC.

To preserve system stability and support the growth of the economy, banks are subject to a dedicated supervisory and regulatory framework to ensure consumer confidence. Banks must conduct their businesses – and compete – within the confines of these heightened regulatory obligations. With regulatory and compliance costs increasing, banks face increasing competition from non-banking entities that are not subject to the same levels of scrutiny and regulation.

Westpac believes that for consumers to have the highest level of protection when making important financial decisions, Australia must maintain a strong and effective regulatory regime across the entire financial services sector.

Conclusion

This Inquiry is a welcome opportunity for Australia to reinforce the strength of our financial system, and to confirm the strength of our financial institutions.

It should also emphasise that a competitive market supports customer choice in product and service offerings, not just price.

The Inquiry needs to balance the stability and strength of Australia's financial system (including existing consumer protections) with business models and product offerings that may be based on weaker standards and less robust safeguards, to minimise the risk of system instability and financial harm to consumers.

SECTION 1

The nature of competition in the Australian financial system

SUMMARY

- The Australian financial system is competitive, with a diverse range of participants contesting each market segment and offering significant choice to customers.
- Competition in the financial system is not static – in particular, competition for lending and deposits typically increases or decreases depending on the broader economic cycle. Any consideration of competition in the financial system must therefore have regard to maintaining the strength of the system as a vital enabler of sustainable growth through economic cycles.
- The profitability of the Australian banks is consistent with a sector that needs to be seen as “unquestionably strong” to continue to support economic functions, even during times of stress. Evidence suggests that the major banks’ returns do not stand out when compared with those of companies in other Australian industries.
- The cost and accessibility of funding influences the prices charged to customers for financial products and services. The ability to maintain access to capital markets over the cycle and obtain wholesale funds at efficient cost is a key determinant of any lender’s ability to compete for business.

1.1 Introduction

The Australian financial system is competitive, dynamic and resilient. A diverse range of system participants compete to provide banking and other financial services to individuals, households, businesses and government, including:

- Banks – the four ‘majors’, together with regional, customer-owned and international banks;
- Non-banks – credit unions, building societies, finance companies and wholesale lenders;
- Exchanges and trading platforms;
- Managed funds – including retail, industry, corporate, public sector superannuation funds and self-managed super funds (SMSFs);
- Insurance companies;
- International investors;
- Payment providers – including Visa, MasterCard, American Express and PayPal; and
- Increasingly, technology companies, including Apple, Google and Square, with Facebook and Amazon also developing competitive offerings.

Collectively, these participants provide the essential functions of the financial system.

Competition through the economic cycle

Any consideration of competition in the financial system must have regard to maintaining the strength of the system as a vital enabler of sustainable growth through economic cycles. Recent history, such as the effects of the GFC, has shown that large and resilient financial institutions provide essential financial strength to support economic stability through cycles, and particularly during downturns.

As a result of cyclical trends, competition across specific products or services is not static – it may develop or emerge more quickly at various points in the cycle. The competitiveness of the financial system must, therefore, be evaluated in light of the fundamental economic role of banks and in the context of the highs and lows of the economic cycle.

Westpac Group's role

Westpac is one of a number of banks and non-banks providing banking and other financial services in Australia. As one of the four major banks in Australia, Westpac plays an important role in contributing to the financial system through all stages of the economic cycle.

Westpac's vision is *'To be one of the world's great service companies, helping our customers, communities and people to prosper and grow'*. Our strategy seeks to deliver on this vision by building deep and enduring customer relationships, being a leader in the community, being a place where the best people want to work and, in so doing, delivering superior returns for shareholders.

Westpac has five customer-facing divisions, operating under multiple brands:

- **Consumer Bank** is responsible for sales and service to consumer customers in Australia under the Westpac, St.George, BankSA, Bank of Melbourne and RAMS brands. Activities are conducted through a dedicated team of specialist consumer relationship managers along with an extensive network of branches, call centres and ATMs. Customers are also supported by a range of internet and mobile banking solutions. Consumer Bank also works in an integrated way with BT Financial Group (Australia) and Westpac Institutional Bank in the sales and service of select financial services and products, including in wealth and foreign exchange.
- **Business Bank** is responsible for sales and service to micro, small to medium enterprise (SME) and commercial business customers in Australia for facilities up to approximately $150 million. The division operates under the Westpac, St.George, BankSA and Bank of Melbourne brands. Customers are offered a wide range of banking and financial products and services to support their borrowing, payments and transaction needs. In addition, specialist services are provided for cash flow finance, trade finance, automotive and equipment finance, property finance and treasury. The division is also responsible for certain customers with auto finance loans. Business Bank works in an integrated way with BT Financial Group (Australia) and Westpac Institutional Bank in the sale and service of select financial services and risk management products, including corporate superannuation, foreign exchange and interest rate hedging.

- **BT Financial Group (Australia) (BTFG)** is the Australian wealth management and insurance arm of the Westpac Group providing a broad range of associated services. BTFG's funds management operations include the distribution of investment, superannuation, retirement products, wealth administration platforms, private banking, margin lending and equities broking. BTFG's insurance business covers the manufacturing and distribution of selected life, general and lenders' mortgage insurances. The division also uses third parties to manufacture certain general insurance products as well as reinsuring certain risks with external providers across all insurance classes. BTFG operates a range of wealth and financial advice brands (including Ascalon, which is a boutique incubator of emerging fund managers) and operates under the brands of Westpac, St.George, Bank of Melbourne and BankSA for Private Wealth and Insurance.
- **Westpac Institutional Bank (WIB)** delivers a broad range of financial products and services to commercial, corporate, institutional and government customers operating in, or connected with, Australia and New Zealand. WIB operates through dedicated industry relationship and specialist product teams, with expert knowledge in transactional banking, financial and debt capital markets, specialised capital, and alternative investment solutions. Customers are supported with operations throughout Australia and via branches and subsidiaries in New Zealand, the United States, the United Kingdom and Asia. WIB is also responsible for Westpac Pacific providing a full range of banking services in Fiji and Papua New Guinea. WIB works in an integrated way with all the Group's divisions in the provision of more complex financial needs, including across foreign exchange and fixed interest solutions.
- **Westpac New Zealand** is responsible for sales and service of banking, wealth and insurance products for consumer, business and institutional customers in New Zealand.[1] Westpac New Zealand operates via an extensive network of branches and ATMs across both the North and South Islands. Business and institutional customers are also served through relationship and specialist product teams. Banking products are provided under the Westpac brand, while insurance and wealth products are provided under Westpac Life and BT brands, respectively. New Zealand also has its own infrastructure, including technology, operations and treasury.

Like other financial services providers, Westpac's competitive position across customer segments, products and geographies is determined by a variety of factors. These include:

- The quality, range, innovation and pricing of products and services offered;
- Digital and technology solutions;
- Customer service quality and convenience;
- The effectiveness of, and access to, distribution channels;
- Brand reputation and preference;
- The type of customer served; and
- The talent and experience of our employees.

[1] Westpac conducts its New Zealand banking business through two banks in New Zealand: Westpac New Zealand Limited, which is incorporated in New Zealand; and Westpac Banking Corporation (NZ Branch), which is incorporated in Australia.

With a focus on domestic markets, and over 13 million customers,[2] our emphasis is on organic growth, growing customer numbers in our chosen segments and building stronger and deeper customer relationships.

1.2 Market structure

The impact of the Global Financial Crisis

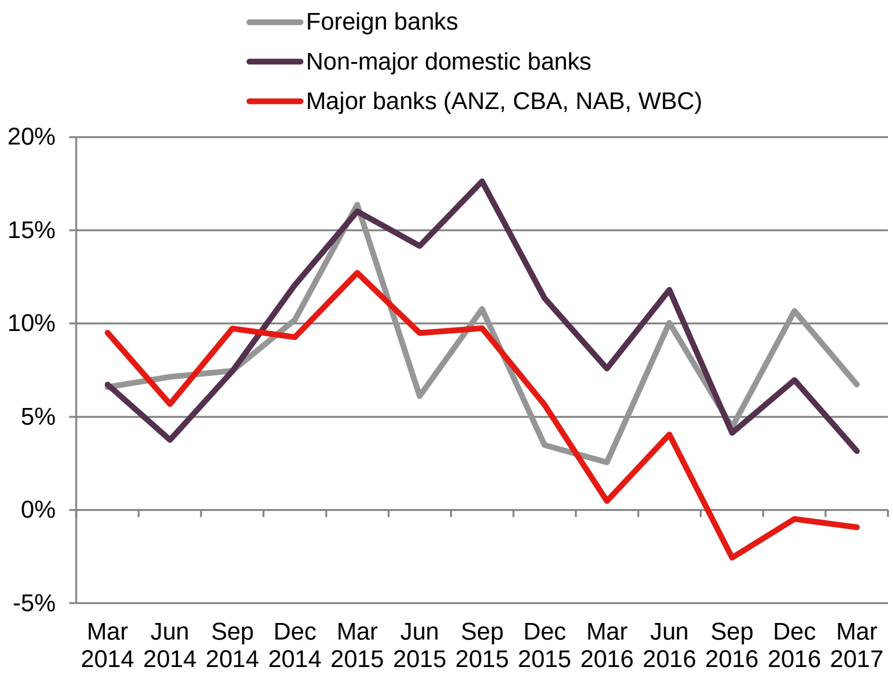
The GFC had a significant effect on the structure and composition of financial systems, both in Australia and internationally.

Although there were no bank failures in Australia, the GFC led to a significant rationalisation of the industry. Between 2008 and 2012, for example, the proportion of total Authorised Deposit-taking Institution (ADI) assets held by the four major banks increased from approximately 72 per cent to 78 per cent, largely as a result of two significant consolidations within the banking sector:

- Commonwealth Bank acquired BankWest and St Andrews from HBOS in October 2008; and
- Westpac and St.George merged in December 2008.

Since then, the share of total ADI assets held by the four major banks has declined slightly, with statistics from the Australian Prudential Regulation Authority (APRA) indicating that the major banks are growing at a slower rate compared to foreign banks and other domestic banks.

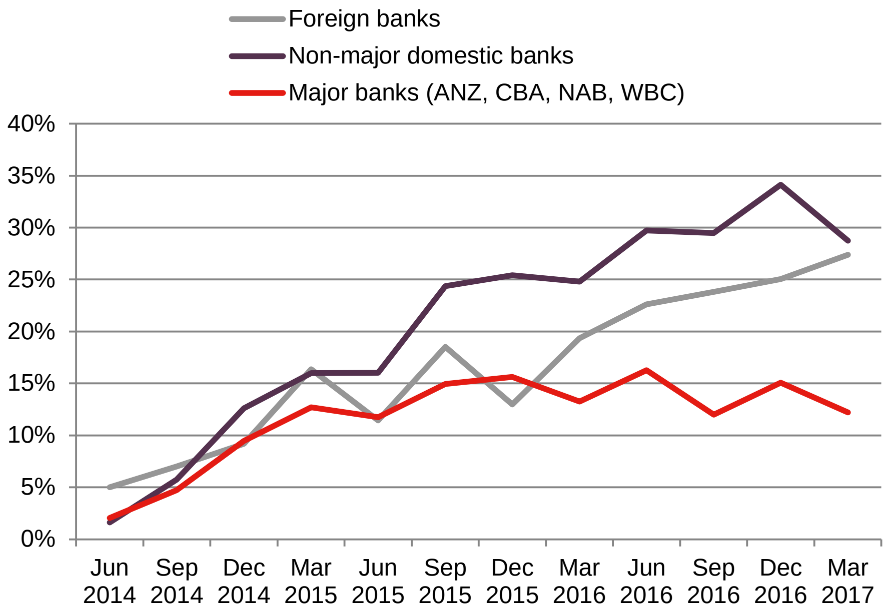
Figure 1.1: Annualised rate of growth in total assets (by bank type)



Source: APRA

[2] All customers with an active relationship (excludes channel only and potential relationships) as at 30 September 2016.

Figure 1.2: Cumulative growth in total assets since March 2014 (by bank type)



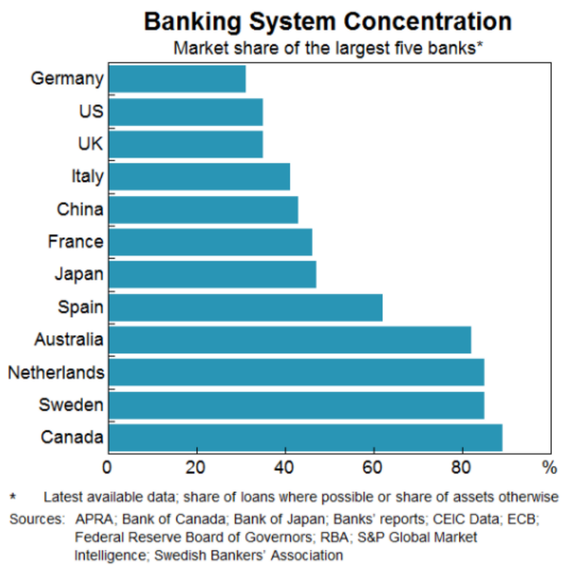
Source: APRA

Concentration

Notwithstanding the period of industry rationalisation that occurred as a result of the GFC, Australia has always had a fairly concentrated banking system.[3]

As demonstrated in Figure 1.3 below, the concentration of Australia's banking system is not unique internationally and it is broadly in line with the banking systems of similar sized economies.

Figure 1.3: Banking system concentration



Source: RBA

[3] Michele Bullock, Assistant Governor (Financial System), Reserve Bank of Australia, *'Big Banks and Financial Stability',* Speech delivered at the Economic and Social Outlook Conference, 21 July 2017, https://www.rba.gov.au/speeches/2017/sp-ag-2017-07-21.html.

In testimony to the House of Representatives Standing Committee on Economics in September 2016, Reserve Bank of Australia (RBA) Governor Dr Philip Lowe noted that most banking systems now have a similar concentration to Australia as a result of the GFC, which led to a number of mergers around the world. In particular, the Governor confirmed that Australia is not unusual in having four or five banks that account for a significant proportion of financial intermediation.[4]

More broadly, the Productivity Commission has observed that many sectors of the Australian economy have higher levels of market concentration by international standards, and that this is *"due in part to [Australia's] comparatively small domestic market"*.[5] However, relative to many other sectors in the Australian economy where there are only two major participants, the banking sector is not as highly concentrated.

Importantly, higher market shares and concentration are not indicative of a lack of competition, consistent with judgments of the Courts and the Australian Competition Tribunal (Tribunal), as well as competition policy reviews and assessments of concentrated industries. For example:

- The 1993 Hilmer Report noted*, "In some cases competition between a few large firms may provide more economic benefit than competition between a large number of small firms"*;[6]
- The 2003 Dawson Report noted *that "Concentrated markets can be highly competitive. It may be possible to object to the structure of such markets for reasons of policy… but not on the grounds of lack of competitiveness"*;[7]
- The Tribunal acknowledged in *Re Chime Communications (No 2) Pty Ltd* that the competitiveness of a market *"cannot be measured simply by the number of firms in the market, their market shares and the market concentration. That can only be the starting point of the analysis";*[8] and
- The Productivity Commission noted, *"Market concentration alone does not provide much guidance to the competitiveness of a market. What matters more are barriers to entry and, associated with these, the extent of market contestability. <u>There are many examples in Australia of highly concentrated markets where barriers are low, exposure to international trade is high and competition is intense</u>"*[9] (emphasis added).

The RBA and the Financial System Inquiry (FSI) both reached the same conclusion in respect of the banking sector. For example, in its submission to the FSI in March 2014, the RBA observed that *"the Australian banking system has been subject to increasing levels of*

[4] Evidence to the House of Representatives Standing Committee on Economics, Parliament of Australia, Canberra, 22 September 2016, 17, (Dr Philip Lowe, Governor of the Reserve Bank of Australia).
[5] Commonwealth Government, Productivity Commission Inquiry Report No 56: Economic Structure and Performance of the Australian Retail Industry (4 November 2011), p XVIII.
[6] Hilmer Report, p 3.
[7] Dawson Report, p 36.
[8] *Re Chime Communications (No 2) Pty Ltd* [2009] ACompT 2, [51] (Finkelstein J, Members Davey and Round). Referred to in "The evolution of the "substantial lessening of competition" test – a review of case law", Peter Armitage (2016) 44 ABPR 74 at 94.
[9] Commonwealth Government, Productivity Commission Inquiry Report No 56: Economic Structure and Performance of the Australian Retail Industry (4 November 2011) 38. Referred to in "The evolution of the "substantial lessening of competition" test – a review of case law", Peter Armitage (2016) 44 ABPR 74 at 96.

competition and market contestability" over the past two decades, and that *"the increase in competition aided market efficiency and provided important benefits to consumers, both in terms of increased choice through innovation and through lower prices for financial services".*[10]

Broad choice of products and providers

Customers enjoy the benefits of choice in the Australian financial services market. Choice is abundant across each of the major product segments, both in terms of product offering and the number of providers. In total, 151 ADIs currently compete in the Australian banking services market.[11]

Across each segment, there is a wide range of products and services available from Australian and international participants, both ADIs and non-ADIs, including the four major banks, other domestic and foreign banks, as well as building societies and credit unions, as summarised in the following table.

Figure 1.4: Products on market[12]

August 2017	Total products listed	Total institutions	% Banks	% Mutuals	% CUBS	% non-ADIs
Deposit Accounts	727	79	41	20	39	0
Credit Cards	241	60	28	27	35	10
Housing Lending	3993	107	24	16	41	19
Business Lending	300	20	70	10	20	0
			Banks	**Mutuals**	**CUBS**	**non-ADIs**
Number of Providers %			35	13	33	19

Source: Canstar

While choice is a key indicator of a vibrant and competitive market, Westpac acknowledges that a high degree of choice can present challenges for customers to meaningfully compare products and services in the market. Options to help facilitate better customer outcomes are discussed further in Section 3.

1.3 Business models

The Australian financial system supports a variety of business models. In any one segment, there are typically numerous ADIs and non-ADIs – with diverse business models, strategies and incentives – competing with one another. These factors help to prevent larger participants from holding or exerting any market power or behaving anti-competitively.

[10] Reserve Bank of Australia, Submission to the Financial System Inquiry, March 2014, p 6.
[11] APRA, List of Authorised Deposit-taking Institutions (current as at 6 September 2017).
[12] These figures should be regarded as indicative. Listing a product with Canstar is not compulsory and generally, credit unions and building societies are more likely to list their products than banks. 'CUBS' is credit unions and building societies.

In recent years, public discussion has focused on horizontally and vertically integrated business models, particularly in the mortgage broking and wealth management sectors, with some arguing these models reduce competitive pressures.

Westpac considers that demand for banking services is strong enough to support competition based on a diverse range of strategies and business models. Some providers may, for example, find it profitable to operate in particular geographical areas, while others may focus on particular customer groups, or specialise in distributing certain products. Equally, new competitors have also emerged, taking advantage of innovative methods of distribution in the digital environment.

Horizontal integration

Horizontal integration refers to the acquisition of additional business activities at the same level in the supply chain. This can be achieved through internal expansion, merger or takeover.

As noted above, since the GFC, there have been two significant consolidations within the banking sector, where smaller banks were absorbed by larger banks. While these consolidations contributed to an immediate increase in the proportion of ADI assets held by the major banks, there was little change in the market share of banks overall.

Vertically integrated business models

Vertical integration refers to the integration of different levels in the same supply chain (such as manufacturing and distribution). Westpac considers that vertically integrated business models are frequently a feature of a competitive environment, resulting in better customer experiences and efficiencies.

In particular, in the banking sector, Westpac considers vertical integration is not having any adverse effect on competition, as the diverse range of competitors reduces the ability and incentive for vertically integrated businesses to foreclose competition at any level of the supply chain.

Westpac believes that vertical integration can offer real benefits and efficiencies for consumers, including:

- A cost efficient means of bringing more innovation and choice of quality solutions to more customers;
- The convenience of having all financial products and services in one place;
- Deepened relationships (providers are highly motivated to provide a high-quality service offering through all of their interactions with a customer, or risk losing a customer relationship entirely); and
- Economies of scale, including strengthened compliance and technology capability.

In July 2017, Westpac commissioned independent market research to understand consumer attitudes towards different business models in financial services. The research also sought to understand why consumers had chosen to structure their own financial affairs in the way they had.

The research involved a series of focus groups, as well as a quantitative survey covering a representative sample. The research found:

- There is consumer awareness of the various business models in the financial services industry. Consumer feedback demonstrated that customers consider the advantages of each model when making decisions about their own financial affairs;
- Consumers value being able to access all of their key financial accounts and products easily in the one place and believe that this level of convenience makes it easier to properly manage and protect their financial affairs. When presented with a variety of possible drivers for why they chose to structure their financial affairs in the way they had, drivers related to convenience and ease of use ranked the highest; and
- Not surprisingly therefore, the vast majority of consumers (77 per cent) were comfortable with banks providing a wide range of products and services in order to meet the breadth of their customers' financial needs.

Beyond convenience, the research also showed that consumers consider a wide range of factors when making choices about how to structure their financial affairs, including expertise, trust, existing relationships and the financial security of the provider.

While convenience is a dominant driver, consumers also need to manage a range of risks associated with the financial products they hold and the institutions that have provided them. This is especially relevant in financial services, where consumers need to be able to rely on the promises made by financial product providers, and often over a long period of time (such as in the case of superannuation, life insurance and retirement products, like annuities).

Westpac believes that there is a clear benefit for consumers in being able to transact with a well-capitalised institution that has the financial strength to keep its promises and respond appropriately should anything go wrong.

1.4 Key indicators of competition

The competitive nature of the Australian financial system has benefited customers, by driving banks to continually improve productivity and deliver products and services at lower cost to customers.

The following key indicators provide strong evidence of these benefits.

- **Lower customer costs**

  Competition and innovation in the Australian financial system have contributed to lower financial transaction costs for customers.

  In particular, banks have reduced and abolished many fees, while at the same time customers are increasingly choosing free, or lower fee, banking products. As discussed in Section 3, technological innovation is also empowering customers to change their behaviour and in some cases, pay no fees.

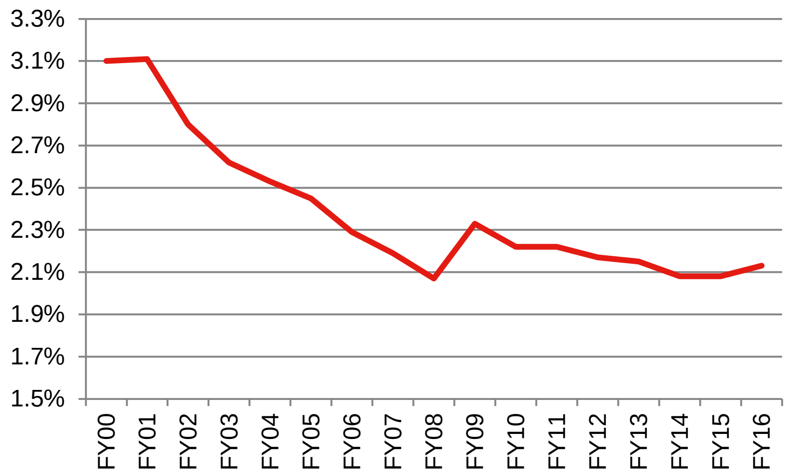
- **Net interest margin**

  Net interest margin (NIM) is one indicator of competition between the banks. It measures net interest (i.e. the difference between the interest income generated and the amount of interest paid out) relative to the amount of interest-earning assets.

  In effect, NIM measures how successful a company is at investing its funds compared with the expenses incurred in relation to the same investments.

  Figure 1.5 shows that Westpac Group's NIM has generally been flat or declining over a long period.[13] Over the past 10 years, Westpac's NIM has declined by 16 basis points (FY06: 2.29% to FY16: 2.13%), or 9 basis points in the last five years (FY11: 2.22% to FY16: 2.13%).

Figure 1.5: Westpac Group net interest margin (cash earnings basis)[14]



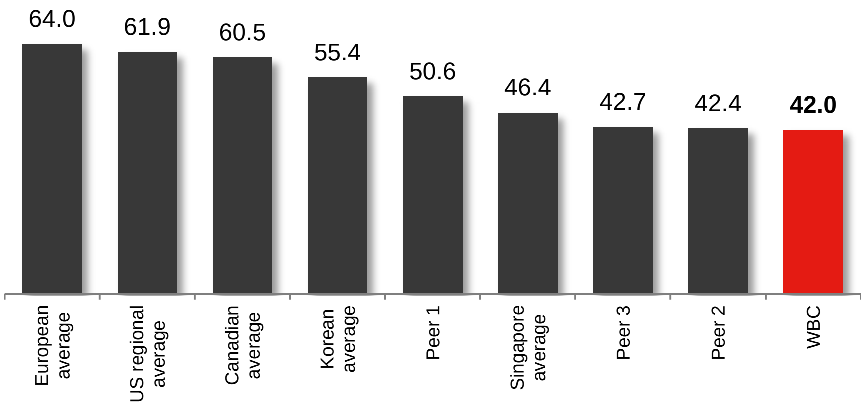
- **Cost-to-income ratio**

  Competition has meant that banks have redesigned and improved business processes, restructured, and continually sought to lower costs, while also improving the customer experience.

  The May 2016 Productivity Commission Productivity Update report highlighted that the Australian financial sector has been one of the most productive sectors in the economy over the past 20 years.[15] Similarly, a global peer comparison of bank cost-to-income ratios demonstrates that the Australian banking system is one of the most cost-efficient in the world.

[13] This decline is with the exception of a small increase in 2009. The onset of the GFC and the dislocation in capital markets reduced the availability of funds and increased their cost. Volatile markets also increased treasury earnings, which positively impacted net interest margin. This is reflected in a small upward adjustment of net interest margin in 2009.
[14] In assessing financial performance, Westpac uses a measure of performance referred to as 'cash earnings'. Cash earnings, as calculated by Westpac, is viewed as a measure of the level of profit that is generated by ongoing operations and is expected to be available over the long term for distribution to shareholders.
[15] Commonwealth Government, Productivity Commission Productivity Update, April 2016 (Figure 1.1 Industry MFP 1989-90 and 2014-15).

Figure 1.6: Global peer comparison of cost-to-income ratios (2016)[16]



Source: Company data, Credit Suisse

1.5 Profitability over the cycle

Profitability is important for sustaining the financial system through economic cycles.

As the economy grows, profitability allows financial institutions to innovate to enhance the customer experience, provide returns to shareholders and strengthen their position by building capital buffers. During financially challenging times, financial institutions can call upon profits to absorb credit losses if required, to reduce the risk of failure.

In light of the shortfall between the demand for credit in Australia and domestic deposit funding (discussed further in Section 1.6), it is also important that offshore debt investors see the banks as profitable when they are making investment decisions between financial institutions in different jurisdictions.

Similarly, profitability is one of the key measures that international rating agencies look at when assessing a company's rating. Higher ratings can support banks to access more diverse sources of cost-effective funding through the economic cycle.

Appropriate levels of profitability and continued earning capacity are therefore key to maintaining the efficiency and strength of the financial system. As such, competition must be assessed in this context.

Major bank profitability

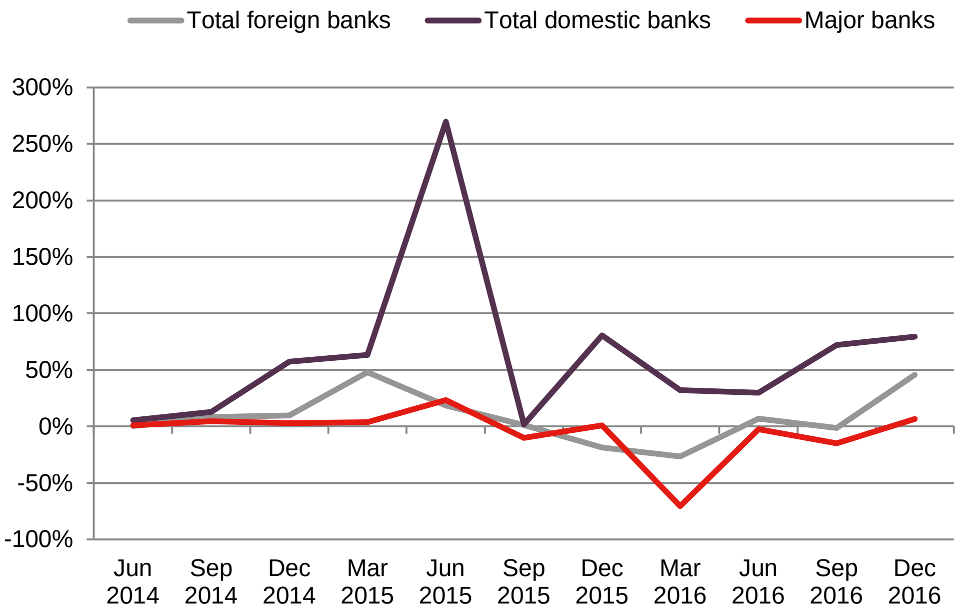
While Westpac believes that the profitability of the major banks is consistent with a sector that needs to be seen as "unquestionably strong", recently, there have been claims that the profitability of Australia's major banks is an indicator of a lack of competition in the banking system.

While Australian banks report large profits in absolute terms, these profits are not disproportionate to their size. Westpac, for example, has an asset base of around $840 billion and earns less than 1% return on those assets.[17]

[16] Peers 1 to 3 are the other major Australian banks.

In addition, smaller banks (such as foreign and other domestic banks) have grown their net profit after tax considerably faster than the major banks in recent years. This increased profitability suggests that the smaller banks may be able to continue to take market share from the larger Australian banks in the coming years.

Figure 1.7: Quarterly net profit after tax, relative to March 2014[18]



Source: APRA

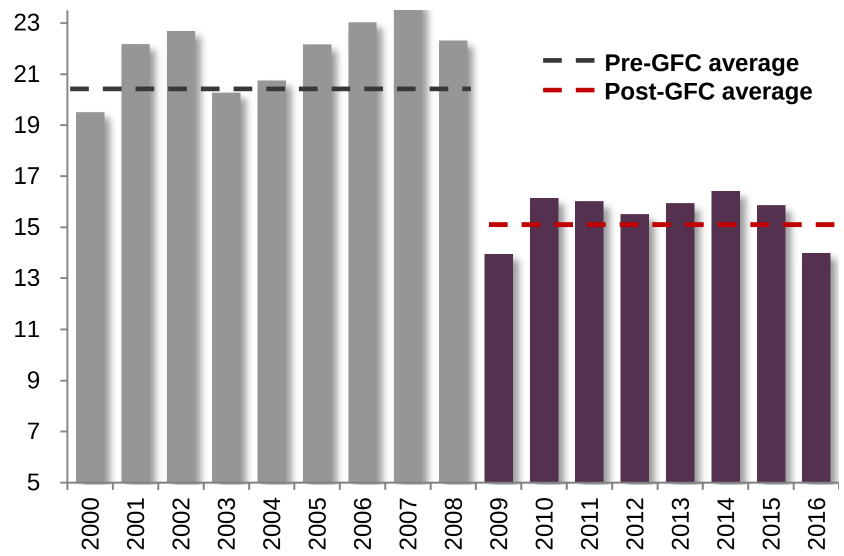
Domestic and international ROE comparisons

Return on equity (ROE) is a measure of profitability, as it demonstrates how effectively a company is using its equity to generate profit. Assessed in this context, the major banks' returns are in line with other leading banking systems internationally, and do not stand out when compared with Australia's largest companies in the ASX 100.

Westpac's ROE has structurally fallen since the GFC, primarily as a result of a decline in interest rates, the St.George merger, lower margins and increased regulatory capital requirements. This declining ROE illustrates that Westpac's shareholders have borne a lower return as the bank has strengthened its balance sheet and strong competition has reduced its margins.

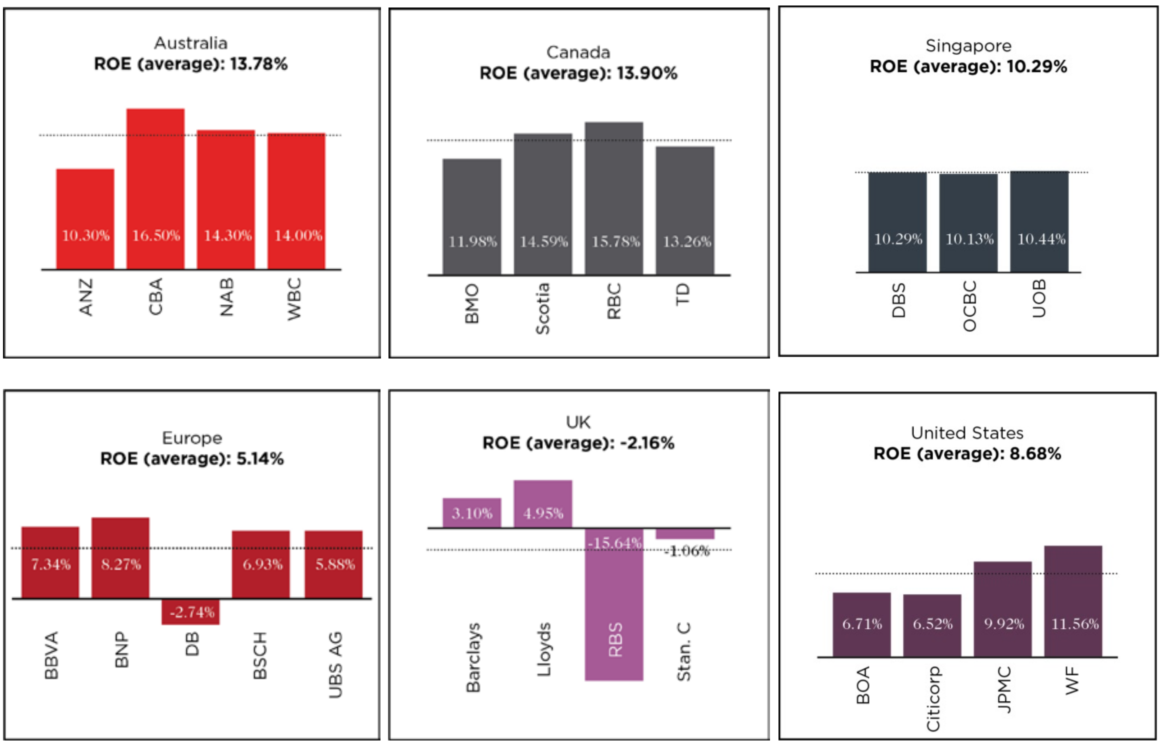
[17] As outlined in Westpac's 2016 Full Year Financial Results Announcement, the Group's FY16 cash earnings profit was $7.8 billion.
[18] Each quarter is presented as a percentage of that category of bank's profits in March 2014.

Figure 1.8: Westpac cash return on equity (%)



As outlined in Figure 1.9 below, the average ROE of the Australian major banks is currently sitting at approximately 13.78%, broadly similar to other well-performing banking markets, such as Canada.[19]

Figure 1.9: International ROE comparisons 2016



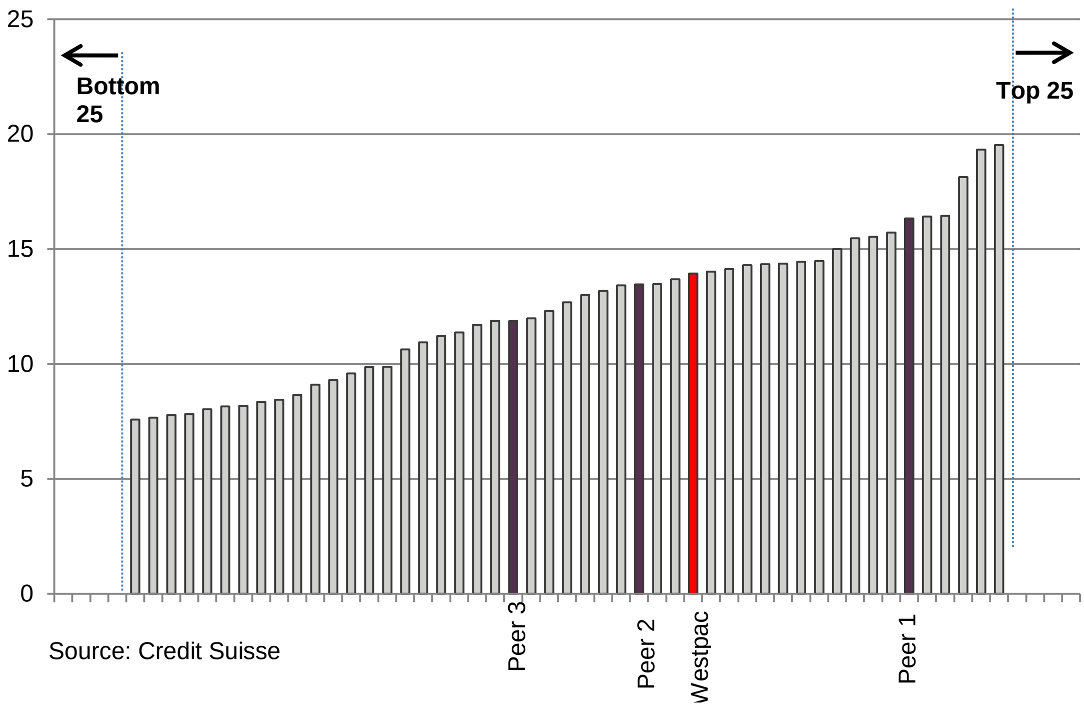
Source: Company data, Credit Suisse

[19] As illustrated in Figure 1.9, Australian major bank returns are above markets such as the UK, parts of Europe and the US. These markets are underperforming and, in many respects, are still recovering from the GFC.

At a domestic level, as illustrated in Figure 1.10:

- In 2016, none of the four major banks featured in the top 25 most profitable companies in Australia, ranked by ROE; and
- The four major banks placed in the middle 50 of the ASX 100 on a ROE basis.

Figure 1.10: FY16 ASX 100 ROE (%)



Source: Credit Suisse

1.6 The funding profile of the banking system

The quantity and quality of funding available to the Australian financial system is central to its ability to fund the economic activities of individuals and businesses.

In Australia, the volume of available customer deposits is insufficient to meet the demand for customer lending; banks therefore rely on access to domestic and international wholesale funding sources (both long and short-term) to make up the shortfall.

Without the ability to attract wholesale funds at efficient cost, Australian banks would either have to constrain lending and investment activities to remain in line with the level of available customer deposits, or undertake these activities at a significantly higher cost. This would:

- Increase the cost of lending to customers;
- Reduce lending overall;
- Reduce bank returns and dividends; or
- A combination of these factors.

Ultimately, the sum of these effects would likely have the impact of reducing competition and inhibiting economic growth.

Composition of bank funding

Like other Australian commercial banks, Westpac funds its lending operations from a mixture of sources, including shareholders' equity, customer deposits and wholesale funding from capital markets.

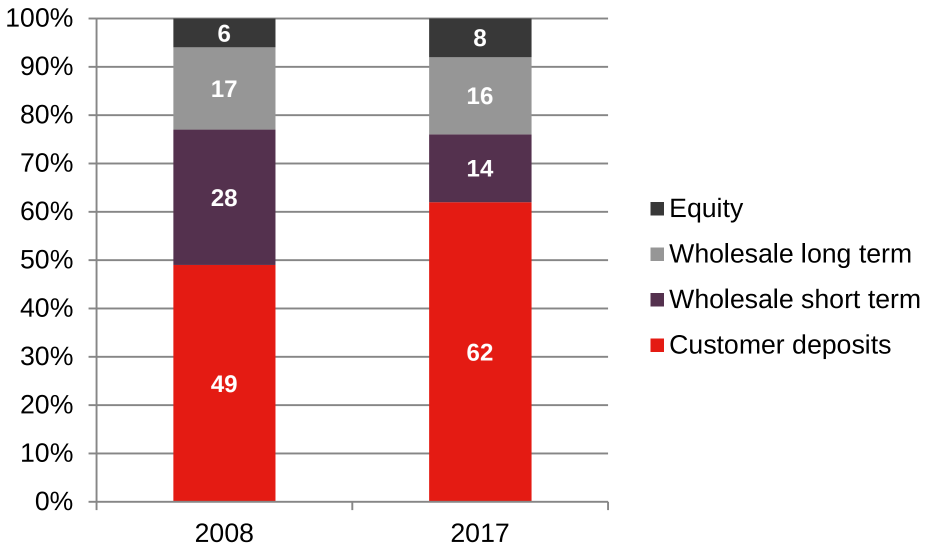
Each funding component is raised at different prices and the overall, blended 'cost of funds' forms part of the prices charged to customers for the bank's products and services.

Westpac's funding composition is similar to the other major banks, but differs from regional banks. Regional banks generally have a higher proportion of customer deposits, with different product mixes, a larger reliance on securitisation and less diverse wholesale funding portfolios.

Post-GFC regulation, aimed at improving the resilience of the financial system, has resulted in banks having to hold more expensive forms of funding – that is, a greater proportion of stable deposits, longer duration wholesale funding, as well as higher-quality liquid assets. In addition, banks have had to hold higher levels of capital.

This is evident in the change in Westpac's funding mix since 2008.

Figure 1.11: Westpac's funding composition



While these reforms have strengthened bank balance sheets and improved liquidity management, they have also increased the cost of lending to customers.

Cost of bank funding – deposits

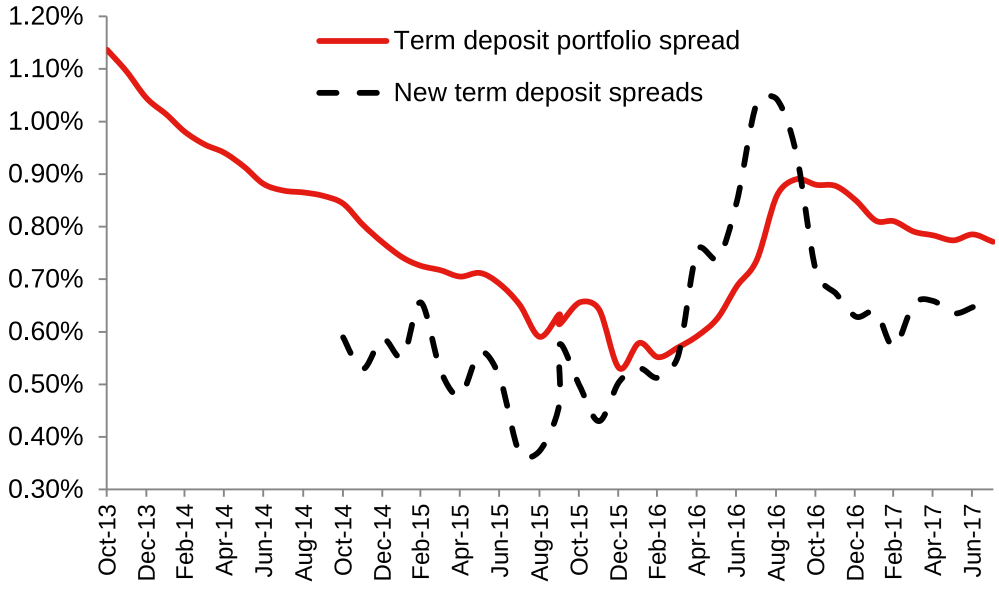
As illustrated in Figure 1.11, the majority of Westpac's funding comes from customer deposits, with a portfolio size of $479 billion (as at March 2017). It comprises:

- 40% Term deposits ($191 billion);
- 28% Transaction accounts ($136 billion);
- 19% Online ($92 billion); and
- 12% Savings ($60bn).

Between 2007 and 2012, term deposit spreads moved from being priced below the equivalent swap rate, to well above the swap rate, as banks competed to attract deposits in order to reduce short-term debt and strengthen their balance sheets.

More recently, the introduction of the Liquidity Coverage Ratio (LCR) in 2015 and the upcoming Net Stable Funding Ratio (NSFR) have further increased competition for customer deposits, as banks respond to requirements to hold a higher proportion of customer deposits. This has impacted customer deposit pricing.

Figure 1.12: Australian term deposit portfolio spreads



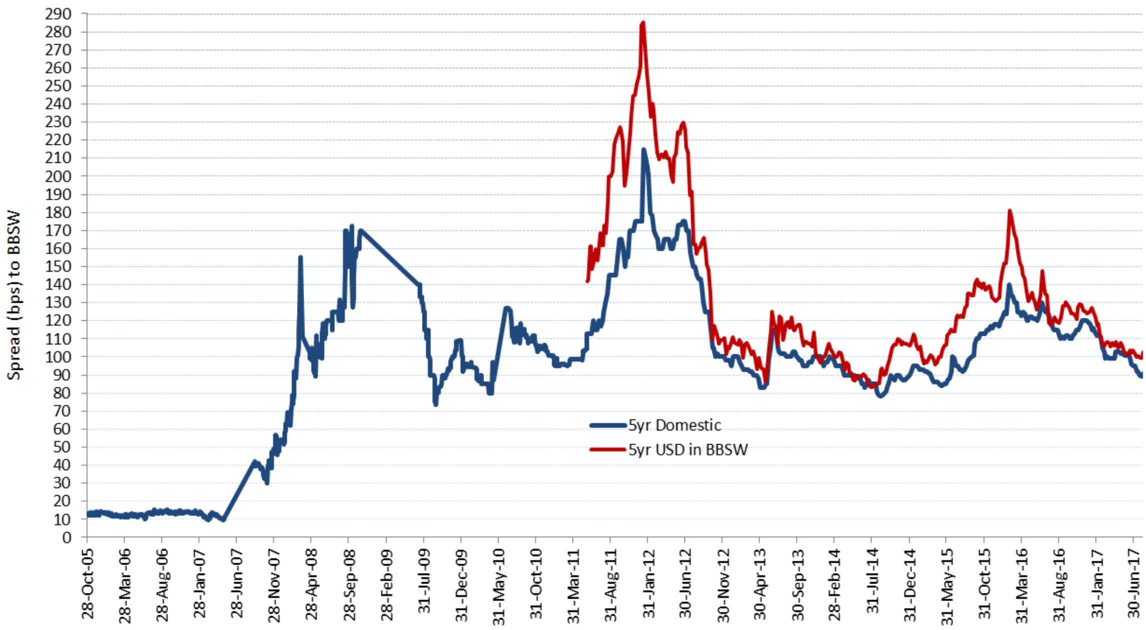
Cost of bank funding – long-term wholesale

As the Group has sought to strengthen its balance sheet and meet new regulatory requirements in the post-GFC environment, the weighted average maturity of Westpac's long-term wholesale portfolio has also increased.

Longer duration funding costs more than shorter duration funding and the trend toward more longer duration funding has impacted Westpac's cost of funds considerably in recent years.

As outlined in Figure 1.13 below, wholesale funding costs have risen from approximately 15 basis points above the 90-day BBSW in 2007, to around 90 basis points above the 90-day BBSW in 2017.

Figure 1.13: Funding Costs – Historic domestic / offshore



Bank funding is also impacted by the requirement to hold liquid assets. Liquid assets increase our ability to raise funds, as we can sell them in times of tight liquidity. The regulatory requirement to hold liquid assets has also increased significantly as a result of the introduction of the LCR in 2015.

Impact of credit ratings on the cost of funding

From a credit rating perspective, Australian banks benefit from having strong financial, risk, capital and funding profiles, conservative business models and appropriate lending policies.

All these factors enable Australian banks to achieve relatively high credit ratings that in turn underpin the ability to introduce additional funds into the Australian economy at an efficient cost.

The major banks' credit ratings also benefit from an uplift[20] based on rating agencies' perceptions that they would receive government support in extraordinary circumstances.

The price of funding is, however, set by the market, with credit ratings by rating agencies one of the considerations that investors take into account.

The recently announced Major Bank Levy by the Federal Government has increased the bank's cost of funds by adding a 6 basis point levy to certain liabilities over and above the market price of these liabilities. Ultimately, when applied to liabilities that are rated, this translates to a budget contribution by the major banks equivalent to approximately 30-35 basis points on their unsecured long-term wholesale funding.

[20] Currently, S&P provides a three notch uplift for government support, with Moody's currently providing a two-notch uplift. There is currently no uplift for government support from Fitch.

SECTION 2

Supervision and regulation

SUMMARY

- The financial system's regulatory framework is critical to the system's ability to meet the needs of customers and to support the nation's growth.
- To preserve system stability and support the growth of the economy, banks are subject to a dedicated supervisory and regulatory framework, with prudential regulation designed to provide customers with confidence in the safety of their deposits. At times, there may be some tension between the goals of increasing competition and maintaining stability.
- While there are good reasons for subjecting banks to a higher regulatory burden than other market participants, banks must conduct their businesses – and therefore compete – within the confines of these heightened regulatory obligations. With regulatory and compliance costs increasing, banks face increasing competition from non-banking entities, which are not subject to the same levels of scrutiny and regulation.

2.1 Introduction

The Australian financial system is subject to a multi-layered regulatory framework. Financial services providers operate within a complex and robust system of Commonwealth, State and Territory regulation and extensive international regulation.

Banking, in particular, is one of the most heavily regulated sectors of the Australian economy and Australia is ranked as one of the world's leading nations for the soundness of its banking sector.[21] Specifically, Australian banks are subject to a sophisticated set of regulatory obligations, with high levels of regulatory intervention and complex intervention structures. Internationally active banks are also subject to regulation in offshore jurisdictions.

The key regulators of the Australian banking system are:

- Australian Prudential Regulation Authority (APRA), which supervises the prudential management of financial institutions, regulating banks, insurance companies, building societies, credit unions and superannuation funds;
- Australian Securities and Investments Commission (ASIC), which regulates financial market conduct and credit and market integrity more generally, and has responsibility for consumer protection in financial services; and
- Reserve Bank of Australia (RBA), which is responsible for the stability of the Australian currency and financial system. It conducts monetary policy and provides selected banking and registry services to a range of Australian and overseas government agencies and institutions.

Other regulatory bodies responsible for aspects of the banking system include:

[21] Ranked 5th according to the World Economic Forum, Global Competitiveness Report 2016-17.

- Australian Competition and Consumer Commission (ACCC), which monitors and regulates competition, fair trading, and (in areas other than financial services) consumer protection;[22]
- Australian Securities Exchange (ASX), which operates equities, derivatives and enterprise trading markets;
- Australian Treasury, which is responsible for advising the government on the stability of the financial system, and on legislative and regulatory matters regarding financial system infrastructure;
- Australian Transaction Reports and Analysis Centre (AUSTRAC), which oversees the compliance of Australian reporting entities with requirements under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) and the *Financial Transaction Reports Act 1988* (Cth); and
- Australian Taxation Office (ATO), which is responsible for the Australian tax and superannuation systems, including collecting revenue and administering key aspects of Australia's superannuation system.

Minimum standards for Australian banks

APRA has a key focus on the safety and stability of the financial system and will intervene where it considers there is a risk to that system. By virtue of the important role that ADIs (and, in particular, banks) play in the economy, they are subject to heightened regulatory obligations and intense levels of supervision when compared to other market participants.

A fundamental aspect of APRA's mandate is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions are met within a stable, efficient and competitive financial system.

Accordingly, it is widely accepted that those who carry on a banking business in Australia should be subject to rigorous entry and authorisation standards, licensing requirements and ongoing prudential monitoring by APRA. In particular, the prudential standards that APRA sets establish minimum standards for regulated institutions and have the force of law. These standards cover a wide variety of topics, including capital adequacy, liquidity, risk management and governance.

While there are good reasons why minimum standards should be applied to banks, banks compete with non-bank entities, which are not subject to the same levels of regulation. For example:

- In payments, banks increasingly compete with non-bank payment providers, such as Apple Pay, Samsung Pay and Android Pay, however, none of these technology companies are regulated as payment providers. In addition, in many cases, these entities do not subscribe to voluntary codes of practice (such as the ePayments Code);

[22] Significantly, the Australian Government has recently designated specific funding to the ACCC to establish a unit dedicated to investigating competition in the financial sector.

- Banks may also face competition in the future from Facebook and others for peer-to-peer payments. In May this year, for example, Facebook was granted a patent in Australia to allow users to make such payments via Facebook Messenger after first linking up a bank-issued debit card;[23] and
- In relation to commercial property, potential disruption may arise from super funds that invest in commercial real estate lending. For example, Maxcap group specialises in commercial real estate debt, and recently teamed up with Australian Super (Australia's largest industry super fund) to offer $100 million-plus loans directly to developers.[24]

Meeting the rigorous prudential requirements also adds costs for banks. In particular:

- Having to hold more liquidity in reserve, while part of regulatory requirements aimed at making banks safer, reduces the amount of funds that can be lent to customers and, accordingly, increases the cost of lending to customers; and
- Regulatory and compliance costs are increasing, as banks respond to an increased number of requests by regulators both in Australia and abroad.

2.2 Competition and regulation

While regulation in Australia is generally well-calibrated to balance competition with financial stability, APRA makes decisions about overall systemic stability without regard to each individual bank's desire to compete.

Similarly, the RBA is required to both control risk and promote efficiency and competition in the payments system. These two objectives can be in tension with each other. The RBA notes that:

> *In practice, the joint objectives of efficiency, competition and controlling risk mean that the Bank must to some degree distinguish between systems whose smooth functioning is important to the stability of the financial system – due to the large values processed and the role played in financial markets or monetary policy – and those for which efficiency and competition are very important, due to the large number of (typically low value) transactions processed.*[25]

The consequence of this approach may be that certain products offered by the banks may be regulated in a way that emphasises stability rather than competition, resulting in some product standardisation, while products offered by new entrants and smaller players can compete more freely, with more differentiated products.

It has recently been suggested that the banks use or take advantage of regulation to limit competition. In Westpac's view, the banks have no capacity to take advantage of regulations to limit competition. Westpac supports the relaxation of regulation where it has

[23] Max Mason, James Eyers, 'Facebook wins patents for Messenger payments' *The Australian Financial Review* (online), 2 July 2017, http://www.afr.com/business/media-and-marketing/facebook-wins-australian-patent-for-messenger-payments-20170629-gx1qgk.
[24] Simon Johanson, 'Former PM Paul Keating joins commercial financier MaxCap', *The Sydney Morning Herald* (online), 22 March 2017, http://www.smh.com.au/business/property/former-pm-paul-keating-joins-commercial-financier-maxcap-20170321-gv2s3u.html.
[25] See http://www.rba.gov.au/payments-and-infrastructure/payments-system-regulation/approach-to-regulation.html.

the capacity to increase competition and comply with the Government's requirements for a stable and secure financial system. As illustrated in this section, due to both targeted exemptions from existing regulations and technological advances that have outpaced regulation, the banks are constrained by regulation where many of their competitors are not.

2.3 Regulatory steps to encourage competition and innovation

Notwithstanding the existing scope for non-banking entities to compete effectively against banks, it is likely that even greater competition in the banking sector will occur in the future.

The Australian Government has indicated it will take steps as part of the 2017 Budget to encourage competition and innovation. Specifically, the Government has outlined its plans to reduce barriers for new banks and improve competition by encouraging new entrants, including by:

- Relaxing the legislative 15% ownership cap for innovative new entrants in the *Financial Sector (Shareholdings) Act 1998* (Cth);
- Lifting the prohibition on the use of the term 'bank' by ADIs with less than $50 million in capital, to allow smaller ADIs to benefit from the branding and marketing advantages of being called a 'bank'; and
- APRA's review of prudential licensing arrangements and considering approaches to make it easier for new innovative banks to commence operations.

The Australian Government has also introduced an "enhanced regulatory sandbox" by way of waiver, which allows eligible financial technology, or 'FinTech' businesses to test a wider range of new financial products and services without a licence, thereby reducing regulatory hurdles. The stated purpose of this initiative is to enable new and innovative FinTech products and services to be tested in Australia, with a view to establishing Australia as a global FinTech hub.

Each of these measures will increase the ability of new entrants to compete with more established providers in important ways, and the Government has demonstrated its commitment to continue to identify and address any barriers to competition, consistent with its need to protect the security and stability of the financial system.

Westpac is supportive of all initiatives that encourage new entrants, provided they get the balance right between competition and consumer and financial stability protections. More broadly, Westpac believes that these reforms should be open to all participants, not just new entrants, to encourage better collaboration between established financial institutions and start-ups.

SECTION 3

Facilitating beneficial customer outcomes

SUMMARY

- The competitive nature of the Australian banking sector drives banks to continually invest in new products, innovate and enhance the overall service proposition for customers.
- Banks and other financial market participants operate in an environment where digital innovation is changing the competitive landscape. 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 and seeking to disrupt existing business models.
- To help customers to meaningfully compare across the wide choice of products and services on the market, ongoing developments in relation to open data and the New Payments Platform will enhance consumer outcomes by facilitating better informed decision making.
- These developments, together with the Australian Government's proposals to encourage new entrants and lower regulatory barriers will further enhance the customer experience and continue to drive competition across the industry into the future.

3.1 Investment in innovation and service

Australian banks invest significantly in technological innovation to continually improve efficiency and to deliver products and services that meet customers' needs.

In responding to consumer demand, Australian banks lead the way globally for technological innovation in financial services. In particular, digital innovation by Australian banks in the areas of mobile wallets, cardless cash and biometric authentications, together with mobile banking apps, are recognised as among the world's best.

In the context of innovation, Westpac is dependent on its ability to offer new products and services that match evolving customer preferences and compare favourably to those of our competitors. The competitive nature of the industry means that if we are not successful in developing or introducing new products and services, or in responding or adapting to changes in customer preferences and habits, we will lose customers to our competitors.

Westpac's Service Revolution strategy

Westpac seeks to remain competitive by attracting and retaining customers. As part of our Service Revolution strategy, we are seeking to:

- Provide a truly personal service for customers while better anticipating their needs;
- Put customers in control of their finances;
- Respond to the increased pace of innovation, disruption and changing customer behaviours through digitisation and increasing our capacity for innovation; and

- Innovate and simplify to reinvent the customer experience.

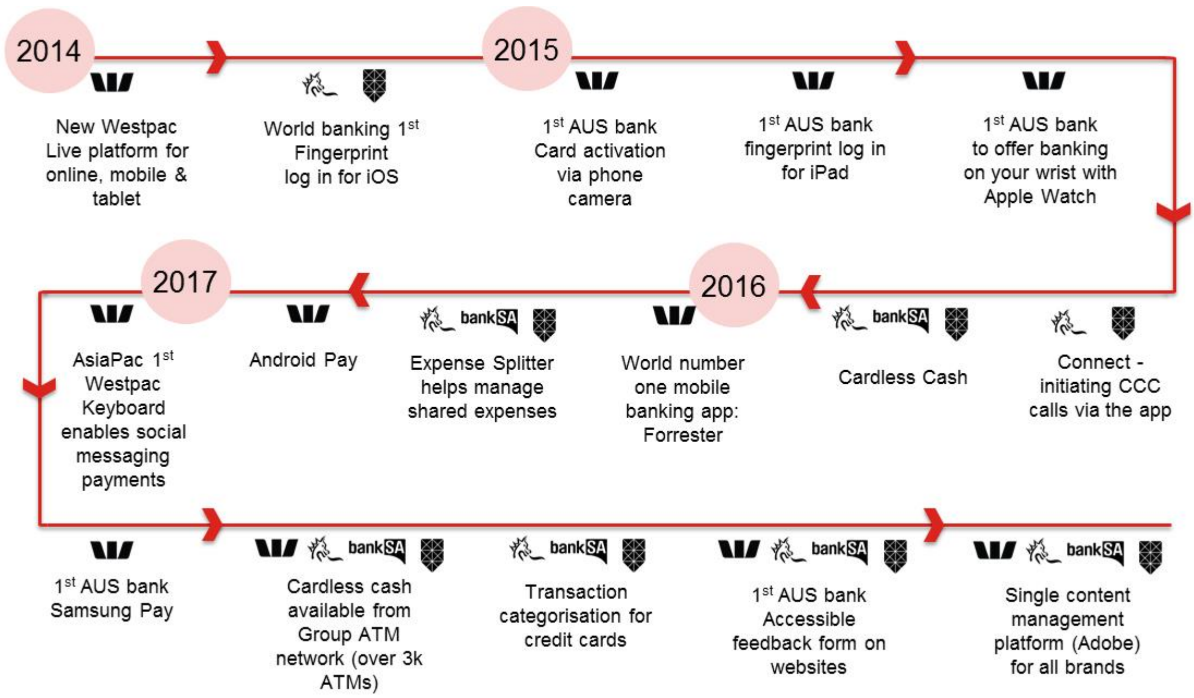
Westpac's investment in digital service

In a short space of time, we have witnessed the enormous changes technology has made to the way Australians engage with their banks and acquire financial services more broadly.

In the 10 years since the introduction of the first full touchscreen smartphone in 2007, mobile banking has quickly become a popular choice for a growing number of Australian customers. Relevantly, Deloitte's 2016 Mobile Consumer Survey[26] revealed that 70% of Australians now prefer to do their banking via an app on their smartphones rather than using a browser-based (i.e. internet) channel.

In a rapidly changing world, Westpac is continually investing in new technology, leveraging new innovations and adapting to meet customer needs. As illustrated in Figure 3.1 below, Westpac has a proud history of digital innovation and market firsts.

Figure 3.1: Westpac digital innovation milestones 2014-2017



Key milestones for Westpac over the past year include:

- **New capability -** We continue to deliver first to market end-to-end customer experiences. For example, we have digitised personal loans in Westpac across all channels. For existing customers, this has reduced the time between applying for a loan to accessing cash from 8.5 days to 18 minutes. This means single applicants can apply for an unsecured personal loan, receive an instant response, accept their contract electronically and receive funds automatically, 24/7. For digitally originated loans, 41% of approvals are now settled same day and, of these, 65% are settled within the hour.

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

- **Helping customers be more digitally active -** As of June 2017, we have 4.4 million digitally active customers, an annualised growth rate of 6.3%. We delivered a number of features to drive continued engagement and retention. These features were focused on minimising friction for core everyday banking tasks such as the extension of our Quick Balance and Quick Transfer (Quickzone) capabilities, which support people who want to bank on the go. Over the past 12 months, Quickzone usage has increased by 80% with the added ability to check the last 5 transactions and move money between accounts (without having to log on). Quickzone activity now represents an additional 15 million customer sessions per month.
- **Making digital services easier to find -** We have also enabled better usability and discoverability of our self service capabilities, such as providing an enhanced menu giving customers faster access to key features in one tap, which lets customers search their transaction history on their mobile device. With our improved mobile on-boarding experience, we have seen a further 600,000 accounts convert to E-statements (or paperless statements), helping increase E-statements as a proportion of total statements to 40%, up from 29% in 2016.
- **Resolving customer pain-points -** Through re-engineering the outage process and tighter approval controls, we have reduced the impact of change to customers by 1 million sessions per year and availability remains above target across our digital platforms (Westpac at 99.78%, St George 99.54%). We are providing customers with the capability to search for more information about merchant transactions that look unfamiliar and allow customers the ability to reset and retrieve their login credentials. Additionally, across Business and Consumer Bank, we have maintained market leading loss rates through improved digital forensics and stronger malware detection.

3.2 New entrants and disrupters

While existing Australian financial services providers are undertaking significant investment in technology to satisfy customer demand for more mobile and flexible banking services, additional competitive pressures have also emerged as a result of new market players.

Within Australia and internationally, competition in financial services is increasingly being shaped by non-traditional financial institutions, with FinTech businesses and major technology companies emerging as legitimate competitive forces.

The rise of FinTech and digital disruption

FinTech innovators are disrupting and reshaping financial services across a wide range of areas, including primary banking accounts, payments, capital markets, investment management and insurance.

New and innovative offerings from FinTech businesses, such as crowdfunding, peer-to-peer lending, mobile payments, digital currencies and robo-advisers benefit consumers by increasing choice and stimulating more competition across the industry.

These developments are not just limited to Australia. At a global level, the Basel Committee on Banking Supervision (BCBS) recently released a Consultative Document exploring the implications and challenges arising from FinTech for both regulators and banks' business models.[27]

The BCBS noted that the nature and scope of banking risks as traditionally understood are likely to change in the coming years, with the growing adoption of FinTech. These changes will arise from both the technologies themselves as well as from new business models.

In response to this digital disruption, Westpac selectively invests in businesses that have the potential to transform traditional banking. We are partnering with businesses in areas as diverse as blockchain, quantum security, and digital mortgage broking.

Westpac has also invested $100m in Reinventure, a venture capital fund that directly invests in FinTech businesses with the potential to make a significant impact in Australia. The fund currently has 11 investments, including data marketplace, Data Republic, employee platform provider, Flame HR, peer-to-peer lender, Society One and crime prevention software provider, Auror.

Disruption from global technology companies

Global technology companies are also emerging as some of the most significant disruptors to the financial services industry.

In Australia, Apple, Google and Samsung launched Apple Pay, Android Pay and Samsung Pay, their respective in-store and online mobile payments services, shortly after their global launches. In June 2017, Apple announced that it was expanding Apple Pay to include peer-to-peer payments via instant messaging.[28] In addition, Facebook has also been granted patents around the world, including in Australia, to allow users to make peer-to-peer payments via Facebook Messenger.[29]

While some of these services have established relationships with existing, and regulated, providers of financial services, new forms of digital payments may not need to interface with regulated payment providers at all and may evolve faster than any attempt to regulate them.

In particular, the global tech giants already have existing financial relationships with millions of customers in Australia and hundreds of millions of customers worldwide, giving them unparalleled brand recognition, loyalty, financial resources and access to data.

Westpac believes that younger customers are particularly likely to be receptive to acquiring financial services from a technology company, rather than a traditional bank.

KPMG's recent 'Banking on the Future' report surveyed 18-30 year old professionals in Australia and found that over 80% would consider banking with a tech giant if the offer was right, with Apple and Google the most seriously considered. The report noted:

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[27] Bank for International Settlements: Basel Committee on Banking Supervision; *Consultative Document - Sound Practices: Implications of fintech developments for banks and bank supervisors*; August 2017.

[28] Avery Hartmans, 'Apple made a big change to Apple Pay that could kill millennials' favourite payment app', *Business Insider Australia*, 6 June 2017, https://www.businessinsider.com.au/peer-to-peer-payments-apple-pay-venmo-2017-6?r=US&IR=T.

[29] Max Mason, James Eyers, 'Facebook wins patents for Messenger payments' *The Australian Financial Review* (online), 2 July 2017, http://www.afr.com/business/media-and-marketing/facebook-wins-australian-patent-for-messenger-payments-20170629-gx1qgk.

[W]hile this cohort will support new fintech disrupters, the biggest threat to financial institutions arguably comes from the tech giants that already have a prominent brand presence amongst this group.[30]

APRA Chairman Wayne Byres agreed, noting in March 2017 that:

Financial services ultimately is an industry that's built on trust and if you think about the next generation that's coming through, certainly when I think about my kids, the brands they trust – Apple, Google – it's the technology brands.

They wouldn't have a clue about the four major banks that we have here ... (and) as far as my kids are concerned, they have accounts with Apple so we're not actually that far away.[31]

In this context, Australian banks will continue to face an ever increasing range of strong, non-bank competitors across a broad range of their products.

3.3 Open data's role in competition

Westpac is supportive of Australia moving towards an open data regime in banking and believe it will be an important driver of customer choice supporting the continued growth of strong competition.

In particular, Westpac believes it will enhance consumer outcomes by facilitating better informed decision making and more targeted and tailored product and service offerings, as well as allowing customers greater autonomy with their products and services and promoting innovation and efficiencies in the financial system.

Open data initiatives

In the context of open data's capability to further enhance the customer experience by offering greater flexibility and choice, Westpac sees three key areas for exploration:

- **Product and services information -** making product and service information available in a standard form via a public API. This would enable third party providers and app developers to offer standardised product comparisons (e.g. for interest rates, fees and charges and service levels);
- **Individual product summary -** making individual product summaries available to customers in a standard form for credit cards, and transaction and savings accounts (including a summary of opening and closing balance, interest paid / gained, fees and charges and points earned); and
- **Account switching -** providing a summary of key data fields to customers, to simplify the ability of customers to switch to an alternative provider (including, for example, credit card limit, current amount drawn and a summary of debits over the past 12 months).

[30] KPMG, *Banking on the Future*, 3rd edition, 2017, p 20.
[31] Alice Uribe, 'Millennials place trust in Apple, Google over banks says APRA's Wayne Byres', *The Australian Financial Review* (online), 20 March 2017, http://www.afr.com/business/banking-and-finance/financial-services/millennials-place-trust-in-apple-google-over-banks-says-apras-wayne-byres-20170320-gv2ceo.

We acknowledge the Productivity Commission's final report into Data Availability and Use released in May 2017 and the independent review into open banking currently underway.

While Westpac has stated its support for the open data initiatives, we recommend a phased, risk-based approach towards open data (within appropriate timeframes), including:

- Industry development of a set of common API standards and controls to ensure the integrity of any open API system is maintained. The current work in the UK can be leveraged for this purpose;
- Developing industry standards for the publication of product reference data;
- Requiring all ADIs and credit providers to publish product reference data (e.g. pricing, eligibility criteria and terms and conditions) via an open API platform. This aligns with the UK 'open data' requirement and enables use of this data by third parties, which will improve transparency for customers and increase competition; and
- Requiring those organisations to provide customer-specific data (e.g. transaction history) in a standardised, machine readable format.

This mandate should be technology neutral to allow for future innovation.

3.4 Supporting customer flexibility and choice

The ability of customers to switch between financial services providers is an important driver of competition. In recent years, industry-led initiatives, together with developments at an individual bank level, have helped empower customers to switch quickly and easily.

Rates of switching[32]

At an industry level, previous estimates provided by the Australian Payments Clearing Association (APCA) and Choice to the Senate Economics Committee Inquiry into Competition in 2010 suggested switching across the banking sector may be around 8-10% per annum for transaction accounts.[33]

These figures are not inconsistent with Westpac's experience. In the 12 months to 30 September 2016, approximately 820,000 new customers joined Westpac[34] and approximately 520,000 customers left (representing approximately 5.5% of the relevant customer base).[35]

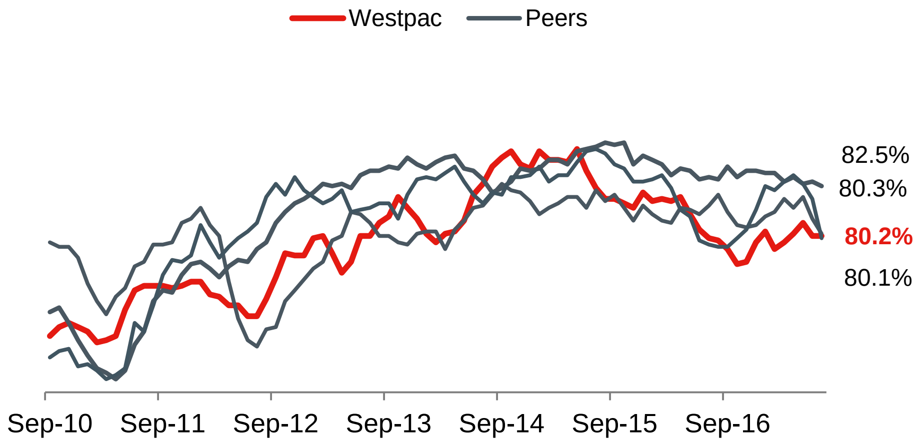
More broadly, Westpac sees clear evidence of customer switching activity across its key products and segments:

[32] Precise switching rates can be difficult for banks to determine because they do not always know when a customer is switching to, or away from, them. Often, when a customer opens an account with a new financial institution, they do not close their old account, which leaves that account open, but effectively 'dormant'.
[33] APCA, Submission to the Senate Standing Committee on Economics Inquiry into Competition within the Australian banking sector, 30 November 2010, p 5; Choice, Submission to Senate Economics Committee on Competition within the Australian banking sector, November 2010, p 9.
[34] Aggregate figure for Consumer and Business Bank.
[35] Evidence to House of Representatives Standing Committee on Economics, Parliament of Australia, Canberra, Question on Notice (11QON), Westpac Banking Corporation, 6 October 2016.

- In our Consumer Bank business, we have, on average, opened or closed over 1.8 million accounts per annum;[36]
- Mortgage refinancing (from an external bank to Westpac) represented approximately 28% of all mortgages written in FY16; and
- 8.59% of credit card balances at Westpac were balance transfers from another provider in FY16.

In the context of any suggestion of low levels of switching, it is also worth noting that customer satisfaction with banks is close to historically high levels.

Figure 3.2: Consumer customer satisfaction (%)[37]



Industry initiatives

Facilitating simpler and cheaper bank account switching has been a policy focus of industry and successive Australian governments.

In 2012, an industry-wide transaction account switching service was introduced. The process involves the following steps:

- Customer approaches a new bank and requests a switch from their old bank;
- The new bank seeks a copy of the Regular Payments List (RPL) from the customer's old bank;
- The RPL contains the last 13 months of direct debit, direct credit and periodic payments on the customer's transaction account/s; and
- The RPL is provided to the customer who can then request the new bank to transfer over payments to the new bank account or cancel payments.

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[36] Figure includes credit cards, transaction accounts and personal loans. Evidence to House of Representatives Standing Committee on Economics, Parliament of Australia, Canberra, Question in Writing (38QW) regarding the review of the four major banks (second report), Westpac Banking Corporation, 6 October 2016.

[37] Source: Roy Morgan Research, September 2010 – July 2017, 6MMA. Main Financial Institution (as defined by the customer). Satisfaction ratings are based on the relationship with the financial institution. Customers must have at least a Deposit/Transaction account relationship with the institution and are aged 14 or over. Satisfaction is the percentage of customers who answered 'Very' or 'Fairly satisfied' with their overall relationship with their MFI. Westpac: Westpac brand only.

Since 1 January 2015, on average:

- Approximately 430 new to Westpac customers per annum have asked us to request a RPL from their old bank; and
- We have received approximately 500 requests per annum from other banks for a RPL (ie for Westpac customers moving to another institution).

Westpac online switching

To supplement the industry bank account switching service, and to offer customers a fully-online option, Westpac has put in place a digital switching solution. By using this self-service approach, customers can switch to Westpac online in less than 10 minutes.

Opportunities to further facilitate switching

Westpac considers that the enhanced open data sharing regime outlined in Section 3.3 may further aid customer switching by facilitating more informed decision making around financial products and services.

In the context of further developments in open data, Westpac believes that the Government should mandate the increased provision of financial product information in a standardised form to customers to help them assess whether they are getting a good deal, and to assist with their decision to switch (i.e. so they can input personalised data into comparison websites).

3.5 Innovations in payments

New Payments Platform

The New Payments Platform (NPP) project is a new national open access payment platform, which is separate from the existing payment streams.

The NPP is a collaborative effort between the RBA and the payments industry to modernise key parts of Australia's electronic payments system. It currently has a target go-live date of early 2018.

The NPP will deliver a network that will facilitate the real time settlement of retail payments. Payments will be able to be made and received in a matter of seconds, 24 hours a day, 365 days of the year.

Other features of the NPP include an Addressing Service, which will enable transaction accounts to be identified by a 'smart' payment address, such as an email address, phone number or Australian Business Number (ABN). This 'proxy identifier' will allow other people to make payments to them without having to use a BSB and account number. This identifier can be moved between accounts or financial institutions through a relatively simple process.

The NPP has been touted as facilitating easier account switching via the proxy identifier, and through the development of additional functionality over time. In particular, banks and other institutions will be able to add their own overlay services – in the form of apps – to the basic infrastructure.

As such, Westpac considers that the NPP will promote further competitive tension, which will provide positive consumer outcomes through the provision of innovation and choice.

3.6 Disclosure and transparency

Westpac considers that transparency supports competition as it eliminates information asymmetries, enhances consumer choice and allows suppliers to better understand market structure and consumer demand.

In the banking industry, there is a commercial and regulatory framework that encourages and facilitates high levels of transparency, including:

- Private companies that provide data analysis and research in relation to particular segments of the industry;
- APRA and RBA collect detailed statistics about the industry, with aggregated data being publicly available on a regular basis;
- An active market for suppliers of market information services; and
- Extensive regulatory product disclosure obligations on banks.

Customers are also readily able to compare products directly, or by accessing comparison services, including specialist comparison websites, or brokers and financial advisers.

Improving product disclosure

As an overarching principle, Westpac believes that regulation of financial products and services should provide effective consumer protection while continuing to allow consumers to take risk.

Recommendation 23 of the FSI recommended the removal of regulatory impediments to innovative product disclosure and communication with customers, and an improvement in the way risk and fees are communicated to consumers.

Westpac supports continued efforts to improve disclosure and provide consumers with the information they need at the right time to make informed decisions. In particular, Westpac believes that continued consultation with industry and other stakeholders should form an important component of any approach to facilitating more innovative disclosure, given the rapid developments in technology discussed above.

3.7 Financial inclusion

A competitive financial system delivers products that fit individual needs and are accessible, affordable and flexible. High levels of financial inclusion are therefore an important driver of competition.

While Australia's financial system participant rates are among the highest in the world and demonstrate high levels of financial inclusion, some Australians remain fully or partially excluded from the financial system. It is important to continue to implement measures to improve financial inclusion, and a number of initiatives are underway at an industry level.[38]

In addition, Westpac has a range of programs and product offerings to help people become more financially resilient and to improve customer outcomes through better products and services at the lowest cost. In 2016, Westpac released its first Financial Inclusion Action Plan (FIAP),[39] which identifies practical ways for Westpac to support the financial inclusion of customers, employees and the broader community. Our FIAP sets out three key areas for action:

- Crisis and hardship;
- Understanding money – enabling individuals' financial resilience; and
- Inclusive growth – supporting small business and social enterprises.

During 2016, financial inclusion milestones for Westpac included:

- Over 39,000 customers sought assistance from Westpac Assist for financial hardship support in 2016;
- Over 59,000 people completed Westpac Group financial literacy training;
- Launched CashNav, an app that helps customers manage spending by automatically characterising banking transactions into needs and wants and notifying customers of how their spending is tracking; and
- Introduced Wealth Review, an online tool designed for BTFG super fund members to help them gain a better understanding of their current financial situation and what they need to do to achieve their financial goals.

As a major financial institution, Westpac is committed to applying its skills, expertise and resources to help prevent people from falling into financial distress, and to provide assistance and pathways towards inclusive growth.

[38] ABA Submission to the Productivity Commission Inquiry into Competition in the Australian Financial System.
[39] Produced as part of an Australian Government and industry initiative, coordinated by Good Shepherd Microfinance and Ernst & Young.

SECTION 4

Competitive dynamics within particular segments

SUMMARY

- The retail banking market in Australia is dynamic and competitors actively seek market share across key products and segments.
- Customers can access a wide choice of financial institutions and financial products, and strong competition ensures financial products and services are keenly priced. There is evidence of substantial customer switching, particularly in the key markets of mortgages and credit cards.
- The SME banking market is operating efficiently and there is strong evidence of competition and contestability between banks and other participants in the market.
- In wealth management and insurance, the market is highly contested across the major segments, with a variety of different business models offering customers a range of products and services.

4.1 Residential mortgages

The residential mortgage market is competitive and highly contested. In Westpac's view, there are various characteristics of the mortgage lending market that demonstrate its competitiveness. These include:

- Contestability – with current evidence demonstrating:
  - The ability of non-major bank mortgage lenders to win market share;
  - Increasing mortgage broker share, offering customers greater variety of choice; and
  - An increase in the number of sizable smaller lenders;
- The broad and extensive range of product choices available; and
- Pricing efficiency.

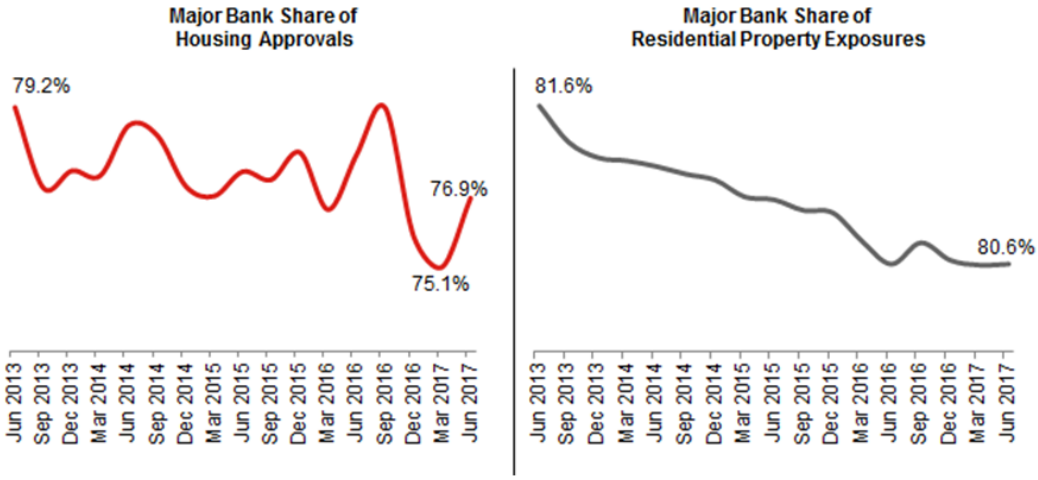
As outlined in Figure 1.4 above, there are approximately 3,993 mortgage products listed with Canstar, indicating that customers have a large range of options available through different product features in a highly competitive mortgage market.

Contestability

Contestability is an important aspect of competitiveness in Australian mortgage lending. The ability of smaller lenders to effectively win market share from larger institutions is a key indicator of contestability.

Figure 4.1 below highlights contestability by reference to the decline in the major banks' share of housing approvals and residential property exposures for the four years to June 2017. For this period, non-major banks have grown at an average rate (CAGR) of 9.5%, outpacing the major banks' average of 7.7% and market (all ADIs) growth of 8.0%.

Figure 4.1: Major banks' share of housing approvals and residential property exposures

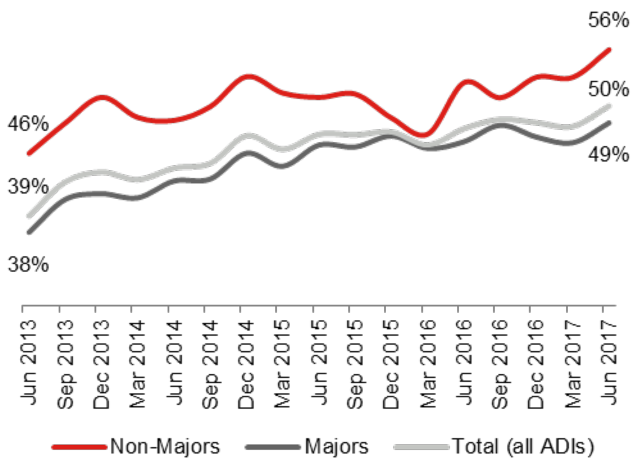


Source: APRA

Contestability is also observable through the overall increase in mortgage broker share, which has supported smaller lenders' market penetration. Some smaller lenders find brokers particularly useful, as these companies may offer competitive rates and quality products, notwithstanding that they may lack the presence (including physical footprint), size and marketing of bigger institutions.[40]

The graph below highlights the overall increasing share of third party (mortgage broker) housing approvals with non-majors' (smaller lenders) broker mix remaining above the major banks.[41]

Figure 4.2: Third party (mortgage broker) share of housing approvals



Source: APRA

Finally, contestability is demonstrated in the table below, with the number of sizable smaller lenders that compete with the majors increasing.[42]

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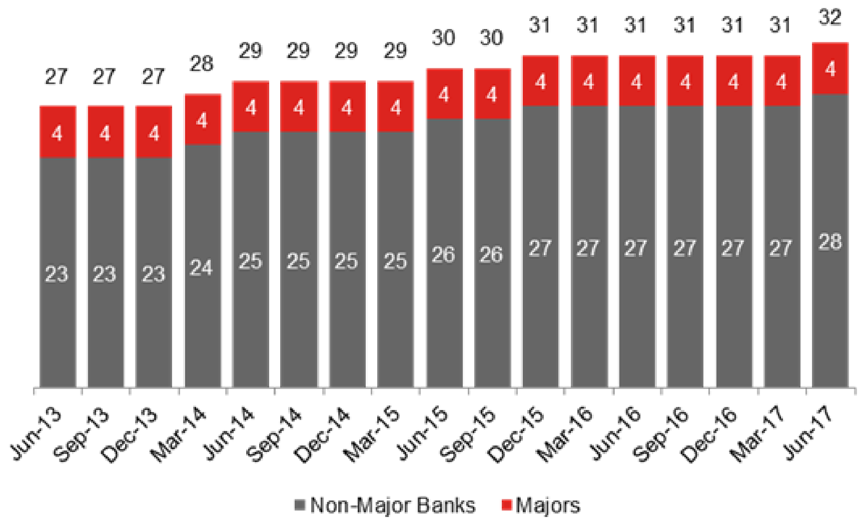
[40] IBISWorld Industry Report K6411b Mortgage Brokers in Australia January 2017.
[41] June 2017 APRA Quarterly ADI Property Exposures (QPEX).

Figure 4.3: Number of entities with >$1b term loans

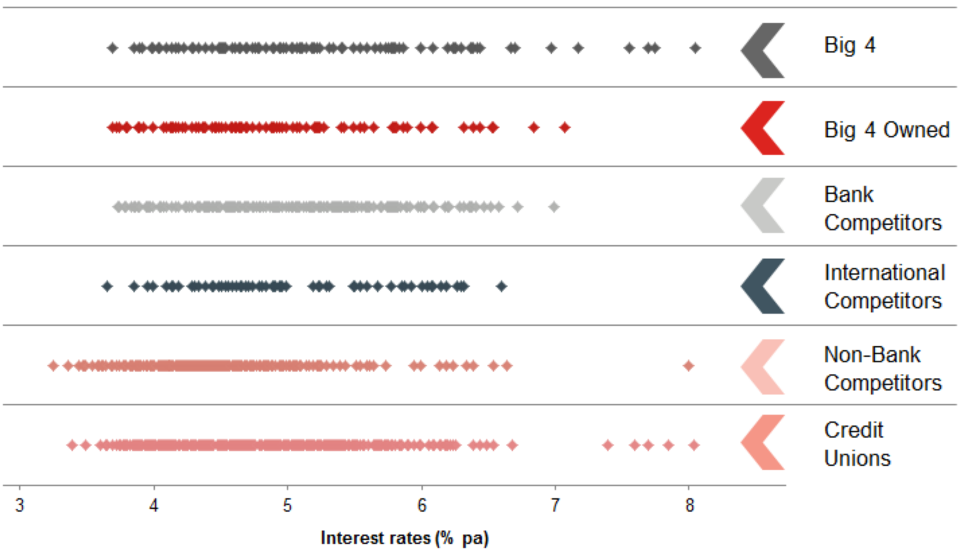


Source: APRA

Broad product choice and flexibility

There is a significant level of product choice and flexibility in mortgage lending. Figure 4.4 below shows a comparison of all available variable mortgage products in Australia as at 4 September 2017, on the basis of their interest rate and differentiated by type of mortgage provider.

Figure 4.4: Comparison of mortgage rates in Australia as at 4 September 2017



Source: Canstar

This chart shows the broad spread of pricing available, ranging from 3.25% to 8.25%. It should be noted that the common practice of offering further discounts on top of the standard rates is likely to also contribute to the range of pricing offers.

[42] June 2017 APRA Quarterly ADI Property Exposures (QPEX).

Mortgage pricing and setting interest rates

Setting pricing for mortgage products involves the exercise of judgement based on a number of factors and data from different sources within and outside Westpac. These factors include:

- Competition from other banks and lenders;
- The cost and composition of funding;
- Balancing the needs of our borrowers, depositors and shareholders;
- Portfolio risk and composition; and
- Economic and regulatory factors (such as addressing regulator requirements and expectations regarding the type of loans provided and the capital required to remain unquestionably strong).

Since 2015, Westpac has also had in place a differential pricing program. This has enabled segment-based pricing across the portfolio with different rates for interest only, investor loans and foreign borrowers. This capability provides more flexibility in pricing and managing the risk and composition of the portfolio.

Mortgage risk weights

Some have argued that the application of mortgage risk weights, and in particular, the different capital requirements for banks that use the Advanced internal ratings based (IRB) approach vs Standardised models, have had a detrimental effect on competition.

This issue was considered by the FSI, which recommended raising the average IRB mortgage risk weights to narrow the difference between average mortgage risk weights for ADIs using IRB risk-weight models, and those using Standardised risk weights.

The Government accepted this recommendation. In July 2015, APRA announced an increase in the average IRB mortgage risk weights to at least 25 per cent from 1 July 2016 to implement this recommendation. This resulted in the major banks undertaking capital raisings to increase their capital levels.

Westpac considers that there is no persuasive evidence demonstrating that a further increase in Advanced IRB mortgage risk weights would provide competitive benefits for customers in Australia's already competitive mortgage lending market.

The FSI focused on the difference in mortgage risk weights between Advanced IRB and Standardised banks. This difference is often solely attributed to the benefits of IRB accreditation and ignores the inherent differences in risk that can arise between IRB and Standardised bank portfolios.

For example, the mortgage portfolios of the Australian IRB accredited banks are well-diversified across geographic and other demographic dimensions. Less diversified portfolios are subject to concentration risks that give rise to higher probability of risk of loss and require a higher rate of capital backing. Seeking to 'reduce the gap', without considering differences in risk profile, has the potential to distort the allocation of capital to the risks in Australia's financial system.

Notwithstanding the above, Westpac supports assistance being provided to Standardised banks to obtain Advanced IRB accreditation. This would remove any differences in risk weights that are unrelated to underlying risk, while allowing more sophisticated modelling to appropriately reflect the differences in the risk profile of lenders' mortgage portfolios.

4.2 Credit cards

Westpac considers that the credit card market is dynamic and robust, providing real choice for customers. Key indicators of competition in this market include:

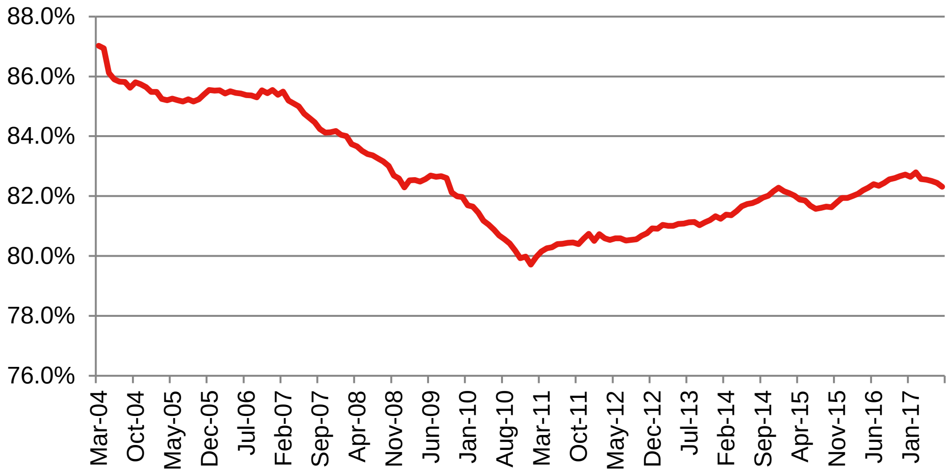
- The number of credit card providers and the wide range of product offerings, designed to suit the needs and behaviours of different customers;
- Low barriers to entry;
- Switching rates; and
- Customer behaviours.

Credit cards are an inherently complex product, where pricing and interest rates are dependent on a broad range of factors over an economic cycle and have little correlation with changes in the official cash rate.

Wide range of market participants and extensive consumer choice

As indicated in Figure 1.4 above, there are 60 participants in the credit card market, offering a wide range of products. These include both ADIs and non-ADIs. The major banks' share of the credit card segment (measured by share of credit card balances) currently stands at approximately 82.3%.

Figure 4.5: Major banks' share of credit card balances (% of financial system)



Source: APRA

Credit card products are offered across three key categories designed to meet the needs of different customers:

- Low or no-fee, low feature cards;
- Lower interest rate, low feature cards; and
- Rewards cards with a range of lifestyle benefits, including complimentary insurance.

Each product type is designed to address different customer needs and preferences, including those of customers who are more sensitive to interest rates or fees.

Credit card market participants compete on all aspects of the product, including:

- Acquisition offers: balance transfers with zero interest for a fixed period on the transferred balance; waived annual fees; bonus rewards points and interest-free purchases;
- Product pricing: 0% foreign transaction fees as a standard product feature, or $0 annual fee;
- Product benefits: rewards, complimentary insurance, shopping discounts, concierge services and free airport lounge passes; upgrades to higher benefit tiers (ie Gold to Platinum); and
- Service experience: elements designed to create customer ease, control and comfort, such as fraud protection, ability to shop with rewards points; card locking and ease of account opening and servicing.

Low barriers to entry

Barriers to entry in the credit card market are low and have not inhibited new entrants. In particular, amendments to the *Banking Amendment (Credit Card) Regulation 2014* (Cth), which commenced on 1 January 2015, further reduced barriers to entry for non-bank credit card providers.

This is evidenced by an increase in the number of providers and products in the market. Recent new entrants include Woolworths and Coles, ME Bank and Myer.

Switching rates

Some commentators have suggested that recurring payments on credit cards create inertia against switching, however, this does not appear to be reflected in the data.

There are approximately 1.4 million new credit card accounts opened each year in Australia. This represents around 8.4% of the 16.7 million accounts on the market. Given net account growth is approximately 1.6% (2015-16), this demonstrates a churn rate of around 6.8% per annum. The data reflects that customers are willing to shop around and that switching credit card type and providers is relatively easy.

In addition, recurring credit card payments are now typically set up online and new cards can easily be substituted online. Consumers are increasingly accustomed to adding, removing and replacing card-on-file details for electronic commerce (including where credit cards expire), and this process is facilitated by web browsers and extensions that can securely store credit card details and insert them into web forms.

Customer behaviours

In addition to the headline rate, customers take into account the range of features and benefits available such as complimentary insurances, concierge services, free lounge passes and access to multiple loyalty programs.

These benefits are normally available on premium products, and customers make a decision based on the value of rewards, annual fee, interest free period and interest rate. The benefit a customer can derive from these premium products may be greater than the cost of annual fees. For example, a similar standalone travel insurance policy from the same underwriter can cost in excess of $500 (vs an annual credit card fee of $395).

In recent years, there is an observable trend towards low feature, low(er) rate credit cards. Over 35% of total customer credit card balances across the Westpac Group are held in low rate accounts. Since 2014, low rate cards have accounted for over 50% of all new sales.

We also note that around 3,000 customers per month are decreasing their credit limit online since the functionality was introduced in December 2016.

Only 3% of Westpac's customers make the minimum payment continuously over a 12 month period. The majority of these revolvers make full use of their product features and pay off far more than the minimum monthly repayment required on a monthly basis.

While the majority of customers use products as intended, we commenced a range of 'nudges' driven by consumer behaviours for customers to consider possibly more suitable use of a credit card or a more suitable card. These nudges are being informed by behavioural economics principles to optimise effectiveness.

Behavioural economics recognises that humans do not always make rational decisions and make use of shortcuts or rely on stereotypes. In some cases, this results in consumer decisions that may undermine competition and good consumer outcomes in financial services.

Westpac is currently working with the Behavioural Economics Team for the Australian Government (BETA) established in the Department of Prime Minister and Cabinet to test "nudges" that may lead to increased competition and improved consumer outcomes in credit cards.

Product innovation

Westpac identified a need for a no-frills, low interest rate credit card product to complement our existing range of credit card offerings. This new card, which was released in August 2017, has an interest rate below 10%.[43]

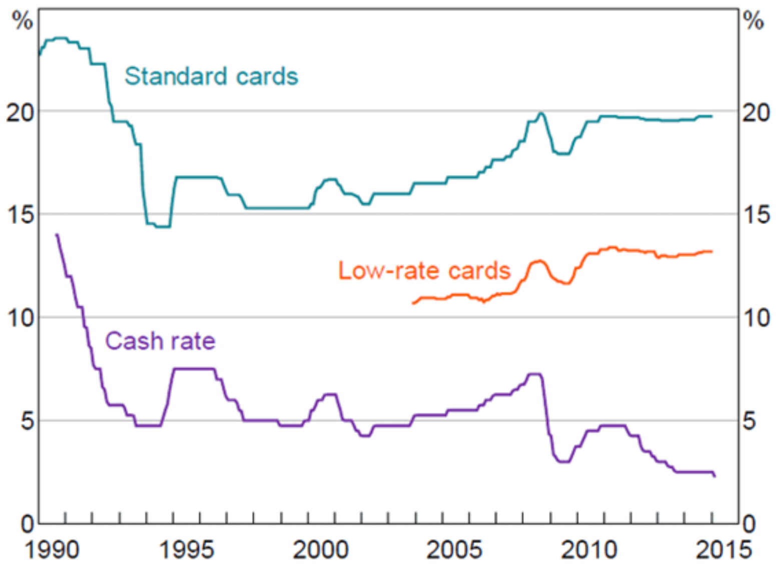
[43] We are able to offer this by removing the benefits usually associated with higher rate cards, such as rewards points, offers, 0% balance transfers and the length of the interest free period. It will, however, have the same security benefits of our other premium credit cards.

Westpac has also introduced Smartplan, which enables customers to better manage their credit card balance. Customers are able to place either a balance or a purchase on an instalment plan. This provides customers with control over their account and helps them to budget more effectively. This feature is not offered by any other of the majors on their credit cards today.

Relationship between official interest rates and credit card interest rates

In recent years, there have been concerns around the relationship between the headline interest rates on credit cards and changes to official interest rates. We note that the correlation between advertised, or headline, credit card rates and the official cash rate is limited.

Figure 4.6: Credit card interest rates compared to RBA cash rate



Source: RBA

Rather, there are a range of factors that are considered when determining credit card pricing, including:

- Expected losses and provisioning through the economic cycle (i.e. probability of default and loss given default);
- Capital required to be held against the loan;
- Costs of origination, servicing and value-added benefits (such as rewards);
- Cost of funding any borrowing; and
- Customer behaviours.

The RBA's 2014 discussion paper, 'The Evolution of Payment Costs in Australia' similarly confirmed that funding costs are a low component of overall credit card issuing costs and consequently, the official cash rate has a low impact on card pricing. Rather, credit card pricing reflects associated high operational costs, payments functionality (such as real time systems) and the rich bundle of benefits associated with credit card products.

Credit card pricing

The cost of funds is not a significant component of cost of credit cards. Rather, pricing is primarily driven by:

- A need to balance interest free periods with funding for the balance of the product;
- The risk characteristics inherent in an unsecured product; and
- The cost of product innovation, including the cost of funding a wide range of features to give customers choice.

In practice, credit cards are complex products. The cost structure of credit cards is fundamentally different to other lending products, such as home loans. Credit cards have a number of materially higher costs, including:

- Higher fraud costs;
- Higher ongoing servicing costs, driven by the need for real time systems, disputed transactions, more frequent statements and higher contact centre activity;
- Scheme fees;
- Costs of benefits offered to consumers, such as rewards, insurances and concierge services; and
- Costs of regulatory and compliance changes.

Most credit cards have an interest free period, which means the issuer is funding the balance over the whole period, but is only earning interest for a portion of that period. In addition, the interest earning portion has been falling in recent years (interest free balances up 9.1% since FY15).

Credit card pricing is further affected by the risk characteristics of the product. As an unsecured product, the credit card portfolio is relatively higher risk than secured loan (i.e. residential mortgage) portfolios. For example, the annual level of credit losses for Westpac's credit cards portfolio is around 2.52% of outstanding balances, compared to around 0.02% for secured home loans.

Credit card pricing therefore needs to take into account risk over the economic cycle, rather than at a point-in-time.

Another cost driver is innovation. There has been a high level of innovation in the credit cards market, giving customers choice, including refining product features, the introduction of contactless payments, mobile payments, chip and PIN authorisation, anti-fraud measures and digitisation of services. We expect this area will continue to be highly innovative.

Advertised headline rate does not reflect portfolio margins

Net margin on a credit card portfolio is determined by the effective interest rate[44] less funding costs. The portfolio effective interest rate varies from the advertised headline rate

[44] Weighted rates of purchase, cash, balance transfer and other promotional rates (based on outstanding balances) multiplied by the revolve rate.

because it reflects a combination of promotional rates, mix of products held and the percentage of customers that “revolve”, or pay interest.

Currently, the average interest rate on Westpac’s credit card portfolio is approximately 15%. The net margin after funding costs and estimated credit losses but before other costs is approximately 5% for a 20% Rewards card.

Conclusion

In summary, various indicators demonstrate that the credit card market in Australia is highly contested and competitive. These include the number of credit card providers and the wide range of product offerings designed to suit the needs and behaviours of different customers, low barriers to entry and customer switching.

4.3 Customer deposits

As discussed in Section 1.6, deposits are a significant source of funds that banks in Australia use to finance their lending to customers. In the post-GFC environment, banks have looked to increase the amount of deposit funding relative to wholesale funding, increasing competition for deposits, and in particular, term deposits.

In terms of customer choice, there are currently 727 deposit account products available in the market from 79 different providers. These range from transaction accounts to bonus interest accounts, online savings accounts, traditional savings accounts and term deposits.

Westpac offers customers a variety of deposit products across its banking brands in the following categories:

- 40% Term Deposits ($191bn);
- 28% Transaction accounts ($136bn);
- 19% Online ($92bn); and
- 12% Savings ($60bn).

Customers are able to easily compare deposit rates across a number of providers using aggregator services, such as ratecity.com.au, canstar.com.au and infochoice.com.au.

Deposit rates currently range from 0% to +3.05%.

As the FSI recognised, a number of foreign banks, including Citibank, ING and HSBC now compete with domestic banks across a range of retail banking products, including deposit and transaction accounts. Some of these participants have limited or no branch networks but use a strong online presence to offer a range of differentiating features and provide competitive interest rates, account and ATM Fees and mobile applications and payments.

Term deposits

The term deposit segment is comprised of an informed and engaged customer demographic (i.e. customers will shop around for the best rates), with investors aged 65 or over accounting for between 50% and 60% of all term deposit accounts at Westpac.

All Westpac term deposit customers receive a notice prior to term deposit maturity, with high levels of customer engagement in relation to their savings and investment needs. This demonstrates that while a term deposit is a low risk investment, investors do not see it as a 'set and forget' product.

4.4 Banking for SMEs

The SME banking market is operating efficiently and there is strong evidence of competition between banks and other participants in the market. Key indicators of this are:

- The level of contestability in the segment with existing market participants being challenged by innovative new entrants;
- Competitive pricing for small business loans; and
- Approval rates for loans to small business.

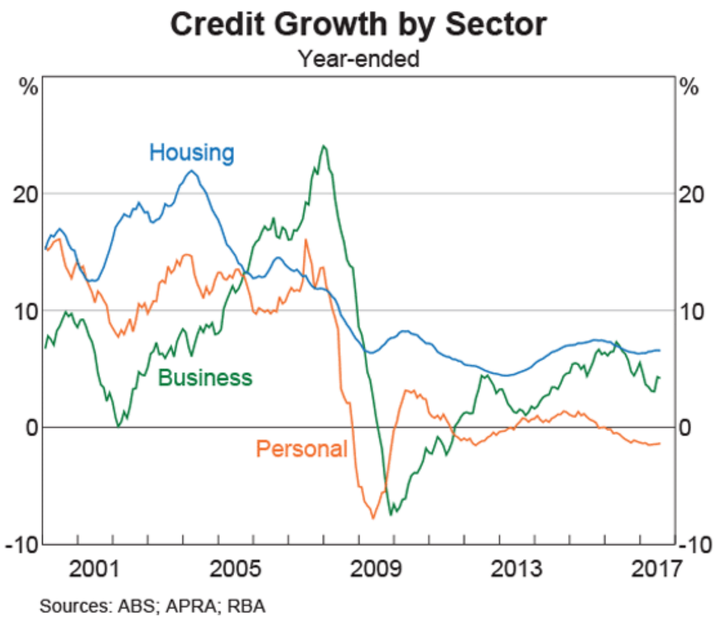
The ability of SMEs to access finance has been a consistent point of discussions globally following the GFC and this section particularly addresses issues surrounding access to finance for SMEs.

Contestability

There are currently around 20 banks providing services to the small business sector, sufficient to provide a vigorously competitive market. When looking at the competitive dynamics in this sector, it is important to consider the impact that the GFC had on the small business lending market.

While Westpac continued to make finance available to SMEs, there was a general slowdown in small business credit growth during the GFC. Post-GFC, growth has improved, however it remains subdued. Business confidence in the Australian economy will continue to play a role in the appetite of SMEs to seek external finance. A reduction in demand for finance by businesses and consumers has been the major driver of slowing credit growth in Australia. This is evident in the chart below.

Figure 4.7: Credit growth (annual)



Source: RBA

The GFC saw a reduction in credit for small business from foreign lenders and non-bank financial institutions (NBFIs). This was largely driven by their inability to source funding. This did have an effect on competition for a period and, due to the risk appetite of the remaining participants, a number of SMEs may have found their finance options constrained.

In the post-GFC era, lenders have entered the market to replace some of the market gap left by the exit of smaller lenders. In particular, online small business lenders and non-bank providers offering an alternative to the traditional banking models have grown significantly over the past few years. Examples include Spotcap, GetCapital SocietyOne, Capify, Prospa, Moula and OnDeck.

While the growth of online lenders has increased considerably in recent years, it is not the only way SMEs can access funding. Equity funding, venture capital, crowdfunding, and angel investment are options, however, the market for these in Australia is relatively immature.

Pricing

Over recent years, SME customers have benefited from increased competition for business lending transactions. Lenders are offering comparatively cheaper lending rates due to increasing competition and the general improvement in customer risk profiles due to prudent debt management. Interest rates for small business borrowers are at their lowest absolute level since 1993.

Lending approval rates

Westpac does not have a portfolio limit on the total amount of money made available for SME lending. As a result, Westpac's approval rate for small business loan applications has consistently ranged above 80-90% since 2009.

This appears consistent with approval rates across the industry based on previous estimates. Deloitte estimates suggest that approximately 90% of SMEs do not have a problem accessing finance, and this is supported by RBA estimates of the proportion of unsuccessful SME credit applications.

Overall, this suggests that the demand for small business lending is largely being met. While there are a small number of small businesses that have not been able to access debt finance, in particular where they are seeking unsecured finance and / or do not have an earning track record (e.g. start-ups), this is not due to a lack of competition in the small business lending market.

SME access to finance

In general, bank intermediated debt is the main source of credit for SMEs as opposed to trade credit[45] or debt capital markets. A range of intermediated SME debt facilities are available, including short and long term lending, working capital and equipment finance.

It is important to note that most small businesses do not borrow – currently only one third of Westpac's existing SME customer base have a business debt facility. While it is hard to identify the source of funding for the remaining customers, some SMEs may make use of personal resources, self-fund from cash flow or access other forms of finance.

In Westpac's view, there is not currently any market failure in the sense of a class of SME borrowers being unable to access debt finance.

In our experience, SME applications for credit are declined mainly due to:

- Failure to demonstrate debt serviceability;
- Poor internal or external credit behaviour; and / or
- Insufficient equity or security.

Failure to demonstrate debt serviceability may be caused by:

- Cashflow uncertainty or projections (e.g. a lack of historical financial information to support a finance request); or
- Uncertainty regarding cashflow management (unclear whether the driver of the issue is related to growth or cashflow management in a good business or alternatively a business that is under stress).

Declined applications are a natural result of the combination of responsible lending principles and sound risk management, and are not an inefficient feature of the financial system. Westpac does not believe that arbitrary relaxation of lending standards should be used to close the gap.

However, some factors that result in a decline of an application may be overcome through improving the quality of information available to lenders.

[45] This is defined by the RBA as credit from an SME's trade suppliers ie when it obtains inventory, equipment and services without immediate payment. Small Business Finance Roundtable, Small Business Funding in Australia, p 20.

Information

Information on a potential borrower, including their credit history, is critical for lenders to make effective credit decisions. For example, many start-up SMEs have difficulty in demonstrating creditworthiness due to ‘information gaps’. Measures that could improve the level and quality of information that lenders have to assess credit risk have the potential to enhance SMEs’ access to credit, even where there is no collateral available or security is less tangible.

Historically, lenders relied heavily on making credit decisions based on information obtained through the banker-borrower relationship, and responsibility sat with the individual who managed and knew the prospective SME borrower. Westpac has undertaken significant investment in building close relationships with our SME customers to ensure credit decisions incorporate the best information available. However, this could be supplemented by Government measures to provide more information to lenders.

Enhancing lenders’ access to business information from Government and regulator sources (such as the ATO and ASIC) could facilitate SME access to credit. Privacy issues would need to be addressed under such an arrangement. Nevertheless, there are existing mechanisms that could mitigate these concerns, including opt-in arrangements.

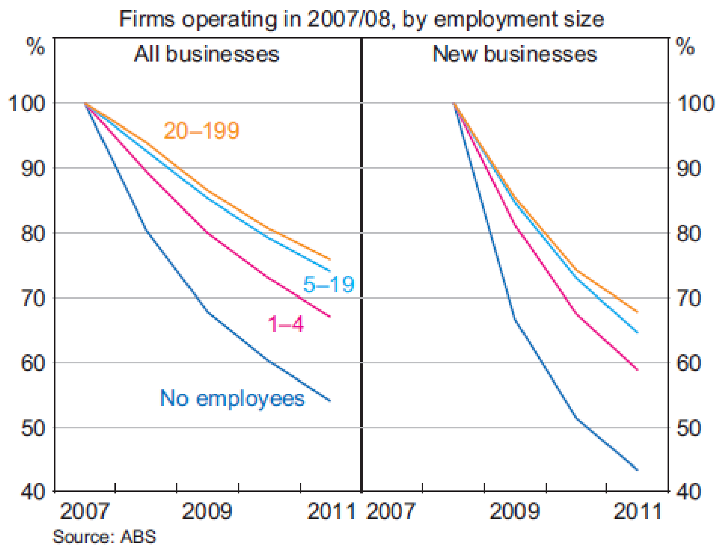
Real time access to certified Business Activity Statements (BAS) could enable dynamic assessment of credit risks for start-up businesses on a quarterly rather than an annual basis. This could include unsecured lending based on certified cash flows, where credit history is not available.

Life cycle factors

In addition to the factors above, there are particular challenges for start-up SMEs, which typically find it more challenging to meet lenders’ requirements. They also represent a higher risk proposition for banks. ABS business survival rate data shows that less than 50% of small businesses are still operating four years after they commenced.

Historically, Westpac has found that the risk of loan default for a start-up has been double that of the remainder of the small business portfolio.

Figure 4.8: Small business survival rates[46]



Mechanisms to improve lenders' access to information may not sufficiently close the gaps in trade and credit history for all start-up SMEs.

Traditionally, a lack of information may be overcome by provision of adequate collateral. Many start-up SMEs rely on non-conventional forms of collateral to demonstrate financial strength and creditworthiness. This is especially so for 'knowledge economy' businesses, such as technology, intellectual property and service-based SMEs.

Westpac will consider all types of collateral. Where no collateral is available, unsecured lending may be an option. However, under responsible lending principles, Westpac has strict controls and a limited appetite around the types of unsecured lending that is made available.

Projected structural changes in the economy suggest that newer, innovative SME business models that rely on intangible assets will become increasingly important. It is likely, therefore, that growth in the unsecured lending market may be required. As noted above, any reduced security requirement would require measures to improve the level and quality of information available to lenders to assess borrowers' credit-worthiness and debt-serviceability.

Furthermore, for a small subset of SMEs, the provision of debt financing may fall outside appropriate risk management and responsible lending criteria. Alternative forms of financing for these businesses should be investigated, including:

- Equity (including private treaty and shared equity models) and venture capital; and
- Emerging financing trends (e.g. crowd funding and peer-to-peer lending).

[46]Reserve Bank of Australia, 'Small Business: An Economic Overview', Small Business Finance Roundtable, May 2012, http://www.abs.gov.au/websitedbs/D3310114.nsf/4a256353001af3ed4b2562bb00121564/d291d673c4c5aab4ca257a330014dda2/$FILE/RBA%20Small%20Business%20An%20economic%20Overview%202012.pdf.

Recent developments

We believe that the market is responding appropriately to the challenges discussed above. For example, new entrants have entered the market offering unsecured loans to small business and in some cases are achieving significant growth. In addition, Westpac, and other lenders, are shifting to focus more on cash flow in credit assessment in recognition that businesses will have fewer physical assets.

4.5 Wealth management and insurance

Wealth management activities in Australia account for a large part of Australia's financial system.

According to RBA data, total assets under management in the sector were $2.72 trillion at the end of June 2016, equivalent to around 40% of financial sector assets and around 60% of Australian GDP.

For the purposes of this submission, wealth management is defined to include the following major segments:

- Financial advice;
- General insurance; and
- Asset management.

The wealth management industry offers customers an abundance of products and competitors. Currently, a number of forces are driving even greater competitive dynamics. These include:

- Market entry of global large-scale players;
- Regulatory reforms, such as the opening of Approved Product Lists and in respect of claims denials rates;
- Banks reducing exposure to manufacturing; and
- New offerings and technological developments (including blockchain and robo-advice).

As discussed below, the market is highly contested across the major segments, with a variety of different business models offering a range of products and services, including foreign owned entities, standalone, vertically integrated, not-for-profit and self-managed.

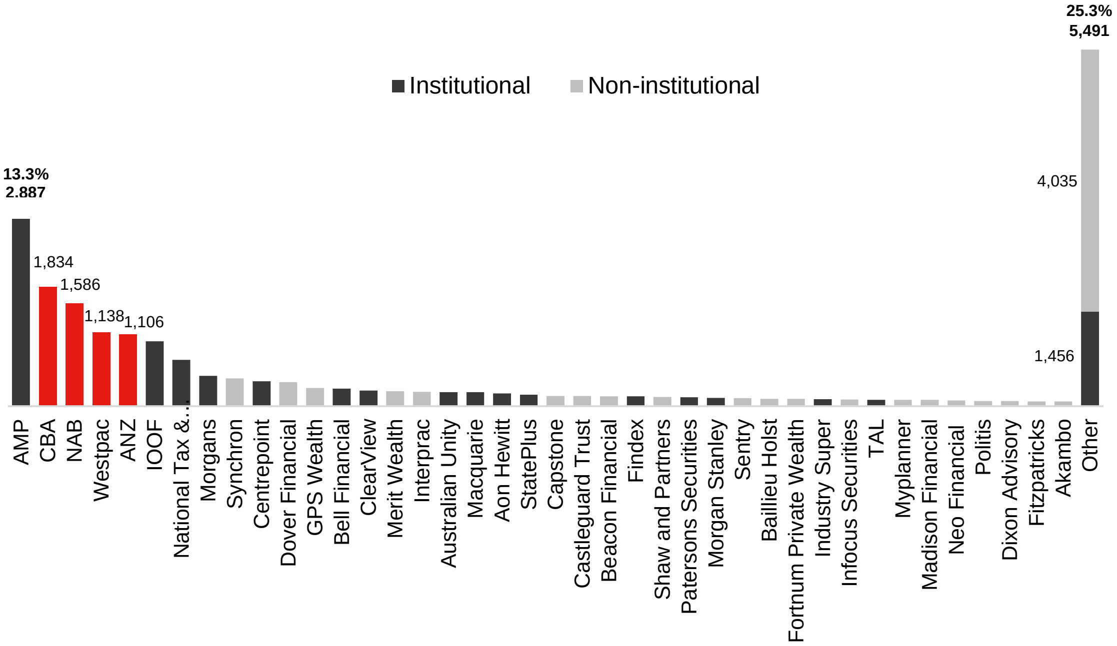
Importantly, no one player holds a dominant position, which means that all players are actively competing for market share.

Financial advice

The financial advice industry has over 22,000 advisers, spread across institutional and non-institutional ownership.

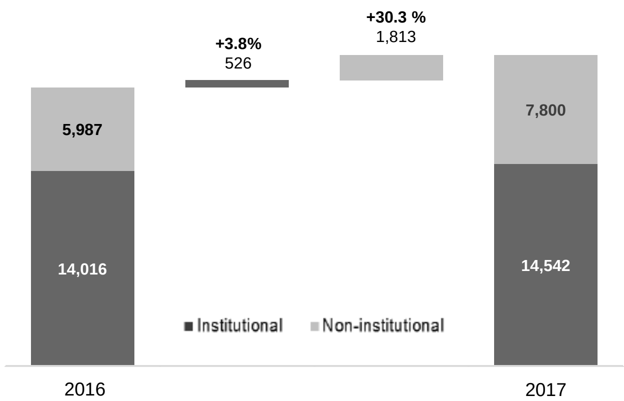
Institutional adviser numbers have slowed in comparison to non-institutional in 2016 (4% vs 30% growth). This is reflective of broader market trends and includes a 1.5% collective decline by AMP, IOOF and the major banks.[47]

Figure 4.9: Market share by number of advisers, March 2017



Source: Rainmaker Advantage

Figure 4.10: Adviser growth (#) March 2016-17



Source: Rainmaker Advantage

Advisers are also managing the impacts of disruption, as robo-advice offers mature and engage the broader contestable market. While there is limited holistic information regarding the take-up of robo-advice across particular demographics, millennials, in particular, appear to have embraced the technology, with robo-adviser Stockspot recently suggesting that 80 per cent of their customer base was aged under 40.[48]

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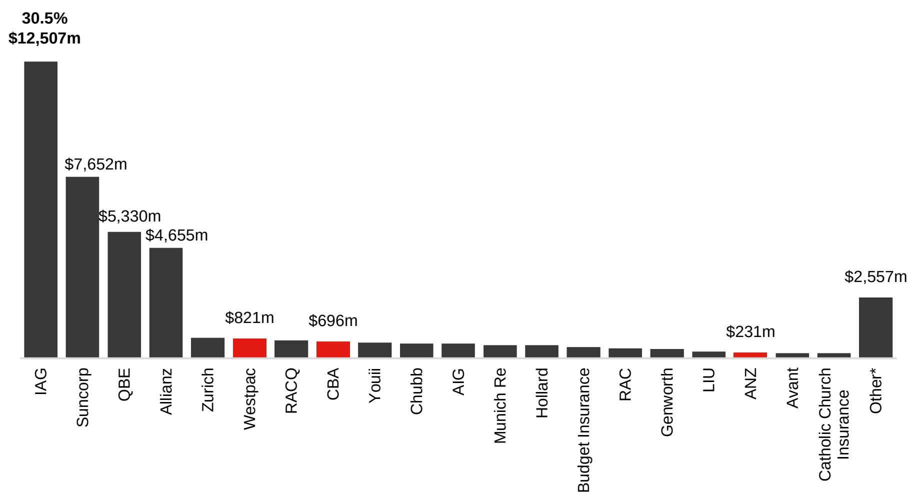
[47] Rainmaker Advantage, Vol 16 March 2017.
[48] Money Management, 'Can robots terminate the human adviser?' 29 March 2016, http://www.moneymanagement.com.au/features/can-robots-terminate-human-adviser.

General insurance

Within the financial system, the insurance industry plays a central role in risk management across the economy.

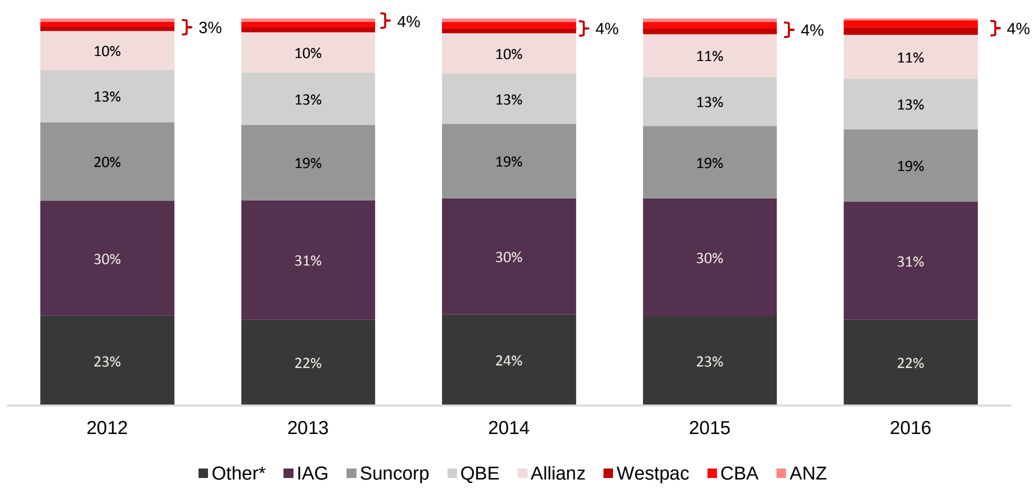
The general insurance industry is dominated by the four major insurers, with IAG, Suncorp, QBE and Allianz collectively writing 74% of total gross written premiums (GWP) in 2016.[49] This is consistent with market share trends over the last five years, with banks collectively holding less than 5% GWP on average.

Figure 4.11: Share of GWP – 12 month period, 2016



Source: APRA

Figure 4.12: Share of inflows, prior 5 years[50]



Source: APRA

49 APRA General Insurance Institution-level Statistics – December 2016 and prior issues.
50 'Other' includes all insurers with <1% share of annual GWP.

A profile of bank product manufacture against classes of business[51] is also presented below, illustrative of limited product reach.

Figure 4.13: Product manufacture profile, by major bank

	Product manufacture profile			
Class of business	Westpac		ANZ	nab
Home & Contents	✓	✓	✗	✗
Motor (personal & commercial)	✗	✓	✗	✗
CTP	✗	✗	✗	✗
Mortgage	✓	✗	✓	✗
Fire & ISR	✗	✗	✗	✗
Public & product liability	✗	✗	✗	✗
Professional indemnity	✗	✗	✗	✗
Employers' liability	✗	✗	✗	✗

Asset management

With over 130 investment managers, asset management is an exceedingly competitive market, with boutiques successfully competing alongside large scale global managers.

The industry is undergoing structural changes, with the trend towards passive investment management philosophies, evident in exchange traded funds (ETF) funds under management (FUM) increasing by over 130% between June 2014 and March 2017.

The major banks have also looked to reduce their participation in manufacturing. Westpac, for example, recently furthered the sell-down of its BT Investment Management stake to 9%.

Platforms

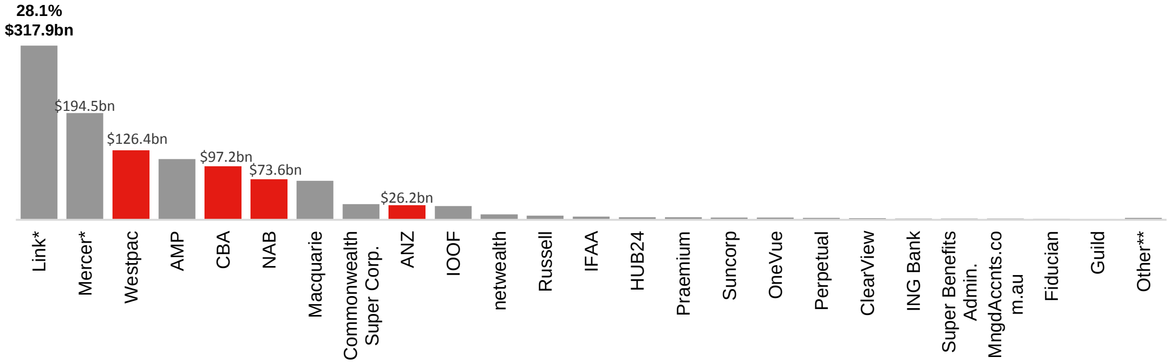
Retail platforms are predominantly a facilitation mechanism that:

- Facilitate efficiency benefits for advisers managing investments on a client's behalf; and
- Enable access to a range of products not ordinarily available to non-wholesale / institutional investors.

Figure 4.14 below illustrates funds on-platform, with Link and Mercer collectively administering more than 40 per cent of total market funds under administration (FUA). This is predominantly driven by their share of industry super fund assets.

[51] Classes of business as defined by APRA.

Figure 4.14: Profile of platform market share - FUA ($bn, March 2017)[52,53]



Source: Rainmaker Advantage

[52] Estimates for Mercer and Link based on APRA institution-level statistics (June 2016).
[53] 'Other' includes proprietary or self-administered.

Conclusion

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

Within the financial system, banks play a critical role in supporting Australia's continued economic growth. More broadly, the stability and resilience of Australia's financial system through economic cycles is important for economic and consumer outcomes, particularly in periods of economic stress.

Australia's financial system must therefore be competitive and calibrated to continue to deliver fundamental banking functions through the economic cycle. In that context, accepting that strong and profitable banks are a necessary outcome of a competitive and well-regulated market should be at the heart of any assessment of the competitiveness and strength of the financial system.

Competition within Australia's financial system is evidenced by both the significant number of providers and the range of products available to customers. The four major banks actively compete for customers within a well-regulated market that also allows choice from banks and non-banks, as well as from domestic and international providers. Customers have more choice than ever before.

Westpac acknowledges, however, that with so much choice, it can be difficult for customers to meaningfully compare across the wide range of products and services on the market.

To help facilitate better customer outcomes, Westpac is supportive of Australia moving towards an open data regime in banking. In particular, Westpac considers that open data will enhance customer outcomes by:

- Facilitating better informed decision making and more targeted and tailored product and service offerings,
- Allowing customers greater autonomy with their product and service choices; and
- Promoting innovation and efficiencies in the financial system.

The open data regime complements the Australian Government's proposals to further encourage new entrants and lower certain regulatory barriers. Collectively, these initiatives will further enhance the customer experience while continuing to promote competition in the financial system.

Technology is also changing the competitive landscape. Banks have always been 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 and seeking to disrupt existing business models, which is welcomed by Westpac.

Westpac believes that for consumers to have the highest level of protection when making important financial decisions, Australia must maintain a strong and effective regulatory regime across the entire financial services sector.

Westpac is proud of the strength of the Australian financial system and its ongoing ability to optimise economic stability and growth and contribute positively to the nation. Within that framework, Westpac will always support changes that further improve competition, enhance customer choice and promote better customer outcomes.